

## **THE MINERAL RESOURCE RENT TAX HAS BEEN REPEALED: IS IT NOW TIME FOR A BETTER-DESIGNED RESOURCE RENT TAX ON ALL EXTRACTED MINERALS AND GAS?**

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### **ABSTRACT**

The Mineral Resource Rent Tax (MRRT) was repealed by the *Mineral Resource Rent Tax Repeal and Other Measures Act 2014* (Cth) in September 2014. The Abbott Coalition Government had promised to abolish the mining tax in the lead-up to the election in 2013, and it was able to achieve this in 2014. The MRRT had its faults, and was created with the help of the mining industry and the biggest mining companies in Australia. There is an overriding philosophical basis for the imposition of a super profits tax on mining resources. It is simply that these resources are finite, and future generations of Australians have a vested interest in knowing where their share of the wealth from taxing the mining companies has been invested by the government or spent by the government. What infrastructure has been developed as a result of collecting a super profits tax from the mining companies or sovereign wealth fund? What is left for future generations when the minerals have run out and the mining companies have moved on to exploit the mining resources of other countries? On the other hand, the Petroleum Resource Rent Tax (PRRT) is still in existence and it has been collecting revenue for the Commonwealth government since 1987. This article examines what was wrong with the recent MRRT. First it briefly considers the political issues raised by both sides of politics in Australia. It then discusses the rationale for taxing the super profits of mining companies when the price of minerals is high. This includes an examination of the taxation of economic rent and the recommendations of the Henry Tax Review. The final part of the article proposes a new and better mining tax that would overcome many of the criticisms the old MRRT faced from politicians, economists and mining companies.

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## I INTRODUCTION

The philosophical basis for a super profits tax is simply that these resources are finite. Once all of the iron ore, coal, coal seam gas and other minerals have been extracted from the ground, nothing further can be mined in the future, and there will be no employment from the mining industry. The mining industry has been a large employer of Australian and international workers, but without a further contribution to the wealth of Australia by the mining industry, future generations will question the role of national governments in what has been developed as a result of the exploitation of the finite resources to which they were given access. The mining companies can move on, exploiting the mining resources in other countries. But what of the wealth of the sovereign nation whose resources have been depleted? What infrastructure has been developed as a result of collecting a super profits tax from the mining companies? What is left for future generations when the minerals have run out?

The MRRT was repealed in September 2014. The Coalition Government abolished the MRRT by passing the *MRRT Repeal and Other Measures Act 2014* (Cth). The Leader of the Opposition, later Prime Minister, Tony Abbott, had campaigned at the election in 2013 that his government would repeal the MRRT along with the Carbon Tax. That was achieved by his government in fulfilment of its election promise. By contrast, the Petroleum Resource Rent Tax was not repealed, and has been collecting revenue for the Commonwealth government since 1987.

Part II of this article considers the weaknesses of the recent MRRT, briefly examining the political issues raised by both sides of politics in Australia along with the opinions of economists and other commentators.

Part III discusses the rationale for taxing the super profits of mining companies when the price of minerals is high. This includes an examination of the taxation of economic rent and the recommendations of the Henry Tax Review. Part III goes on to examine the philosophical basis for a tax on the super profits generated from the sale of mineral resources. It is contended that there are sound reasons for a rent tax on the super profits of mining companies, and that this points to the need for a template of what a 'good' mining tax should look like.

Part IV discusses the options for a better-designed mining tax. What would it look like, and how would it overcome many of the criticisms the old MRRT faced from politicians, economists and mining companies?

Part V concludes that a properly designed resource rent tax, based on the recommendations of the Henry Tax Review, should be implemented in Australia

## II WHAT WAS WRONG WITH THE MRRT?

There are many reasons why the MRRT introduced by the Gillard Labor government was faulty. One of the main reasons was that it was designed by the three major mining companies operating in Australia at that time.<sup>1</sup> Prime Minister Julia Gillard, Treasurer Wayne Swan and Minister for Resources Martin Ferguson met with the senior managers of BHP Billiton, Rio Tinto and Xstrata to design the MRRT that was subsequently repealed in September 2014. To make matters worse, the then Labor government had locked in spending, such as the 'schoolkids bonus', against projected revenue from the MRRT, so that when the actual revenue fell short of the projections, the government lost credibility concerning the MRRT.

Originally, the MRRT was expected to raise \$22.5 billion over four years, of which \$3 billion would be raised in the 2012–13 financial year.<sup>2</sup> It raised only \$200 million.<sup>3</sup> It was supposed to raise \$4 billion in 2013–14. It raised \$100 million.<sup>4</sup> The estimated revenue failed to materialise because the mining boom was coming to an end and the world price of coal and iron ore was starting to decline. The level of demand for these resources, especially by China, had slowed. Coupled with this problem was the fact that mining companies valued their existing mining assets at current market value rather than historical cost, and state royalties had increased; this produced a greater deduction against sales for mining companies when calculating the amount of MRRT to be paid. These issues are discussed later in this article.

A super profits tax such as a MRRT should be designed to capture only additional revenue from mining companies when they make a profit over and above a reasonable rate of return on labour and capital, and this will only happen in an environment in which the price of minerals is high and there is an extraordinary demand for the particular minerals. This was the situation in Australia over the past ten years, but it is not the situation now.

### A. *Opposition to the MRRT*

Professor Henry Ergas was opposed to the MRRT on the basis that it was an inefficient tax and might raise much less revenue than claimed by the government.<sup>5</sup> He was correct. He also contended that future investment in iron ore and coal projects might become less attractive because of the MRRT, and that investment might shift to other resources not subject to the tax.<sup>6</sup> Clearly one of the shortcomings of the former MRRT was the fact that it did not apply to all minerals being extracted in Australia. For example, the price of gold has been at record highs over the past five years and might well have produced super profits in the hands of the gold mining companies. Professor Ergas et al also contended that the MRRT retained the inefficiencies of the royalty system and the inefficiencies of a

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<sup>1</sup> Julia Gillard, Wayne Swan and Martin Ferguson, 'Breakthrough agreement with industry on improvements to resource taxation', (Joint Press Release, 2 July 2010).

<sup>2</sup> Stephen Bartholomeusz, 'Time to move on from MRRT mistakes, Swan', *Business Spectator* (online), 2 September 2014 <http://www.businessspectator.com.au/print/865136>.

<sup>3</sup> Ibid.

<sup>4</sup> Ibid.

<sup>5</sup> Henry Ergas, 'Taxation of the mining industry', Economics Society of the ACT, 8 September 2010.

<sup>6</sup> Ibid.

rent tax.<sup>7</sup> He contended that the MRRT was inefficient because it might discourage investment in high-risk projects while leaving unchanged the viability of low-risk projects.<sup>8</sup> Professor Ergas and others explain this contention on the basis that high-risk projects require a higher rate of return on investment, and if they are successful they will be subject to a greater amount of MRRT, whereas the low-risk projects are financed at an expected lower rate of return and hence less tax is to be paid on them.<sup>9</sup> The MRRT would distort investment away from high-risk projects.<sup>10</sup>

Professor Guj contended that the MRRT was not competitively neutral, in that existing large mining companies would pay less MRRT compared with small to mid-tiered producers. The reason for this was that the existing mining companies were able to value projects commenced before 2 May 2010 at market value for their starting base allowance, which increased their deductions from the sale price of their minerals and gas.<sup>11</sup> This proved to be the case, and was one of the main reasons why the tax did not raise the expected amount of revenue. Surprisingly, the taxing provisions of the repealed MRRT were similar to those of the existing PRRT, and that system has appeared to be quite acceptable for oil companies over the past 15 years.

The former Leader of the Opposition, later Prime Minister, Tony Abbott, claimed that imposing a MRRT on mining companies was 'an economic version of the tall poppy syndrome'.<sup>12</sup> He maintained that it was sufficient for mining companies to pay income tax, that their employees pay personal income tax, and that, as miners, they pay state royalties.<sup>13</sup> He was therefore of the view that no additional taxes should be imposed on mining unless there was some unique feature.<sup>14</sup> This attitude to a proposed MRRT at that time was quite remarkable, given that many foreign countries impose additional taxes on mining companies on the basis that their mineral resources are finite and that the additional revenue may provide benefits for future generations. It was even more remarkable given that the Howard Government was in power in Australia for 14 years and at no time considered repealing the PRRT, which had been adding at least one billion dollars to government revenue each year for the past 15 years.

Mining companies naturally opposed the MRRT because they would be required to contribute a greater share of their taxable profit to the Australian government if they were involved in the sale of iron ore, coal or petroleum products. The MRRT was imposed on a mining company's mining profit, less its MRRT allowances, at a rate of 22.5 per cent. That is, at a nominal rate of 30 per cent, less a one-quarter extraction allowance to recognise the miner's employment of specialist skills. The mining company would also pay company tax on the taxable income at the company tax rate. The three largest mining companies, namely BHP, Rio Tinto and Xstrata accepted the MRRT that they helped to design in

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<sup>7</sup> Henry Ergas, Mark Harrison and Jonathan Pincus, 'Some Economics of Mining Taxation' (2010), 29(4) *Economic Papers* 369, 378.

<sup>8</sup> Ibid.

<sup>9</sup> Ibid.

<sup>10</sup> Ibid.

<sup>11</sup> Pietro Guj, 'Is MRRT competitively neutral', (2010) Association of Mining and Exploration Companies (AMEC, 2010), 2. [www.amec.com.au](http://www.amec.com.au) 14 November 2011.

<sup>12</sup> Matthew Franklin and David Uren, 'Abbott mines resources sector', *The Australian* 24 December 2010.

<sup>13</sup> Ibid.

<sup>14</sup> Ibid.

consultation with the Labor government, and were prepared to pay the tax.<sup>15</sup> At that time the executive chairman of the Fortescue Metals Group, Andrew Forrest, opposed the MRRT, but contended that his company would avoid paying the MRRT for at least five years due to the starting base allowances reducing their profits.<sup>16</sup> He also contended that the big mining companies such as BHP, Rio Tinto and Xstrata were in a similar position and would not pay the MRRT for many years.<sup>17</sup> This proved to be the case. Mr Forrest also contended that the Government had overestimated the amount of revenue that would be collected.<sup>18</sup> Again he was proved correct. There were at least three main design faults with the MRRT which allowed the big mining companies to eliminate any liability to pay the MRRT. These were: allowing the mining companies to deduct the state and territory royalties that they paid; being able to choose the market value of their mines rather than their historical cost for the tax's starting base; and the downstreaming of profits to avoid the application of the MRRT.<sup>19</sup> These faults are discussed in detail in Part III of this article.

### III THE CONCEPT OF AN ECONOMIC RENT TAX

The renewed interest in a resource rent tax on mining was the initiative of Dr Ken Henry and the members of the review of 'Australia's Future Tax System', now commonly referred to as the 'Henry Review'.<sup>20</sup> The review recommended the introduction of a resource rent tax for all mineral and petroleum resources except brown coal.<sup>21</sup> In the final report, Dr Henry contended that the royalty system, which allows the states to collect revenue based on the value of the resource being sold and the volume of output, should be replaced by a resource rent tax.<sup>22</sup> As a result of this review, the then Labor Government announced on 2 May 2010 that it would introduce a 'Resource Super Profits Tax' on mining, not only to generate additional revenue but to compensate for a reduction in the rate of company tax to 28 per cent. The super profits tax was set at a rate of 40 per cent and was to apply from 1 July 2011.<sup>23</sup> However, as a result of a campaign against the tax – by the mining industry, the Opposition in Parliament and public opinion – the incumbent Prime Minister, Kevin Rudd, was replaced by Julia Gillard on 24 June 2010.

The then new Prime Minister, Julia Gillard, negotiated a new form of resource rent tax to be applied to mining companies extracting iron ore, coal and coal seam gas only. The end result was a new 'Minerals Resource Rent Tax Bill' (MRRT) and Exposure Draft that was released for public comment on 18 September 2011. Prior to this happening, the Australian Government had formed a 'Policy Transition Group' made up of resource sector, government and taxation experts to provide advice on the design and

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<sup>15</sup> For a detailed examination of this process see John Passant, 'The Minerals Resource Rent Tax: The Australian Labor Party and the continuity of change', (2014) 27(1) *Accounting Research Journal* 19.

<sup>16</sup> Andrew Burrell and Siobhain Ryan, 'Levy writeoffs "shield" Fortescue', *The Australian*, 8 November 2011, 6.

<sup>17</sup> Ibid.

<sup>18</sup> Ibid.

<sup>19</sup> D. Uren, 'Treasury exposes mining tax flaws as Martin Parkinson blames Labor's concessions', *The Australian*, 15 February 2013.

<sup>20</sup> Australia's Future Tax System Review Panel (Ken Henry (Chair), J Harmer, J Piggott, H Ridout and G Smith), *Australia's Future Tax System: Report to the Treasurer* (December 2009) (AFTS Report).

<sup>21</sup> Ibid 217.

<sup>22</sup> Ibid.

<sup>23</sup> Ibid.

implementation of an MRRT.<sup>24</sup> On 24 March 2011, the Policy Transition Group reported to the Government on its findings. The Government accepted all 98 recommendations of the Policy Transition Group, led by Resources Minister Martin Ferguson and Don Argus AC, relating to the new resource tax arrangements. The recommendations formed the basis of the second draft of the MRRT legislation.

### ***A. The Basis for a Tax on Super Profits from Mining***

The Henry Tax Review advanced arguments for cash flow business taxes as a replacement for business income tax, and for bequest duties, both of which are arguably further examples of the taxation of economic rents – or in the latter case, at least of the taxation of unearned gain. This is an important part of the thinking underpinning economic rent. Indeed, it has been argued that the Henry Tax Review has as one cornerstone of its vision for the Australian tax system the taxation of economic rents rather than income and capital. The then Labor government adopted one small part of such a tax, namely an MRRT, and rejected two other aspects of such a tax, a land tax and a bequest duty.

Economic rent is that return over and above the return necessary for the activity to take place.<sup>25</sup> For example, what does it take to get a supermodel to work? Linda Evangelista told *Vogue* that ‘we don’t wake up for less than \$10,000 a day.’<sup>26</sup> While that example is hardly scientific, it suffices for the purposes of explanation: if a supermodel is paid anything more than that (and they are), the excess over \$10,000 is economic rent. So a Government could tax almost all of that excess without affecting a supermodel’s work decisions at all. The model would still go to work even if the economic rent tax reduced the return to ‘just’ \$10,000 a day. This explanation is similar to the example provided in the Henry Tax Review in defining ‘economic rent’.<sup>27</sup> In that example, if a worker is paid \$100,000 but would still be willing to work at the same job if the salary was \$75,000, the economic rent would be \$25,000.

The following comment from Robin Broadway and Michael Keen provide a good description of economic rent, and an argument in favour of taxing it.

Economic rent is the amount by which the payment received in return for some action – bringing to market a barrel of oil, for instance – exceeds the minimum required for it to be undertaken. The attraction of such rents for tax design is clear: they can be taxed at up to (just less than) 100 per cent without causing any change of behaviour, providing the economist’s ideal of a non-distorting tax.<sup>28</sup>

The Henry Tax Review echoes this and applies the general logic of economic rent to the specifics of minerals. The following passage provides an excellent explanation.

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<sup>24</sup> Australian Government Policy Transitions Group, *Issues Paper: Technical Design of the minerals Resource Rent Tax, Transitioning Existing Petroleum Projects to the Petroleum Resource Rent Tax and policies to Promote Exploration Expenditure*, 1 October 2010.

<sup>25</sup> W H Wessel ‘A note on economic rent’, (1967) 57(4) *American Economic Review* 873, 885.

<sup>26</sup> J Van Meter, ‘Pretty Women’ in *Vogue* (October 1990).

<sup>27</sup> Commonwealth of Australia, above n 18, 737.

<sup>28</sup> Robin Broadway and Michael Keen, ‘Theoretical Perspectives on Resource Design’ in Philip Dean, Michael Broadway and Charles McPherson (eds), *The Taxation of Petroleum and Minerals: Principles, Problems and Practice* (Routledge, 2010), 9.



*The finite supply of non-renewable resources allows their owners to earn above-normal profits (economic rents) from exploitation. Rents exist where the proceeds from the sale of resources exceed the cost of exploration and extraction, including a required rate of return to compensate factors of production (labour and capital). In most other sectors of the economy, the existence of economic rents would attract new firms, increasing supply and decreasing prices and reducing the value of the rent. However, economic rents can persist in the resource sector because of the finite supply of non-renewable resources. These rents are referred to as resource rent.<sup>29</sup>*

However, as the Henry Tax Review recognised,<sup>30</sup> it is not just the minerals sector which profits from economic rents. There appears no reason in logic to limit the economic rent analysis to resources since the overriding consideration is above-normal profits. As Garnaut and Clunies Ross put it, the term 'rent' can be applied to any profits of any kind of enterprise that exceed those whose prospect the investor would have required to induce him to invest in the enterprise.<sup>31</sup> For resources, the reason for that above-normal rate of return is, according to the Henry Tax Review, the finite supply of non-renewable resources.<sup>32</sup> Yet monopoly or oligopoly can create the same above-average rates of return,<sup>33</sup> and arguably should be taxed in a similar fashion. Indeed, these conditions might actually reflect something even deeper: arguably economic rent arises not from monopoly per se but from monopolised property relations –that is, private property. Thus Garnaut and Clunies Ross say that most discussion of economic rent talks about windfall profits, barriers to entry and transfer rents, but these terms are inadequate. For them, windfall profits do not necessarily come as a surprise.<sup>34</sup>

A simple way of demonstrating the way in which economic rent is calculated is found in the following formula:

$$\text{Economic Rent} = \text{Total Revenue Minus Total Economic Cost}^{35}$$

A tax is then imposed on the amount of economic rent derived from the resource at a specific rate. It is in effect a tax on the free cash flow from a resource project. It also takes into account in determining the costs of a project the 'opportunity costs of capital' by incorporating an uplift factor such as a long-term bond rate plus a further component.<sup>36</sup> For example, the PRRT in Australia has a carry-forward rate for undeducted general

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<sup>29</sup> Henry Tax Review, Final Report, Detailed Analysis Chapter C: Land and resources taxes C1. Charging for non-renewable resources C1-1 The community's return from the exploitation of its resources. Viewed 3 December 2014.

<sup>30</sup> Ibid.

<sup>31</sup> Ross Garnaut and Anthony Clunies Ross, *Taxation of Mineral Rents* (1983) 33.

<sup>32</sup> Ibid 76.

<sup>33</sup> This is at the expense of other business, since what is happening is actually a reallocation of value from all sectors of capital to the monopoly or resource sectors.

<sup>34</sup> Garnaut and Clunies Ross, above n 31, 34.

<sup>35</sup> G C Watkins, 'Atlantic Petroleum Royalties: Fair Deal or Raw Deal?', (2001) *Atlantic Institute for Market Studies*, The AIMS Oil and Gas Papers (2), 5.

<sup>36</sup> Martin Van Brauman and Clifford Mangano, 'Resource Rent Taxation as a Basis for Petroleum Tax Policy by Foreign Governments and its Relationship to US Foreign Tax Credit Policy and Tax Law', (2000) 18(1) *Journal of Energy & Natural Resources Law* 19, 20.

project costs of the long-term bond rate plus 5 per cent. The now-repealed MRRT had a mining loss allowance of the long-term bond rate plus 7 per cent.

It must be noted that economic rents would not persist under standard competitive conditions.<sup>37</sup> In other words, if other mining companies entered the market because of the attraction of the size of the economic rent, then the rates of return and supply of minerals would drive the commodity price down, or the market would bid up the cost of fixed assets until economic rents were eliminated.<sup>38</sup> The economic rent is eliminated when commodity prices fall or the extraction costs are too high. This is exactly the current situation in Australia with iron ore: the price has fallen to historic lows due to an oversupply by the big mining companies and a slowdown in economic activity in China, the largest buyer of iron ore from Australia.

The philosophical justification for the imposition of a rent tax has three premises: first, that the minerals belong to the state and the rent tax is the price for extracting the state-owned assets; second, that the collection of economic rents may result in a large amount of revenue being collected without distorting production; and third, that mining companies are very large and usually foreign-owned, and from an equity perspective a higher rate of tax could be justified.<sup>39</sup> This view was reinforced by the objective for the former MRRT as contained in the Act. The objective also reinforced the fact that the mineral resources are non-renewable and the state has only one opportunity to maximise its return for the Australian community.

### ***B. Resource Rent Taxes Imposed in Other Countries***

Australia was not the first country to impose a resource rent tax on mining companies. Many countries impose additional taxes on mining companies selling petroleum and mineral resources that have been extracted from their land. The following examination is limited in its scope, giving merely a brief overview of the resource rent regimes adopted in other countries, but it does show that this form of taxation of mineral resources has been used elsewhere, thus supporting the argument that it should be considered by a future Australian government.

Many countries have imposed a resource rent tax on petroleum and mineral extraction projects. Australia was one of the first countries to introduce a PRRT in 1984, but Papua New Guinea (PNG) had already introduced a resource rent tax (RRT) in 1977 on petroleum projects and then, in 1978, on mining projects. PNG subsequently removed the RRT in 2002 on mining and introduced a progressive profits tax.<sup>40</sup> In 1984, Ghana and Tanzania also introduced a RRT.<sup>41</sup> Since then, many countries have either contracted with mining companies to impose an RRT on profit or legislated to impose an RRT. Russia introduced an RRT in 1994; Kazakhstan in the mid-1990s; Angola in 1996; British

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<sup>37</sup> Michael Hinchy, Brian Fisher and Nancy Wallace, 'Mineral Taxation and Risk in Australia', Discussion Paper 89.8 (Australian Bureau of Agricultural and Resource Economics, 1989) 6.

<sup>38</sup> Ibid.

<sup>39</sup> Garnault and Clunies Ross, above n 31, 18.

<sup>40</sup> J. Sarma and G Naresh, 'Mineral Taxation around the World: Trends and Issues' (2001) January, *Asia-Pacific Tax Bulletin* 2, 7.

<sup>41</sup> Bryan Land, 'Resources rent taxes', in Daniel, Keen and McPherson, above n 28.



Columbia, Canada in 1990; Namibia in 1993; and Timor-Leste in 2006 – to name just a few.<sup>42</sup>

Both the United Kingdom (UK) and Norway impose an RRT on petroleum profits derived from the North Sea on the Continental Shelf. The UK first introduced a petroleum resource tax when the North Shelf was developed in 1975. Since then the tax has been amended and altered a number of times.<sup>43</sup> The UK and Norway abolished royalties based on the value of oil and gas extracted in 2002 and 1986 respectively.<sup>44</sup> The reason given for abolishing royalties was that it was a regressive tax, as it applied to gross revenue and acted as a disincentive to exploration and production.<sup>45</sup> The UK applies a petroleum rent tax (PRT) at the rate of 50 per cent as well as the normal company income tax. Norway applies a special petroleum tax (SPT) at 50 per cent as well as the normal company tax on income.<sup>46</sup> The UK government imposed a supplementary charge of a further 10 per cent in 2002, and in 2005 increased the rate to 20 per cent on the company income. However, the PRT is deductible for income tax purposes. Norway does not allow the SPT to be deducted for income tax purposes, and the effective marginal tax rate on the income of the company is 78 per cent.<sup>47</sup>

The UK system is complicated by the fact that the PRT is based on the development of the oil fields and different regimes apply to fields given development consent before 1993 and those given consent after 1993. Fields approved before 1993 are taxed on their income at a company tax rate of 50 per cent and a PRT at the rate of 50 per cent, whereas the later fields are subject only to a company tax rate of 50 per cent.<sup>48</sup> In 2002, the UK government introduced a 10 per cent supplementary charge on the same basis as company tax, but there was no deduction for financing costs against the supplementary charge.<sup>49</sup> The royalty was abolished on older fields that had received development consent before 1983 in an attempt to encourage fuller exploitation of reserves from those fields.<sup>50</sup> In 2005, in light of an increase in oil prices, the UK government doubled the supplementary charge to 20 per cent.<sup>51</sup> This means that in the UK, oil and gas is taxed at the highest rate of any industry: for fields given approval after 1983, a company tax rate of 30 per cent and the supplementary charge of 20 per cent. For fields given approval prior to 1983, the marginal rate of tax is 75 per cent, and they are also liable to company tax at the rate of 50 per cent.<sup>52</sup>

Zambia nationalised its copper industry in 1964, but the legislation effecting nationalisation was repealed in 1985. Since then, the government has imposed a royalty rate of 3 per cent, a variable income tax rate and a windfall tax applied to the value of

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<sup>42</sup> Ibid 243.

<sup>43</sup> Carole Nakhle, 'Can the North Sea still save Europe?' (2008) *OPEC Energy Review* 123, 134.

<sup>44</sup> Ibid 133.

<sup>45</sup> Ibid.

<sup>46</sup> Ibid.

<sup>47</sup> Ibid 134.

<sup>48</sup> Ibid.

<sup>49</sup> Carole Nakhle, 'Petroleum fiscal regimes: evolution and challenges,' in Daniel, Keen and McPherson, above n 28.

<sup>50</sup> Ibid 111.

<sup>51</sup> Ibid.

<sup>52</sup> Ibid.

production. However, in 2009 the windfall tax was discontinued.<sup>53</sup> A similar situation occurred in Chile, Bolivia, Peru, Democratic Republic of the Congo, Ghana and Jamaica – countries where the mining industry has been nationalised.<sup>54</sup> Some countries have subsequently privatised parts of their mining industry, but the sovereign risk still remains. Chile now has a mixture of state participation and private investment in the mining industry, and has imposed a sliding scale of rates of royalties based on the value of sales.<sup>55</sup> Kazakhstan and Liberia have introduced a rent-based tax on the exploitation of their mineral resources.<sup>56</sup>

Given the range of extra taxes that are imposed on mining and petroleum projects by different nations, the introduction of a MRRT in Australia should not have created the hostility that it did. The fact that a PRRT has been in existence in Australia since 1987 should have provided comfort for the then Labor Government that an RRT would gain acceptance by the mining companies and by the then federal Opposition, led by Tony Abbott. For the purpose of clarity, it is useful to briefly discuss the PRRT that has been operating in Australia.

### ***C. The Australian PRRT***

While the Abbott Coalition Government was committed to repealing the MRRT, the PRRT was allowed to continue to raise a rent tax from offshore petroleum operations in Australia. In 1984, the federal government announced the introduction of an RRT for new offshore petroleum projects and indicated that that the projects would be exempt from imposition of royalties and the crude oil levy.<sup>57</sup> It was a further three years before the legislation was finally passed by parliament. The federal government was not able to extend the rent tax to onshore petroleum production in lieu of state royalties because the state governments of Western Australian and Queensland objected.<sup>58</sup> In 1990, Bass Strait petroleum projects became subject to the PRRT.<sup>59</sup> The North West Shelf projects are subject to a federal royalty and the crude oil levy.<sup>60</sup>

The Hawke Labor Government of 1984 introduced a resource rent tax, based on the Garnaut and Clunies Ross model, in order to remedy the state-based taxation system of imposing royalties on resource production output.<sup>61</sup> The PRRT was imposed on oil companies with the enactment of *Petroleum Resource Rent Tax Act 1987* (Cth) and the *Petroleum Resource Rent Tax Assessment Act 1987* (Cth). The regime was effective from 15 January 1984, even though the legislation was not passed by Parliament until 1987. The Act applied retrospectively to exploration permits awarded on or after 1 July 1984, and recognised expenditure incurred on or after 1 July 1979. It was originally imposed on

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<sup>53</sup> Lindsay Hogan and Brenton Goldsworthy, 'International mineral taxation', in Daniel, Keen and McPherson, above n 28, 122, 126.

<sup>54</sup> Ibid 127.

<sup>55</sup> Ibid 125.

<sup>56</sup> Carole Nakhle, above n 49, 149.

<sup>57</sup> Michael Crommelin, 'Governance of Oil and Gas Resources in the Australian Federation', (2009) *University of Melbourne Law School, Research Series 8*, 12.

<sup>58</sup> Ibid 13.

<sup>59</sup> Ibid.

<sup>60</sup> Ibid.

<sup>61</sup> Rob Fraser, 'The state of resource taxation in Australia: "An inexcusable folly for the nation"?', (1999) *Australian Journal of Agricultural and Resources Economics* 259, 260.

offshore petroleum projects other than Bass Strait and the North West Shelf. However, oil and gas production in Bass Strait moved from a royalty and excise regime to the PRRT regime in the fiscal year 1990–91. The PRRT is imposed on the taxable profit of a petroleum project that is located ‘offshore’ in Australia. The *Petroleum Resource Rent Tax Act 1987* (Cth) is imposed on the profit at the rate of 40 per cent. The *Petroleum Resource Rent Tax Assessment Act 1987* (Cth) contains the provisions relating to the calculation of the profit subject to the rent tax. The PRRT raises in excess of an additional \$1 billion a year in revenue over and above the normal company tax on income.<sup>62</sup> It might reasonably be assumed that the current federal government is content to allow a resource rent tax to be imposed on offshore petroleum projects, since it has not repealed the PRRT, although the change of leadership from Tony Abbott to the more centre-right Malcolm Turnbull in mid-2015 could bring a change of perspective. In addition, the Labor Opposition has stated that if re-elected, it will consider the reintroduction of a MRRT. It is therefore timely to set out a template for a future MRRT in Australia.

#### IV WHAT A RESOURCE RENT TAX SHOULD CONTAIN

It is contended in this paper that Australia needs a new MRRT, and this section outlines the previous flaws in the repealed MRRT and the most desirable characteristics that a new resource tax should contain. There are a number of matters that any future Australian government should consider when examining the merits of an MRRT. These matters are discussed in detail below.

##### A. Replicate the Existing PRRT

A good starting point might be to simply replicate the design of the PRRT, which still successfully collects a resource rent tax in Australia. This means that the super profit or economic rent generated in any year from each project will be taxed at an extra rate of 40 per cent over and above the normal company tax at the rate of 30 per cent paid by the oil and gas company. The PRRT only applies to super profits generated from offshore petroleum projects after the uplift factor of 5 per cent on development expenditure plus the long-term bond rate and a higher uplift factor on exploration expenditure. According to Professor Garnaut, the structure of the PRRT is widely understood and accepted within the oil and gas industry.<sup>63</sup> Professor Garnaut goes on to say that the PRRT is a stable tax, in that there have been no changes since it was introduced in 1985.<sup>64</sup> It clearly demonstrates the flexibility of the tax, in that when the projects are profitable more tax is paid and when less profitable, less tax is paid.<sup>65</sup> It must be noted that the PRRT taxes super profits generated by the oil and gas industries from offshore resources. This means that no state or territory royalties are paid by the exploration companies. This is a major

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<sup>62</sup> Australian Taxation Office statistics: 2002–03 = \$1.2 billion; 2003–04 = \$1.5 billion; 2004–05 = \$2.0 billion; 2005–06 = \$1.8 billion; 2006–07 = \$1.9 billion, 2007–08 = \$ 1.6 billion, 2008–09 = 2.18 billion, 2009–10 = 1.25 billion, 2010–11 = 0.80 billion, 2011–12 = 1.46 billion and 2012–13 = 1.82 billion, but this figure also includes the MRRT collection.

<sup>63</sup> Ross Garnaut, ‘Development and operation of the minerals resource rent tax’, *Senate Economics Reference Committee Public Hearings, No.1, 1*, <http://parlinfo.aph.gov.au/parlInfo/download/committees>.

<sup>64</sup> *Ibid* 5.

<sup>65</sup> *Ibid*.

advantage of this particular tax, as there are no royalties which would be deductible against the PRRT and no potential disputes with state governments on the level of royalties to be paid.

### ***B. Potential State and Territory Conflict – Royalties***

One of the major problems that faced the repealed MRRT was the fact that the payment of royalties to state and territory governments was a deductible expense when calculating the amount of tax payable under the MRRT. In the later year of the MRRT certain state governments increased the royalty rates, which only added to the reduction in tax that was likely to be paid under the MRRT to the federal government.

Any future MRRT must have state and territory input so that there is an equitable sharing of the tax revenue. Ideally, royalties would be reduced or abolished, to be replaced by a share of the MRRT. Because royalties are an inefficient system of taxation they should if possible be replaced with an RRT. This view is supported by professors Garnaut and Ergas. Professor Garnaut contends that in order to bring about efficiencies in resource developments in the States, there needs to be a comprehensive revision of fundamental aspects of federal financial relations.<sup>66</sup> He pointed to the fact that the distribution arrangements for the GST between states has created large disincentives for efficiencies in resource development.<sup>67</sup> Ergas et al recommend that before any new MRRT is introduced, agreement be reached between the state governments and the federal government on distribution of mineral taxes between the states and the impact that this will have on Current Commonwealth Grants.<sup>68</sup>

### ***C. All Mining Should Be Subject to an MRRT***

An MRRT should be directed at all mining companies engaged in the business of extracting any particular mineral or collection of minerals. It should not be restricted to just iron ore, coal and coal seam gas. In this way, if the price of gold remains at very high levels but iron ore remains at historically low levels, at least some mining companies will be paying the MRRT. Ergas et al contend that the former MRRT had the potential to produce undesirable consequences, with mining companies investing in mining operations which did not involve iron ore, coal or coal seam gas.<sup>69</sup> Mining companies wanting to avoid the MRRT would potentially move investment into projects that did not attract the tax. This would distort all investment in mining in Australia.

### ***D. Restrict the Deductions Associated With Write-downs of the Value of the Mines***

One of the most significant design flaws with the former MRRT was the ability of mining companies to claim a depreciation deduction against the MRRT for the cost of their mining assets. The problem was that instead of using historical cost as the basis of valuation, they were able to use market value as the starting cost base. This resulted in higher than

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<sup>66</sup> Ibid 1.

<sup>67</sup> Ibid.

<sup>68</sup> Ergas, Harrison and Pincus, above n 7, 382.

<sup>69</sup> Henry Ergas and Alex Robson, 'Revenue allocation under the MRRT: Economic aspects' (2012) 14(2) *Journal of Australian Taxation* 183, 185.

expected depreciation deductions against the MRRT. Mining companies were able to claim an additional deduction on mining assets that had been written down to zero many years earlier by now attributing market value to the assets for the purposes of the MRRT, but not for income tax purposes.<sup>70</sup> In addition, the depreciation was calculated on the basis of the life of the mine, and many companies lower their estimates of mine life in order to increase the depreciation deduction. Professor Garnaut makes the point that a resource rent tax is not designed to collect tax until the mining company has recouped its investment with a reasonable rate of return, and in the case of the former MRRT it was 5 per cent plus the long-term bond rate.<sup>71</sup> This would result in the market value of the mine being written down over the life of the mine – not, as occurred with mines with a zero value, being written down at current value rather than at historical cost. According to Professor Garnaut, by allowing mining companies to depreciate established mines at market value, the government was giving away the value of the untaxed rent.<sup>72</sup> This was the case with the former MRRT, and the main reason why a very small amount of tax was raised. One solution to this problem is to introduce an MRRT on new projects that commence after the law is introduced and then allow the mining companies a number of years to obtain a return on their initial investment before expecting any tax to be paid. Ergas et al are of the view that a MRRT should apply to new ventures, and that the tax should be levied at a modest and internationally competitive rate.<sup>73</sup>

### ***E. Problems With Allocating Revenue to Vertically Integrated Mining Companies***

Ergas et al identified a major flaw in the MRRT legislation in relation to the allocation of income between downstream activities and upstream activities within the mining process.<sup>74</sup> Vertically integrated mining companies not only extract minerals but also blend, load and transport the minerals to ships for export. The tax was imposed on income generated from upstream activities, but the mining company itself determined to what extent expenses and income were allocated to the separate upstream extraction and downstream processing activities. Ergas et al examined the problem of allocation in detail and concluded that the former MRRT legislation would produce considerable uncertainty and ultimately lead to litigation.<sup>75</sup> As a result of the repeal of the MRRT this issue will not eventuate. However, this potential problem of cost allocation must be taken into consideration when designing a new MRRT. The now-repealed MRRT Act set out a number of statutory assumptions to be made in determining the correct allocation of income generated from upstream and downstream activities. The main thrust of these assumptions was to treat the upstream and downstream activities as separate entities operating at arm's length and independently from one another.<sup>76</sup> Ergas et al highlighted the problems with this approach, but concluded that similar problems currently exist with the PRRT, and that after 25 years of operation of the PRRT some of the problems with allocating income are now being considered by the Federal Court of Australia.<sup>77</sup> Perhaps

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<sup>70</sup> David Uren and Lauren Wilson, 'Flaw to blame for tax shortfall as Treasury miscalculates write downs', *The Australian*, 11 February 2013.

<sup>71</sup> Ross Garnaut, above n 63, 6.

<sup>72</sup> Ibid.

<sup>73</sup> Ergas, Harrison and Pincus, above n 7, 382.

<sup>74</sup> Ergas and Robson, above n 69, 186.

<sup>75</sup> Ibid 199.

<sup>76</sup> Section 30–25, MRRT Act.

<sup>77</sup> Ergas, Harrison and Pincus, above n 7, 379.

the courts will find a lasting solution to this problem in relation to the PRTT, which in turn can be applied to a new MRRT.

### ***F. Government Approach to a New MRRT***

While it is accepted that governments have the sole discretion in determining how and where taxation revenue will be spent, any future Australian government examining the potential introduction of a MRRT should take into account two of the major errors that occurred with the approach to the former MRRT. First, the government should not invite mining companies to assist in the design of the resource rent tax. The industry will not then be in a position to 'capture' the regulatory process and implement its own agenda, as was the case with the former MRRT.<sup>78</sup>

The second error in the approach to the former MRRT was to commit the potential revenue from the tax to specific expenditure programs. This is directly contrary to the essence of the concept of a rent tax on super profits. Any government that re-introduces an MRRT must not allocate set tax expenditures against possible tax revenue from mining companies. It must be recognised at the outset that a MRRT only provides revenue when the price of mineral commodities is high and the mining companies are making abnormal profits. These super profits are then calculated only after allowing the mining companies to generate a return on capital and labour plus an uplift factor such as the long-term bond rate plus a percentage. Moreover, the rate at which the tax is set should be reasonable.

### ***G. A new version of an MRRT***

A new MRRT should have as its core objective fairness to both the mining company and to the people of Australia, who have a vested interest in the finite mineral resources that are being extracted. A well designed mineral resource tax should contain the following features, based on the above analysis of the problems identified in the now-repealed MRRT:

- The tax rate should be reasonable and comparable with other countries. It should be no higher than the current PRRT rate of 40 per cent.
- The tax should be easy to understand, and in this respect the PRRT legislation should be used as a guide. It has been collecting a resource rent tax from oil and gas producers in Australia for more than 25 years.
- The Commonwealth Government should discuss the question of royalties on mining with the state governments in order to resolve a number of outstanding issues. The main issue is the deductibility of state royalties from mining income when calculating the profit from the mining project. If the royalties are to be deductible, the states must agree not to increase the rate of the royalty for a set period, otherwise the amount of MRRT to be collected will be at risk. Ideally, royalties should be abolished by the states and a share of the MRRT should be paid to the individual states in compensation.
- All projects involved in the extraction of finite mineral resources in Australia should be subject to an MRRT. When the price of certain minerals is high and a

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<sup>78</sup> John Passant, *The Minerals Resource Rent Tax: The Australian Labor Party and the continuity of change*, (2014) 27(1) *Accounting Research Journal* 19.



super profit is being generated by the mining company, the MRRT will be paid. If that particular resource is at a low price, then no tax will be paid.

- A new MRRT should only be applied to new mining projects, and the value of the mining assets will be at their historical cost for depreciation purposes. There will be no need for mining companies to revalue their existing assets because the tax is only applied to new projects from the date the new law is introduced.
- The potential problems in the allocation of income and expenses associated with vertically integrated mining companies ought to have been resolved in relation to the PRRT before a new MRRT is introduced. The now-repealed MRRT provisions contained in the former Act and based on the PRRT should be reintroduced in new MRRT legislation.

The previous Australian Government made mistakes in the initial design and promotion of the now repealed MRRT, as discussed above. Nevertheless, it is contended that super profits generated from mining activities in Australia should be subject to a rent tax. The tax itself was a good idea, and it was one of the few taxation reforms that was implemented based on the Henry Tax Review recommendations.

## V CONCLUSION

The MRRT should ideally be used to invest in projects that will benefit future generations of Australians over the next hundred or so years, on the basis that mining will not be the employer or generator of substantial wealth for the Australian economy. Future governments owe future generations a duty to provide potential wealth and prosperity by investing in projects that have a long-term potential for increasing or maintain at least the current living standards.

The federal government has repealed the MRRT but left the PRRT in place so that it collects revenue for the government on offshore petroleum exploration. The Labor Opposition has publically stated that if re-elected it will introduce a new MRRT. This article acknowledges that there were design faults in the former MRRT. But it moves beyond that analysis to provide the philosophical basis for the introduction of a super profits tax on the economic rent generated by mining companies.

A new MRRT must overcome the shortcomings of the now-repealed MRRT. As discussed in Part IV, a good starting point for a new MRRT is to tax all minerals extracted by mining companies. The tax should be fair and at a reasonable rate. It should be based on the PRRT and adopt many of the provisions relating to the allocation of income and expenses where vertically integrated mining companies are involved in a project. The new MRRT must only apply to new mining projects, so that the valuation of the assets will be at current market values. The most difficult problem to be overcome with a new MRRT is how to obtain the support of state and territory governments and move to the reduction or abolition of state-based royalties. This problem must be overcome by any future government wanting to reintroduce an MRRT.

The idea of a resource rent tax on the super profits from mining projects is based on the recommendations of the Henry Tax Review and should be implemented in Australia. While the concept is sound and a new MRRT is justified, any future Australian government must not make the mistakes of the previous Labor Government that introduced the now

repealed MRRT. That future government must not link spending programs to an expected level of revenue from a MRRT, and it must not involve the biggest mining companies in its design.