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This tax won't win any respect

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THE bad news on the death and taxes front is that death is still certain. The worse news, in a world where investors value predictability, is that taxes are not.

The flashpoint is the proposed new tax on mining, which the government (perhaps channelling Aretha Franklin) has termed the Resources Super Profits Tax, or RSPT. Unfortunately, the mining industry believes the proposed scheme delivers anything but R-E-S-P-E-C-T.

And it is so complicated even the Prime Minister finds it impossible to explain.

The truth is that the new tax could be more efficient than relying on royalties. But royalties are not likely to go away any time soon. And adding the two could make matters worse.

So could flaws in the way the proposed tax is designed.

Consider the proposed tax and its effects.

Imagine a company is going to dig a mine at a cost of $100 in year one and without needing to incur any other costs, it will then sell all the output in year two, getting revenues of $120 (after which the mine shuts). Overall, the company will have realised a 20 per cent rate of return.

If its cost of capital (the return investors need to compensate them for risk) is only 10 per cent, its owners have earned super profits, or economic rents, of 10 per cent on top of that.

Now, assume the government taxes the company on the following basis: if the company incurs a cash loss in a year, the tax office will cover 40 per cent of that loss; conversely, if it makes a cash profit, 40 per cent of that profit is due in tax.

In the example above, the company would receive $40 from the government in year one but would pay tax of $48 (40 per cent of $120) in year two.

The government's $40 payment reduces the capital private investors need to provide to $60; on that $60, they now earn $72 ($120 of revenues minus the $48 tax in year two).

There are two important points here. First, the rate of return to investors is unchanged by the tax, but they now get it on a smaller base (earning $72 on private investment costs of $60, rather than $120 on private costs of $100). Second, the government is now effectively an equity investor, taking its share of the risk and getting a commensurate share of the profits.

Of course, the company's stockmarket value is smaller than it would otherwise be, as it now excludes the share of income that will go to government. But so too is the equity investment the new project requires.

This is what economists call a Brown tax, after American economist E.Carey Brown, who proposed it in the 1950s.

In its pure form it has the claimed advantage of leaving investment incentives unchanged, and hence being superior to other forms of taxation.

There is merit in this. But it relies on crucial assumptions. One is that having government as a silent partner, bearing a share of costs and risks, has no effect on the incentives for businesses to be efficient.

But this is incorrect, as every dollar of effort management invests in resisting union wage claims or increasing revenue now yields a smaller absolute return to the owners of the private equity.

The result: like cost-plus contracts in defence, Brown taxes can lead to slack management and slow productivity growth.

These adverse effects, ignored in the Henry review, increase steeply with the tax rate, causing large welfare losses.

Additionally, what the government proposes is not a Brown tax in its pure form.

A crucial difference is Brown taxes are meant to apply from the outset of projects, or at least to allow all costs incurred to be brought to account.

But the tax will have its most immediate effect on existing projects. If only book costs (unadjusted for inflation and other price changes) for those projects are allowed as offsets, then the government will not bear its share of losses and the tax would affect investment incentives.

Moreover, these existing projects are not a random selection of all Australian mining projects over recent decades.

Rather, they are the lucky survivors: the projects profitable enough to start and remain in production. Many others were terminated and have been written off the books, even by current producers.

Those projects costs will apparently be ignored in calculating the tax liability.

This amounts to taxing the winners without funding the losers, as the Brown tax requires.

Further, in a Brown tax, the government contributes when cash losses are incurred.

Not so in the government's proposal, which requires investors to accept a promise that those losses, compounded at the bond rate, will be deducted when any tax liabilities come due.

This is fine if (given the promise the government has made) companies can fund those losses at the bond rate or dispose of them at no cost to someone who can.

In practice, however, they cannot, not least because government's tinker constantly with tax rules, so promises about the distant future lack credibility.

The result: the bond rate understates, perhaps greatly, the cost to investors of deferred payment.

Finally, Brown taxes are a good idea if they replace royalties, as royalties (a tax on each unit sold) distort decisions about how much to produce.

But in the proposal, royalties paid to the states are credited against the amount owed to the commonwealth. This creates an incentive for states to increase royalties, as South Australia has already indicated it may.

Depending on how far this goes, the outcome can be more distorting than a royalty tax alone. Given that the problems of our fiscal federalism remain entirely unsolved, this risk of compounding taxation cannot be ignored.

The proponents of the RSPT tend to compare an ideal Brown tax to existing, imperfect, alternatives. But this is as useful as saying that nirvana is preferable to our earthly vale of tears.

Unfortunately, we have a long history in this country of interventions that, were they capable of perfect implementation, might increase welfare.

Typically, when reality hits, they have the opposite effect. The scientific tariff, which helped ruin our economy for decades, is a striking case in point.

The RSPT, with all of its complexities, risks being deja vu, all over again.

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