8 State mining royalties and the MRRT

8.1 State royalties and the Commonwealth's resource taxes

The Panel's second interim report explored at some length the interaction between the Commonwealth's new resource taxes (the MRRT and the expanded PRRT) and State mineral royalties. Some of the key conclusions of this analysis were that:

- well-designed rent-based taxes are likely to be more economically efficient than royalties, particularly in periods of low commodity prices or high costs
- other factors, such as the size, variability and timing of the return received by government, as well as administration and compliance costs, are also important considerations when choosing between alternative resource charging regimes
- the States, through their long-standing role in charging for the right to mine under their soils, and the Commonwealth, via its well-established position in the field of taxation, have roles in obtaining mining revenue on behalf of the community
- the Commonwealth's design of the MRRT and PRRT has created an opportunity for States to seek to increase their revenue at the expense of the Commonwealth — an undesirable and unsustainable situation, which needs to be resolved
- the Commonwealth and the States should negotiate an integrated resource charging system, addressing how the revenue is shared between them.

While the Panel notes the strength of several States' objections to the Commonwealth's expansion of its role in resource charging, the submissions received in response to the interim reports have not given the Panel cause to alter these conclusions.

Finding 8.1

The States and the Commonwealth both have legitimate roles in obtaining mining revenue on behalf of the community. The challenge is to reconcile these interests.

Developments since the second interim report

Since the Panel finalised the second interim report, there have been two important developments, both of which serve to highlight weaknesses with current arrangements:

- iron ore and coal prices have declined considerably[1]
- the Queensland Government has announced it will increase its coal royalties.

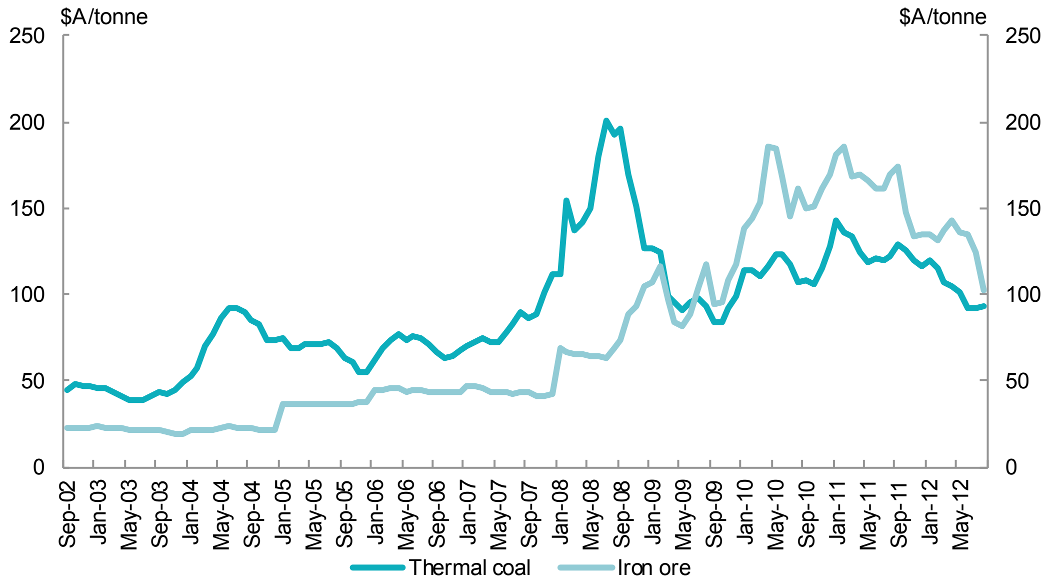
1 Falls in commodity prices have led the Commonwealth to reduce its expectations of MRRT revenue. In its 2012-13 Mid-Year Economic and Fiscal Outlook the Commonwealth estimates net revenue from the MRRT will be around one-third lower than estimated in the 2012-13 Budget.

Iron ore and coal prices have declined in recent months

The Panel finalised its second interim report in late May 2012. Since that time, both iron ore and coal prices have fallen considerably, although the iron ore price in particular remains well above its long-term historical average (see Figure 8.1).

Since the 2012-13 Commonwealth Budget in early May the spot prices for iron ore and thermal and metallurgical coal have fallen between 15 and 33 per cent.[2] These price falls, coupled with increasing costs, have contributed to some proposed mine expansions being postponed, as well as some earlier closure of existing capacity. The closures have in turn contributed to job losses, particularly in the regions affected.

Figure 8.1 Monthly iron ore and thermal coal prices



Source: www.indexmundi.com.

Queensland has increased its coal royalties

The Queensland Government announced an increase in coal royalties in its 2012-13 Budget, delivered on 11 September 2012. With effect from 1 October 2012 the previous single rate of 10 per cent on the value above $100 per tonne was replaced with a rate of 12.5 per cent on the value between $100 and $150 per tonne, with a rate of 15 per cent applied to the value above $150 per tonne. The base 7 per cent rate that applies on the first $100 received per tonne was left unchanged. Queensland estimates that this change will increase coal royalties by around $1.6 billion over the four years to 2015-16.[3]

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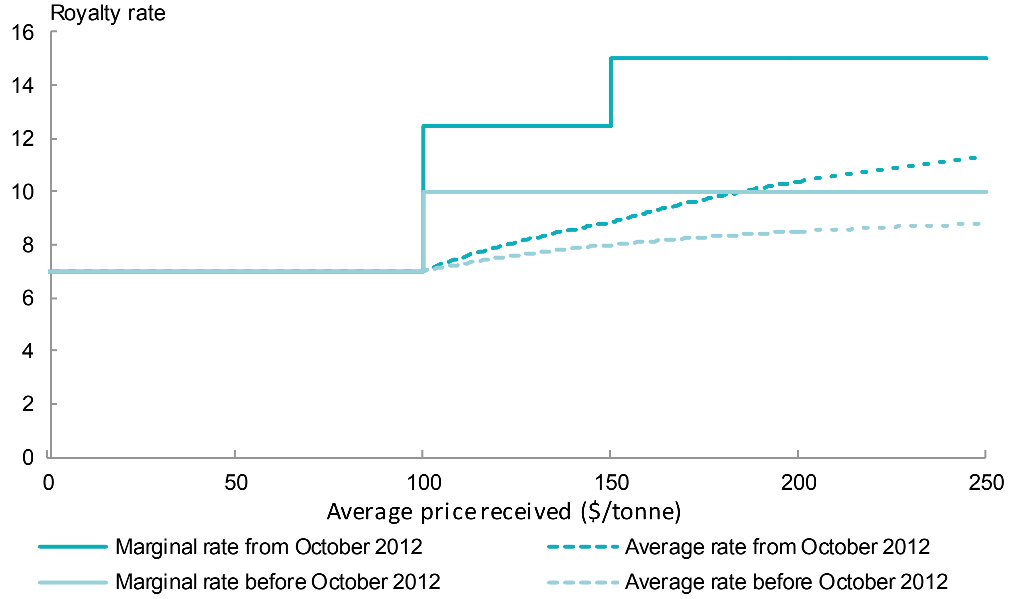
2 Metallurgical coal and iron ore prices, in particular, have also been highly volatile. The iron ore spot price fell around 38 per cent in US dollar terms between the Commonwealth Budget and the first week of September, before recovering around two thirds of this fall by the second week of October. See Commonwealth Government, 2012-13 Mid-Year and Fiscal Outlook, page 19.

3 Queensland Government, 2012-13 Budget, Budget Paper 4, page 134. As part of this budget measure, the Queensland Government also announced that a Cabinet Committee would work with the coal industry to 'reduce costs and the regulatory burden with the package to be finalised within 100 days of the 2012-13 Budget' and that the Government 'will also guarantee for a period of ten years (end of 2021-22 financial year) that coal royalties will not be increased again.'

Figure 8.2 Queensland's coal royalty regime



Source: Based on Secretariat analysis of Queensland's 2012-13 Budget.

With this increase, Queensland joins Western Australia, New South Wales, Tasmania and South Australia as having increased its royalties since the announcement of the MRRT. There should now no longer be any doubt that the Commonwealth's decision to fully credit State royalties under the MRRT and PRRT (without reaching any agreement with the States regarding their royalty regimes) has created an incentive for States to increase these royalties. The States have chosen to act on this incentive.

While the States' decisions to increase royalties are unsurprising, particularly given the current fiscal environment, they are regrettable when looked at from a system-wide perspective. Their decisions will cost jobs and investment, as well as hinder regional development. This is because as commodity prices decrease, the economic harm caused by royalties tends to increase as production and investment decisions become increasingly distorted.[4] In the second interim report the Panel suggested that an improved overall system could comprise lower royalties on iron ore, coal and petroleum, with greater use being made of resource rent taxes to deliver a return to the community (along with negotiated arrangements to ensure that no State is left worse off).[5] Instead of moving in this direction, all available evidence is that the opposite is occurring.

Finding 8.2

The Commonwealth's decision to fully credit State royalties under the MRRT and PRRT has created an incentive for States to increase these royalties. This situation is neither desirable nor sustainable.

4 Queensland's coal royalty regime attempts to limit these distortions by having the royalty rate vary somewhat with price. See Figure 8.2.

5 GST Distribution Review, *Second Interim Report*, June 2012, Chapter 4.

8.2 A cooperative approach remains the best solution

Having reiterated the Panel's conclusion that the current impasse is neither desirable nor sustainable, it is worth also restating the Panel's position on the relative merits of the possible resolutions to the problem.

- The Panel agrees with the States that it would not be desirable for the Commonwealth to adjust the GST distribution system to penalise States for increasing their royalties.[6]
  - Not only might this not achieve the Commonwealth's goals, the zero-sum nature of the GST distribution system would result in a corresponding unintended reward for other States.
- Given that the Commonwealth provides significant non-GST revenues to the States, there are other means at the Commonwealth's disposal to seek to dissuade States from eroding its resource rent tax revenue base. However, use of these means would be a less desirable alternative to a cooperative solution.
- The Commonwealth and the States could act on the advice of the Australia's Future Tax System (AFTS) review, the Policy Transition Group and this Panel and strike an agreement on the taxation of resource projects to secure, and build upon, the benefits of the resource tax reforms already undertaken.

The third of these alternatives represents the best approach. Given that the cause of the current impasse is the Commonwealth's decision to provide an open-ended guarantee to credit State royalties without reaching an accommodation with the States as to their levels, the primary onus to seek a resolution rests with the Commonwealth. The Panel encourages the Commonwealth to take the lead in proposing discussions, and urges the States to respond positively and negotiate in good faith.

Recommendation 8.1

The Commonwealth and the States should acknowledge that a cooperative approach to resource charging will produce a superior outcome to any available alternative.

Accordingly, the Commonwealth should actively seek to engage the States with a view to reaching agreement on the taxation of resource projects. The States should be receptive to such a request for negotiations.

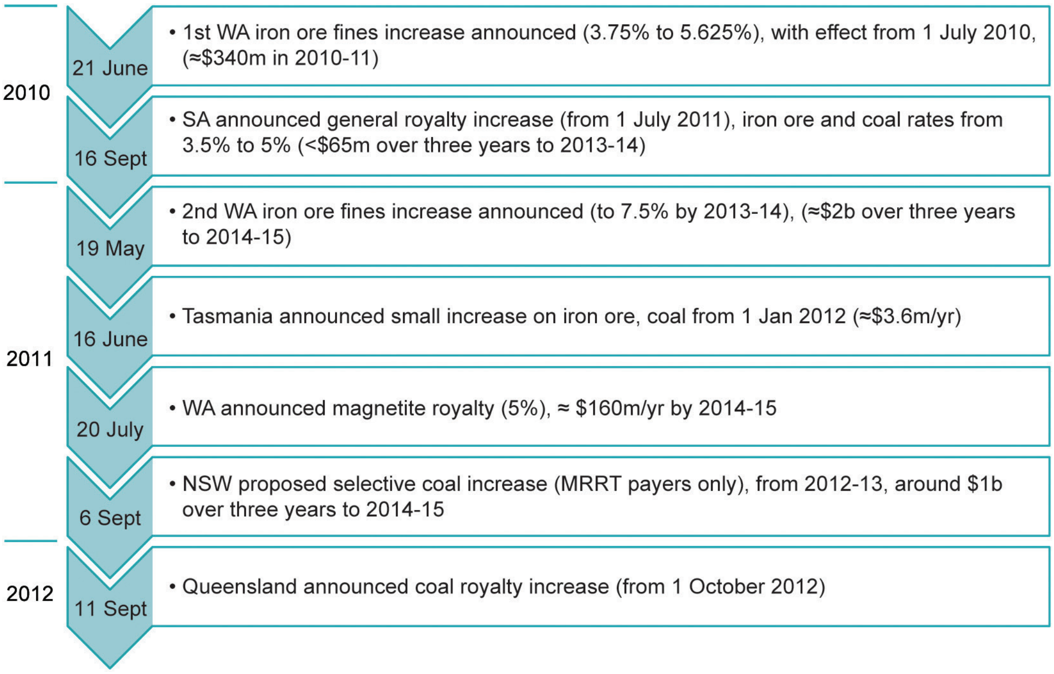
Options in the absence of cooperation

As discussed above, and shown in Figure 8.3, five States, including the large resource States of Western Australia, Queensland and New South Wales, have increased royalties on commodities subject to the MRRT since the Commonwealth's original announcement on 2 May 2010 of its intention to introduce a Resource Super Profits Tax.

6 Box 8.1 canvasses the limited circumstances in which a departure from this principle may be justified.

The Commonwealth Treasurer has criticised States for these royalty increases. In August 2012 it was reported that Mr Swan wrote to his State counterparts stating, in part that, 'in the event that we are not able to reach an agreement on the interaction between state minerals royalties and the MRRT, the Commonwealth will implement measures to protect MRRT revenue from recently announced or future royalty increases.' The report further stated that the Commonwealth was referring specifically to royalty increases occurring after 1 July 2011.[7] This date would indicate that the Commonwealth does not intend to pursue further the relatively small increases made by South Australia or Tasmania, or Western Australia's changes to its iron ore fines royalties, but that it does intend to respond in some way to New South Wales' and Queensland's announcements, as well as any future increases.[8]

Figure 8.3 Announced increases to State royalties on MRRT commodities since 2 May 2010



Source: Compiled from various State Budget documents and media statements.

The Panel sees its role under the Terms of Reference as being to examine the incentives for States to increase their royalties under the current arrangements. Having concluded that the current situation is undesirable and unsustainable, the Panel has also offered some suggestions for how to improve it.

7 See Coorey, P, 2012, 'Swan Warns States Not To Gouge Royalties', Sydney Morning Herald, 21 August 2012, accessed 17 October 2012, http://www.smh.com.au/opinion/political-news/swan-warns-states-not-to-gouge-royalties-20120821-24kql.html#ixzz28DSyxe53. It has also been reported that Mr Swan wrote to the New South Wales Treasurer in November 2011 on this issue, see Salusinszky, I, 2012, 'NSW Premier Barry O'Farrell calls Gillard government a pack of thieves over mining royalties', The Australian, 23 November 2011, accessed 17 October 2012, <http://www.theaustralian.com.au/national-affairs/state-politics/nsw-premier-calls-gillard-government-a-pack-of-thieves-over-mining-royalties/story-e6frgczx-1226202979951>.

8 This division is consistent with other statements made by the Commonwealth Treasurer. Less clear is the Commonwealth's attitude towards Western Australia's announcement on 20 July 2011 to impose a 5 per cent royalty on magnetite (a form of iron ore). In any case, this increase is expected to have much less impact on MRRT revenue than the New South Wales or Queensland changes.

The Panel's role does not extend to passing an opinion on the merits or otherwise of any State's individual policy decision, or on whether or not the Commonwealth would be justified in 'penalising' that State for increasing its royalties.

That said, the current dynamic is neither stable nor conducive to the sort of negotiated 'win-win' outcome that the Panel recommends be pursued. States continue to have an incentive to increase their royalties, not only to gain revenue (collectively) at the expense of the Commonwealth, but also to seek to gain at the expense of other States by increasing their 'relative effort' to raise revenue as assessed by the CGC. The way that coal and iron ore royalties interact with the MRRT means that the concept of relative effort is largely meaningless in this context. This creates a risk that, for example, New South Wales and Queensland might engage in escalating coal royalty increases. If this happened, then it would become harder to craft a 'deal' acceptable to all parties.

In these circumstances, a stop-gap measure may serve to improve the likelihood of a negotiated agreement being struck. The CGC could be instructed to assess the extra revenue that States receive from royalty rate increases after a given date on an 'actual per capita' basis. The effect of this would be to reduce the GST share of a State increasing its royalties so as to offset the additional own-source revenue it receives. Ultimately, after the lag and averaging in the HFE system has taken effect, each State would receive its population share of the additional royalty revenue (see Box 8.1).

Box 8.1 Assessing certain royalty increases on an actual per capita basis

Although mining is dominated by a few States, and so they have more scope to affect the average than in other areas, States still retain the majority of the benefit of a policy decision to increase their royalties.

To take some hypothetical examples based on current estimates for 2013-14, and holding everything else constant:

- If New South Wales increased its royalties by $500 million, then, after taking into account GST share effects it would ultimately end up $526 million better off.
- If Queensland increased its royalties by $500 million then it would ultimately end up $373 million better off.
- If Western Australia increased its royalties by $500 million then it would ultimately end up $428 million better off.[9]

Like most policy changes under the current system, royalty increases like these will affect all States, sometimes adversely. For example, a $500 million increase by New South Wales would ultimately make the other major mining States *worse off* (Queensland by $127 million and Western Australia by $72 million).

9 These estimates are Secretariat calculations based on data from current State budget estimates, and on the simplifying assumptions that the current mining revenue assessment remains in place and that all royalty rate increases relate to minerals in the high royalty rate group. If a different method of assessing mining revenue were to be put in place, then this would lead to different financial impacts for each State in these examples. However, the main conclusions would not be affected.

The distribution of a hypothetical $500 million increase in New South Wales' royalties under the current approach

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
Additional royalty revenue from policy change ($m)	500	0	0	0	0	0	0	0	500
Final budget effect, including GST share effects ($m)	526	124	-127	-72	26	11	8	4	500

This may be seen as an inappropriate outcome, particularly in the current circumstances where States have an artificial incentive to increase certain royalties due to the way they interact with the MRRT and PRRT. It could easily be seen as perverse that a decision by, say, New South Wales, to collect an extra $500 million in royalties, that might have little or no practical effect on miners and ultimately is borne by the Commonwealth's budget, would also harm Queensland and Western Australia.[10] It also arguably creates a situation where those States may feel obliged to ratchet up their own royalties so as to maintain their relative position.

If the Commonwealth directed the CGC to assess the revenue from such additional royalty increases on an actual per capita basis, this would ensure that each State received exactly its population share of the extra revenue.

Continuing with the New South Wales example, instead of getting $526 million from its increase, ultimately it would retain only $160 million. Queensland and Western Australia would also get their population shares of the extra revenue rather than going backwards as they would otherwise do. This may reduce their imperative to respond with royalty rate increases of their own.

How the same $500 million increase in New South Wales' royalties would end up being distributed if it was assessed on an 'actual per capita' basis

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
Additional royalty revenue from policy change ($m)	500	0	0	0	0	0	0	0	500
Final budget effect, including GST share effects ($m)	160	124	102	53	36	11	8	5	500

This approach would be most effective if applied to an increase by only one State. If several States all increased their royalties, then adjusting the mining revenue assessment in this way would be of limited benefit.

Of course, in the event that States proceed with increasing their royalties on MRRT commodities under the existing arrangements, then the Commonwealth's budget will be left in a worse position, regardless of how the additional royalty revenue is ultimately shared between the States.

Such an approach might serve in the short-term to reduce the incentives for States to increase their royalties on MRRT commodities. However, it is not a substitute for a long-term solution, and still suffers from the drawbacks the Panel identified in the second interim report. For example, reducing the GST share of one State would increase

10 The point here is not to single out New South Wales in any way, but instead just to use one example to illustrate the sorts of perverse outcomes that may arise under the existing arrangements.

the GST shares of the other States, giving them an arbitrary windfall. It also would do nothing to support the Commonwealth's revenue base in the event that States proceed with increasing their royalties.

> ***Finding 8.3***
>
> *As an interim measure, the Commonwealth could announce that it intends to direct the CGC to assess any revenue raised from royalty increases on MRRT and PRRT commodities after a particular date on an actual per capita basis.*
>
> *This would reduce, but not remove, individual States' incentives to increase their mineral royalties, while also potentially providing a windfall to other States. It would not represent an effective substitute for a negotiated outcome.*

8.3 Fixing the interaction between MRRT and State royalties

While the details of any changes to the current arrangements are a matter for governments to decide, the Panel has considered it may be worthwhile to outline some principles which could serve as a guide to any negotiations between governments on these issues. While such advice perhaps lies at the outer edge of our Terms of Reference, we hope that all parties receive these suggestions in the manner that we intend them, as a genuine attempt to make ground on a real, and worsening, problem.

The Panel considers that at a minimum, the following three conditions will need to be satisfied if the nation's resource charging arrangements are to be placed on a sustainable footing:

- The States must retain their autonomy to set their royalty policies.
- The States must be accountable for the effects of their royalty policies.
- The gains from the Commonwealth's introduction of the MRRT and expansion of the PRRT must be secured.

States must retain their autonomy to set their royalty policies

As several States have pointed out, the responsibility for regulating mining activity and the right to charge for accessing the community's mineral resources have long rested with the States. The resource States see this as one of their fundamental responsibilities. There is no prospect over the short or medium term of the States agreeing to any significant reduction in their autonomy to set their royalty policies.[11]

In the Panel's view, this effectively precludes any arrangement requiring the States to 'fix' in place their royalty regimes, even if this were to be limited to the MRRT and PRRT commodities. The States greatly value the flexibility to adjust their policies over time to suit their changing priorities and circumstances. While in theory there might be some

11 Over the longer-term, the States and the Commonwealth may agree to revisit their respective roles and responsibilities as part of a broader consideration of how the Federation operates. Responsibility for the mining industry could conceivably form part of that discussion (see Chapter 12).

price at which the Commonwealth could 'buy off' the States, it is likely to be so high as to prevent this from being a realistic approach, even if thought to be desirable.

In the Panel's view, the States should retain the flexibility to charge royalties that they deem appropriate for the right to extract minerals from within their jurisdiction.

States must be accountable for the effects of their royalty policies

While States retain their ability to set royalty policies, they are now less accountable for the consequences of these policies. Prior to the introduction of the MRRT each State's best interests clearly lay in seeking to strike the right balance between short-term royalty revenue (suggesting a high rate) and encouraging exploration and development of projects over the longer term (suggesting a lower rate). If a State government failed to achieve this balance, the accountability was clear.

Now, accountability is blurred and States face different and somewhat perverse incentives. Because at least part (and in some cases, most) of the additional revenue from an increase in iron ore or coal royalties will effectively flow to the States from the Commonwealth rather than being borne by the miners, States have an incentive (at least at the margin) to set higher *ad valorem* royalty rates. This would be most harmful to the least profitable miners.[12] These higher rates will, in some cases, cause a marginal mine to close earlier than it would have, or contribute to mine expansion plans being delayed. Allocating responsibility for the resulting economic and social costs between the State and the Commonwealth would be unsatisfactorily difficult. The link between States' mining royalty policy settings and their consequences should be fully restored.

The Commonwealth's resource revenue base should not be further eroded

It is desirable for States to retain the flexibility to adjust their royalty policy settings to respond to changing priorities and circumstances. However, this does not extend *carte blanche* to deliberately undermine the Commonwealth's MRRT and PRRT revenue base. Such actions, even if they may be consistent in the short-term with the incentives provided to the States by the Commonwealth's actions, would nevertheless be harmful over time, including to the States themselves.

As the Panel said in the second interim report, if it is unreasonable for the Commonwealth to expect the States to relinquish their discretion over royalty policy, it is equally unrealistic for the States to expect the Commonwealth to allow them to capture the revenue stream generated by the Commonwealth's undertaking of a significant and challenging reform.

If a Commonwealth-State agreement on resource charging is not reached, then the MRRT and PRRT design should be revisited

There are only two possible ways of satisfying all of the above principles. One, the States and the Commonwealth could reach an accommodation regarding their respective shares of future mining revenues. If the parties were minded to do so, it would be possible to design a framework within which the States would have the ability to adjust their royalties to suit their particular circumstances, while also reassuring the

12 Western Australia has suggested that the current arrangements could in theory also *discourage* States from reducing mineral royalties, to the extent that such reductions would result in an offsetting increase in the Commonwealth's MRRT.

Commonwealth that the States would not seek to undermine the MRRT and PRRT revenue base. The Panel outlines one such framework in the next section.

In the absence of an accommodation along these lines, the only other way of preserving both the States' royalty policy autonomy and the Commonwealth's tax base is to revisit the MRRT's and PRRT's design. The sustainability of the Commonwealth's open-ended guarantee to credit all State royalties has always depended on its ability to reach an accommodation with the States regarding their royalties. If it is judged that such an accommodation is unable to be reached, then the MRRT and PRRT royalty crediting arrangements should be adjusted so as to do delink them from future State decisions.

As discussed in the second interim report, instead of linking the royalty credit to payments actually made to State governments, a credit based on some notional royalty rate could be applied uniformly. This could be calculated in any number of ways, and would be a matter for the Commonwealth to decide (although clearly the miners would have a significant stake in the particular rate chosen).[13]

Recommendation 8.2

If the Commonwealth and the States are unwilling or unable to reach an accommodation regarding resource charging, the Commonwealth should amend the design of the MRRT and PRRT to remove the open-ended crediting of all royalties imposed by the States.

8.4 What form should an agreement take?

The Panel has reaffirmed that an agreement between the States and the Commonwealth is the best available solution to the current impasse over resource charging. It has outlined a temporary measure which may help make a deal easier to strike (by directing the CGC to assess some royalty revenue on an 'actual per capita' basis) and it has suggested what it thinks needs to happen in the event an agreement is not reached (the design of the MRRT and PRRT ought to be revisited). This Chapter concludes with the Panel's views on what a national agreement on resource charging should look like.

In the second interim report the Panel suggested that there are potential solutions which could benefit all parties.[14] For example, a reduction in the rate of *ad valorem* royalties on iron ore, coal and petroleum, with greater use being made of resource rent taxes to deliver a return to the community would:

- secure the MRRT and PRRT revenue base, allowing the Commonwealth to return to the States the value of foregone royalty revenue

13 In the second interim report the Panel noted that the options would include calculating a uniform allowance with reference to the average (or highest or lowest) royalty rate that applied at a point in time, such as the announcement of the Commonwealth's resource tax reforms (2 May 2010), the announcement of the MRRT (1 July 2010), the commencement of the MRRT (1 July 2012) or other date.

14 GST Distribution Review, *Second Interim Report*, June 2012, page 75.

- produce a more efficient system overall, by reducing the distortions to production and investment decisions that can be caused by royalties
- be expected to deliver a tangible fiscal dividend over time.

The Panel noted such a fiscal dividend would be available to be shared between levels of government. This remains the Panel's view and, alongside the principles described above, would represent a realistic, sustainable improvement to current arrangements.

A potential resource charging model

In the Panel's view, a hybrid resource charging structure, at least for iron ore, coal and petroleum, represents the best way forward for the Commonwealth, the States, and the nation as a whole. In part this reflects a slightly different conclusion by the Panel on the relative merits of royalties and resource rent taxation to that of the AFTS review. While we agree with that panel that a resource rent tax offers the most efficient way to collect an appropriate return from mining production, we see there is merit in having this operate alongside an *ad valorem* charge that ensures the community always receives something for the use of its valuable non-renewable resources. This approach would also be an easier transition from the current system which already acts as a hybrid of the two approaches (with a royalty payable by all miners, topped up by the MRRT or PRRT payable by the most profitable projects). Nevertheless, we consider it would be ideal if the royalty component was somewhat lower, perhaps more in the order of around 5 per cent of sales value in the case of iron ore and coal, rather than the typical prevailing rates of around 7.5 per cent.

A reduction in royalties on this scale by itself would cost the States a large amount of revenue, perhaps around $4 billion a year based on current estimates.[15] Realistically, a reduction in royalties on this scale could only occur if it was accompanied by (at least) an equivalent guaranteed increase in payments from the Commonwealth to the States. Much of this amount would be able to be sourced from the additional MRRT and PRRT revenue that would be expected to flow as a consequence of the reduced royalty allowances. As for the remainder, the Commonwealth would have at least two options. It could allow the fiscal cost to hit its own budget bottom-line. On one view, such a cost, while painful for the Commonwealth might nonetheless be preferable to the current situation whereby its MRRT and PRRT base is being steadily eroded. However, the Panel recognises that the Commonwealth itself is unlikely to be so sanguine about the prospect of taking such a budget 'hit', especially in the current tight fiscal environment.

Accordingly, a second option may be more attractive. The Commonwealth could seek to revisit aspects of the design of the MRRT and PRRT to ensure that overall revenue neutrality (in combination with the reduction in State royalties) was achieved (see Table 8.1). For example, one possibility worth careful consideration would be making royalty payments deductible for MRRT purposes like they are for income tax, instead of them being grossed-up and credited.[16] Another option might be to reduce (or remove) the generous uplift arrangements provided for unused royalty allowances.

15 Initially this effect would be felt predominantly by Western Australia, Queensland and New South Wales, but would flow through to all States over time through the operation of the equalisation system.

16 GST Distribution Review, *Second Interim Report*, June 2012, pages 52-53.

Table 8.1: Revenue neutrality by adjusting royalties and MRRT/PRRT

Scenario	Most profitable projects would …	Less profitable projects would …	Revenue would be … States	Commonwealth	Total
MRRT/PRRT tightened to achieve revenue neutrality	pay more	pay less	lower by $x	higher by $x	the same
MRRT/PRRT parameters unchanged	pay the same	pay less	lower by $x	higher by <$x	lower

The net effect of these changes would be to improve the overall efficiency of the system by reducing the distortions caused by inefficient royalties, without altering the Commonwealth's or the States' fiscal positions, or increasing the total burden faced by the mining industry.[17] However, by themselves these changes would neither restore full accountability to the States for the consequences of their policies, nor would they resolve the fundamental clash of incentives at the core of the current impasse.

The only way of fully restoring the States' accountability for their royalty policy decisions within a hybrid system is to sever the automatic link between the royalty allowance provided under the MRRT and PRRT and the amount imposed by the States. The Panel considers that if an overarching agreement along these lines was in prospect, the Commonwealth should amend the MRRT and PRRT to provide miners with a fixed credit, perhaps equivalent to 5 per cent of the sale price, in lieu of the existing royalty allowance that is linked to States' policies. States would then be free, as now, to adjust their royalty rates (either up or down). However, unlike the current situation, they would be clearly accountable for the effects of such decisions on the development of the industry within their State.

Finally, there is the question of how to bring the Commonwealth's and the States' fiscal incentives into line. What would be in this for the States? Ultimately, the Commonwealth may need to provide the States with some additional benefit to secure their support. Clearly this would be a matter for negotiation. One possibility though would be for the Commonwealth to commit to share with the States any expected fiscal dividend flowing from the improved efficiency of the overall system (see Box 8.2).

Box 8.2: A fiscal dividend from a better resource charging system?

The logic for certain reforms yielding a fiscal dividend is that by improving overall efficiency and productivity, they contribute to an increase over time in economic activity. Part of this increase then flows to governments as higher tax revenue.

KPMG Econtech modelling done for the AFTS review found that completely replacing royalties with an equivalent amount of resource rent tax revenue would improve welfare by an average of 50 cents for every dollar of revenue replaced, or $1.2 billion per year in aggregate in the long run. If an incremental approach to reducing royalties was adopted, the first steps in the reform process would deliver the greatest benefits

17 The constraint of revenue neutrality coupled with a lesser role for royalties and a somewhat tighter MRRT and PRRT would however produce a change in the way that this burden is shared amongst the mining industry. More would be paid by the most highly profitable projects, and less would be paid by the less profitable ones.

(initially improving welfare by 70 cents for every dollar of revenue).[18]

As with all modelling, these estimates are highly sensitive to the assumptions used, especially the relevant commodity prices in this case. The KPMG Econtech modelling assumed a return in the long run to mineral prices prevailing in 2004-05, significantly lower than their current levels. If higher prices were assumed instead, the distortion caused by royalties would be found to be lower, and so the welfare gain flowing from replacing them with a rent tax would also be lower.

These welfare gains also rely on the assumption that the decrease in royalty revenue is exactly offset by the gain in resource rent tax revenue. Essentially, the estimated gains are the product of a change in the distribution of the tax burden. The less profitable mining projects, those where royalties do most damage, would have paid less (or even had losses partly refunded, under the Resource Super Profits Tax). The more highly profitable mining projects would have paid more (without having much or any impact on their production and investment decisions, at least according to the theory that underpinned the modelling). Whether displacing State royalties with the MRRT would produce similar gains would depend on the precise details of the change.

Because most tax revenue, especially that from the major personal and business income bases, is collected by the Commonwealth, it will receive most of the extra tax that is collected as a result of reforms that increase the overall size of the economy. This is the case whoever undertakes the initial reforms.

For example, in the mid-1990s the then Industry Commission estimated that the proposed suite of National Competition Policy (NCP) reforms would result in a long-run increase in real GDP of around $23 billion a year (in 1993-94 dollars), which in turn would increase total tax revenues by around $9 billion a year. Around two-thirds of this was estimated to flow to the Commonwealth, even though its reforms were thought to generate less than one-fifth of the extra revenue.[19]

A key principle of the NCP reforms was that all governments should share in the benefits of higher tax revenue resulting from the reform program. The Industry Commission's analysis formed the basis for calculating the size of the 'competition payments' made by the Commonwealth to the States that effectively 'returned' to them their share of the fiscal dividend from the reforms.

Australia's acute vertical fiscal imbalance means that most of any fiscal dividend flowing from an improved, cooperative resource charging model along the lines outlined here would flow to the Commonwealth. The National Competition Policy model offers a useful template, which the Panel endorses, for ensuring States get a fair share of this fiscal dividend, especially in cases where the dividend is the product of reforms partly implemented by the States themselves.

18 KPMG Econtech, CGE analysis of the current Australian tax system, Final Report, March 2010.

19 Industry Commission, *The growth and revenue implications of Hilmer and related reforms: A report by the Industry Commission to the Council of Australian Governments*, Canberra, 1995.

Recommendation 8.3

A negotiated outcome adhering to the following principles would secure and build upon the benefits of resource tax reforms already undertaken.

- *The MRRT and PRRT should be amended to sever the link between the royalty allowance provided and prevailing State policies. This would restore full accountability to the States for their royalty policy settings.*
- *State royalties on iron ore, coal and petroleum should be reduced (perhaps by around one-third).*
- *The Commonwealth should guarantee to increase payments to each State so as to offset the royalty revenue foregone.*
  - *Most of the revenue to do this will come automatically through increased MRRT and PRRT collections. The Commonwealth should consider tightening aspects of its resource taxes to ensure an approximately revenue neutral overall result is achieved.*
- *The Commonwealth and the States should jointly commission a credible, independent estimate of the fiscal dividend expected to flow over time as a result of these improved arrangements. This amount should be shared between the Commonwealth and the States following a similar approach to that used for the National Competition Policy reforms.*