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Managing Prosperity In The Next Mining Boom - Beyond the 'lucky country'

Address to the Australian Business Economists

Sydney

4 May 2010

Introduction

Thanks for having me here today, in what has to count as one of the busier weeks in our history to be a Federal Treasurer.

Since I am in Sydney today, I thought I might start my remarks not with the thoughts of a great economist, but with those of a great historian and favoured son of this town, Donald Horne.

Donald Horne was not the first to discover a great truism of public life: the idea that irony doesn't always translate well when it ventures beyond the narrowcast world of ideas and into the broadcast world of retail politics. I'm thinking of course of the reception given his most famous book, *The Lucky Country* from 1964.

Everyone in this room knows what I mean. Meant as a savage attack on the complacency of a country he saw as more fortunate than intelligent, the fate of Horne's great book was to be repeatedly misinterpreted as a celebration of how wonderful it is to live in a country with such good fortune.

It's still happening today, five years after his death.

Reading the report of the tax review over Christmas, and thinking about the Government's response, I found myself thinking about the lucky country.

Because what became clearer with every passing summer's day as I got more sand between each of the thousand pages of this review and started thinking about our response, is that our country was about to experience another of its trademark bouts of good luck. You could read it in the daily reports about commodity prices and the gathering global economic recovery.

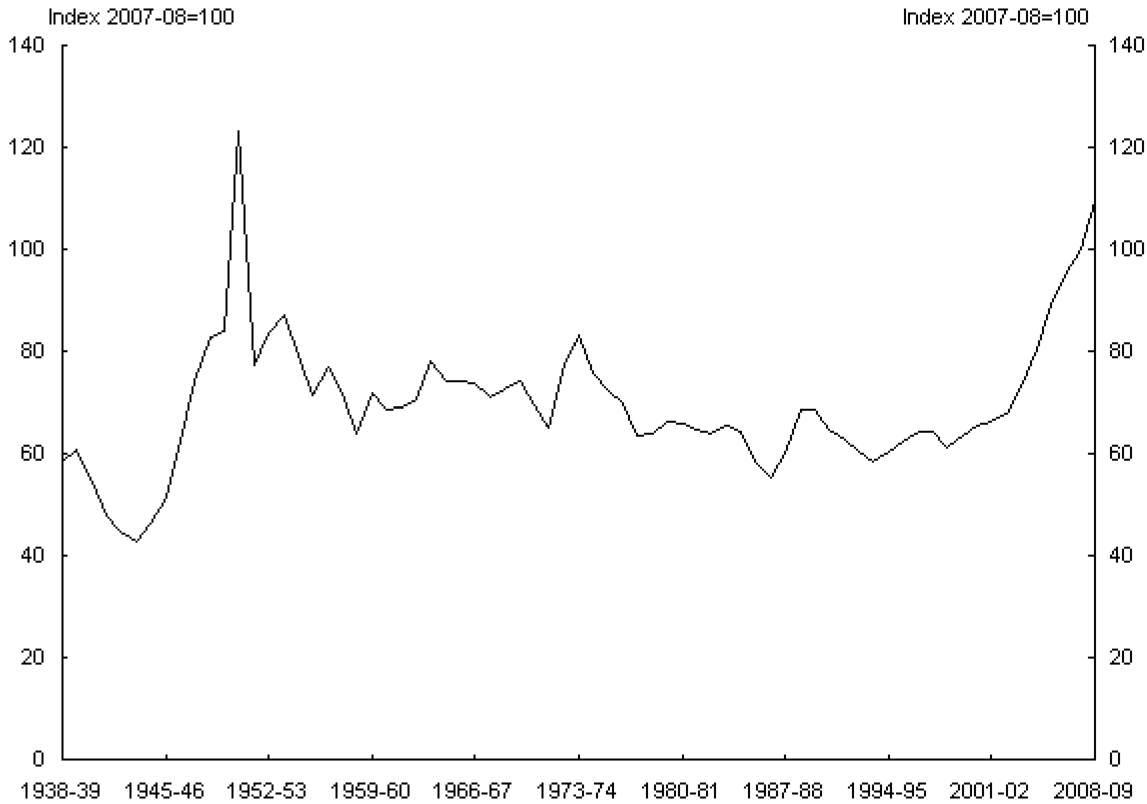
Perhaps it was being back with the family at Maroochydore for the briefest of beach holidays, but I couldn't help but remember how it felt precisely a year earlier, as we worked intensely on our fiscal stimulus package to rescue this country from the onslaught of a savage global recession.

But this tale of two summers was more than just a case of economic and emotional whiplash for the nation's Treasurer. For me, it got to the heart of our sometimes precarious economic existence in this part of the world.

It got to the heart of a frankly seductive and dangerous idea we have rarely properly confronted in this country: that luck and prosperity don't last forever, and when we have them, they must be managed and not just enjoyed.

What is by now obvious to every commentator and indeed every citizen in this country is that we are about to go through yet another extraordinary resources boom. Not since the Korean War wool boom of the 1950s have our terms of trade been as high as they were when we came into government.

Terms of trade



That raises the obvious question of whether we as a nation managed the last mining boom well. I doubt there is a single soul in this room who thinks we did.

I hope there are the same number of people as determined as I am that we will manage this next one well.

Today I want to talk to you about the challenges and opportunities that we face as we enter what has been called 'Commodity Boom Mark II'.

I want to start with a frank assessment of what we failed to do in Commodity Boom Mark I.

- We allowed capacity constraints to flash amber and then red all around the country, restricting our ability to develop our nation.
- We ignored the effect of the mining boom on the non-resource economy, and allowed the two-speed economy to take hold.
- We did far too little to save some wealth for the future. We simply spent too much of it.
- We simply assumed our resources industry would prosper during the boom, and did far too little to build a platform for future growth.
- And, of course, we failed to capture for the taxpayer a fair share of the wealth generated from the community's mineral resources.

Well, not this time.

I want now to go through each of these five failures in the past, and talk to you about how our tax policy will address each of them for the future.

Capacity Constraints

Let me start with capacity constraints.

We all remember the stories from Mining Boom Mark I of ships queued off the coast, waiting to be loaded with coal, and bottlenecks at our major ports. To some extent, this was and will remain unavoidable – supply can never perfectly match demand, and it won't always in future. But this mining boom is not unexpected, and we are acting to ensure we are well-placed to benefit from it.

This government has been the first to properly engage in providing critical national infrastructure. We established Infrastructure Australia and we have put in place critical capacity enhancing investments.

But we must do more.

This is why the Rudd Government will establish a dedicated infrastructure fund – to be built up with Resource Super Profits Tax revenue and dedicated to States according to their share of resource production. This is a unique partnership between the Commonwealth and the States that will provide much-needed funds to the States to address capacity constraints before they occur.

For the first time, infrastructure spending will be a permanent feature of State and Commonwealth budgets, starting with $700 million in 2012-13.

Sharing the Wealth

But capacity constraints are just one symptom of the broader problem we face in managing a resource rich economy at a time of high world demand.

Other countries have gone through similar experiences in the past – you may have heard of the 'Dutch disease' where the exploitation of natural gas in the 1970s is supposed to have 'hollowed out' the Dutch economy. Manufacturing and other industries found it difficult to compete with the higher exchange rate that bountiful resource exports bring.

In more extreme forms it is part of what is called the 'natural resource curse' – there are countries today that would have higher GDP per head if they'd never discovered oil.

Australia's own version is now known as the 'two-speed economy' – the non-mining related parts of the economy find it difficult to attract and retain workers and investment as they are drawn to the expanding mining sector.

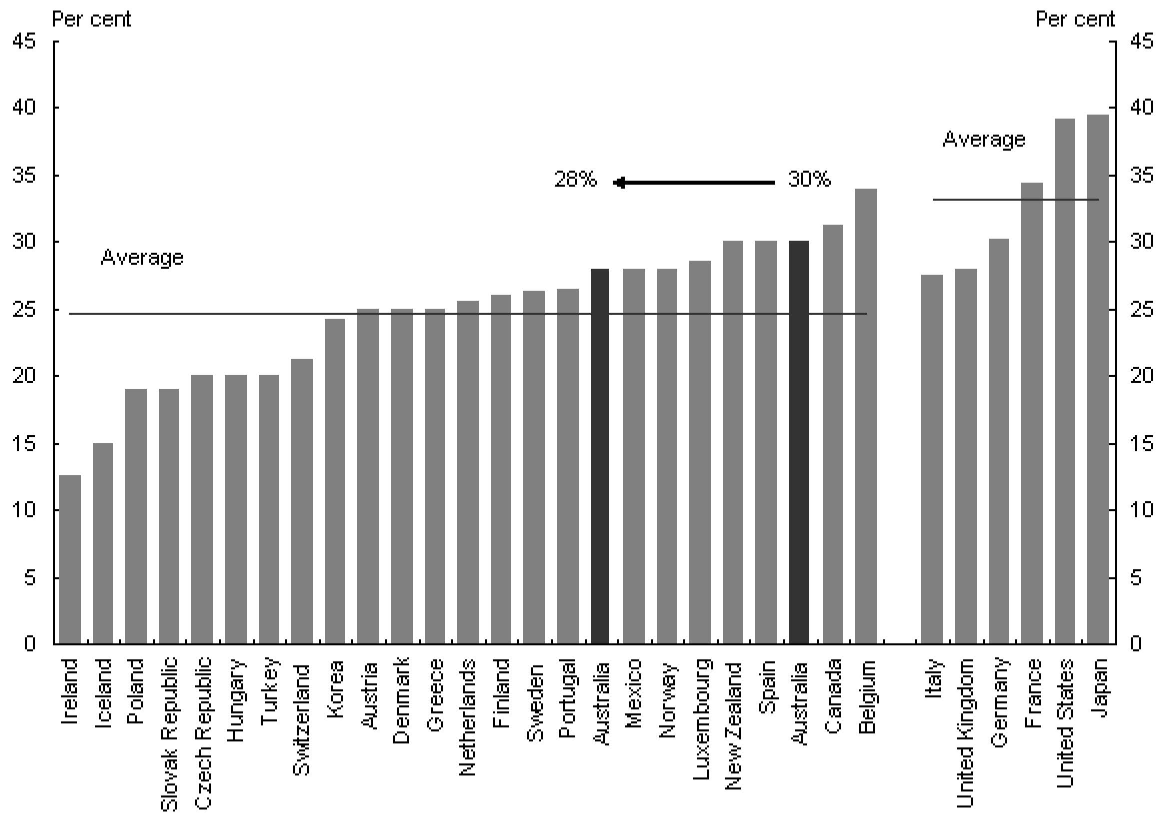
As I move around the country, I hear the same thing over and over again. The success of our resource sector drives up the exchange rate, making it hard for other Australian industries to compete on the global stage. I hear this from tourism operators in Queensland to manufacturers in Victoria. I also know it affects the ability of smart new industries to start up and grow in Australia.

Now this should never be taken as an argument somehow to slow the fast lane of the resources sector. We would never agree with that argument, and indeed our tax package does no such thing.

The task is to grow our economy together, not have the success of one part come at the expense of the other.

That is why we believe that some of the revenue from a Resource Super Profits Tax must be dedicated to cutting the company tax rate and providing a better tax deal for small business.

Australia's corporate tax rate at 30 per cent and 28 per cent compared to other OECD countries



Enhancing our nation's business tax competitiveness is a solution for the long term, and a solution that will grow investment and job opportunities across our economy.

By cutting the company tax rate by 2 percentage points and removing the economic effect of royalties, the Government's tax plan is expected to increase GDP by 0.7 per cent and real after-tax wages by 1.1 per cent in the long run.

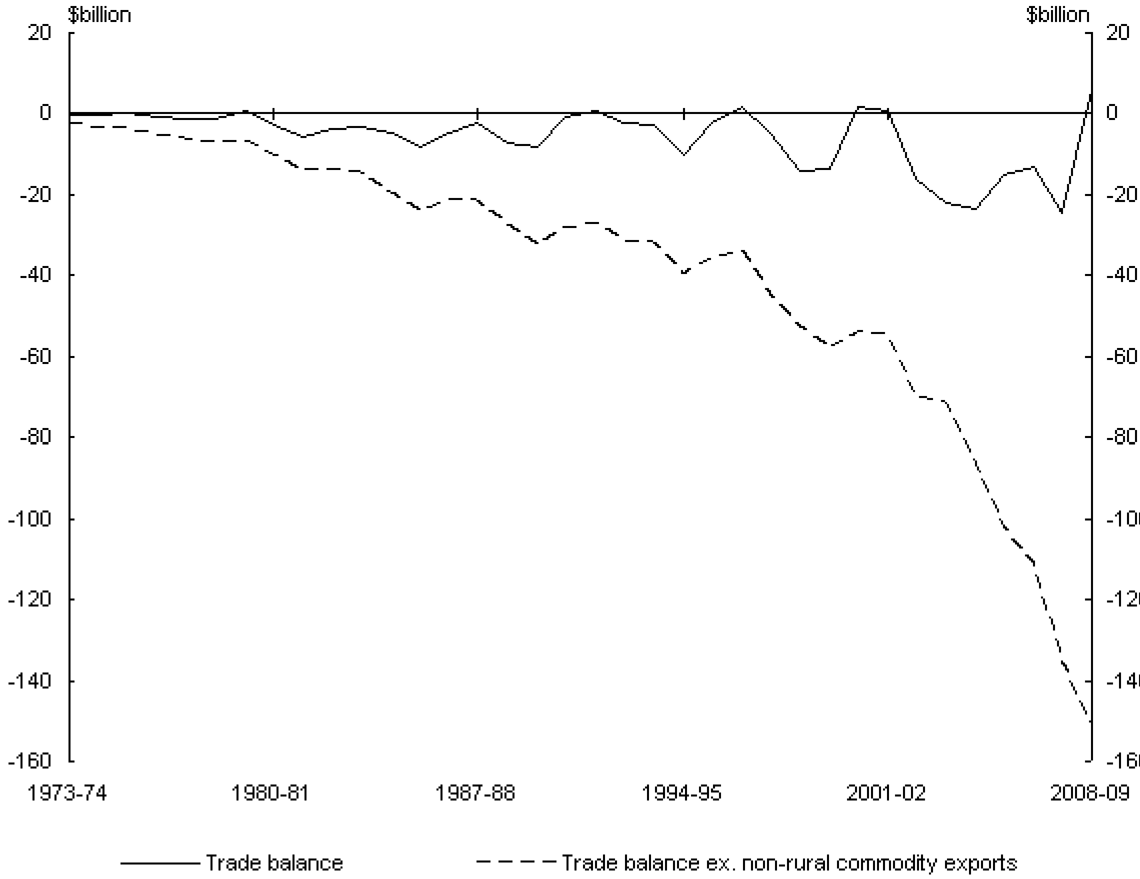
Providing small business with an instant asset write-off will deliver ongoing tax and compliance savings to many hardworking small businesses as they purchase business assets.

Managing the Wealth Sustainably

The further challenge for us looking forward is how to best manage the wealth generated from the boom.

This chart shows what the balance of trade looks like without including mineral exports.

Balance of trade



You can see that mineral exports are an increasingly important means for us to finance our current lifestyle. We would all be much poorer, if not for our mining exports.

But minerals are also non-renewable. And whenever you sell something non-renewable to pay for something that recurs every year, there is a very strong case to save some of the revenues for the future.

One such idea is for a new sovereign wealth fund to hold our resource wealth for a rainy day and to prevent the revenues from fuelling consumption, to prevent a recurrence of the early years of the current century.

That's a fine idea, but we have a better one.

Instead of investing in one sovereign wealth fund, why not invest in millions of them? Why not invest in everyone's superannuation accounts? The wealth will not be controlled by government, but will be the property of working people.

Low income earners will have the tax rebated on their superannuation contributions and those approaching retirement will have more generous contributions caps. Businesses benefiting from a lower tax environment will be asked to contribute as the superannuation guarantee is raised to 12 per cent, starting with a ¼ per cent rise from 2013-14.

Rather than being spent on inflation-fuelling consumption, the wealth from the ground will be returned to a different form of national saving – one that is less subject to the vagaries of mining prices; that is not appropriable by government; and that will redress some of our long-term fiscal challenges.

And of course, this time the benefits would flow to all Australians, but particularly those on lower incomes, such as women with interrupted work histories.

A Platform for Resources Industry Growth

I mentioned above that I believe we did too little during the last mining boom to build a platform for future growth of our resources industry. This is something we have explicitly sought to remedy in this reform package.

Now I understand that the introduction of a new Resource Super Profits Tax will always capture the headline, but I also know a roomful of economists would never let it obscure the real economic effects.

The fact is, the Government's reforms will tax the mining industry better. In fact, the most significant 'spend' in the entire tax package is over $8 billion every year in State government royalties that will be refunded or credited to mining companies.

Mining investment, jobs and production are all expected to grow when the Resource Super Profits Tax effectively cashes out these royalties. This is because royalties apply no matter how profitable a mine is.

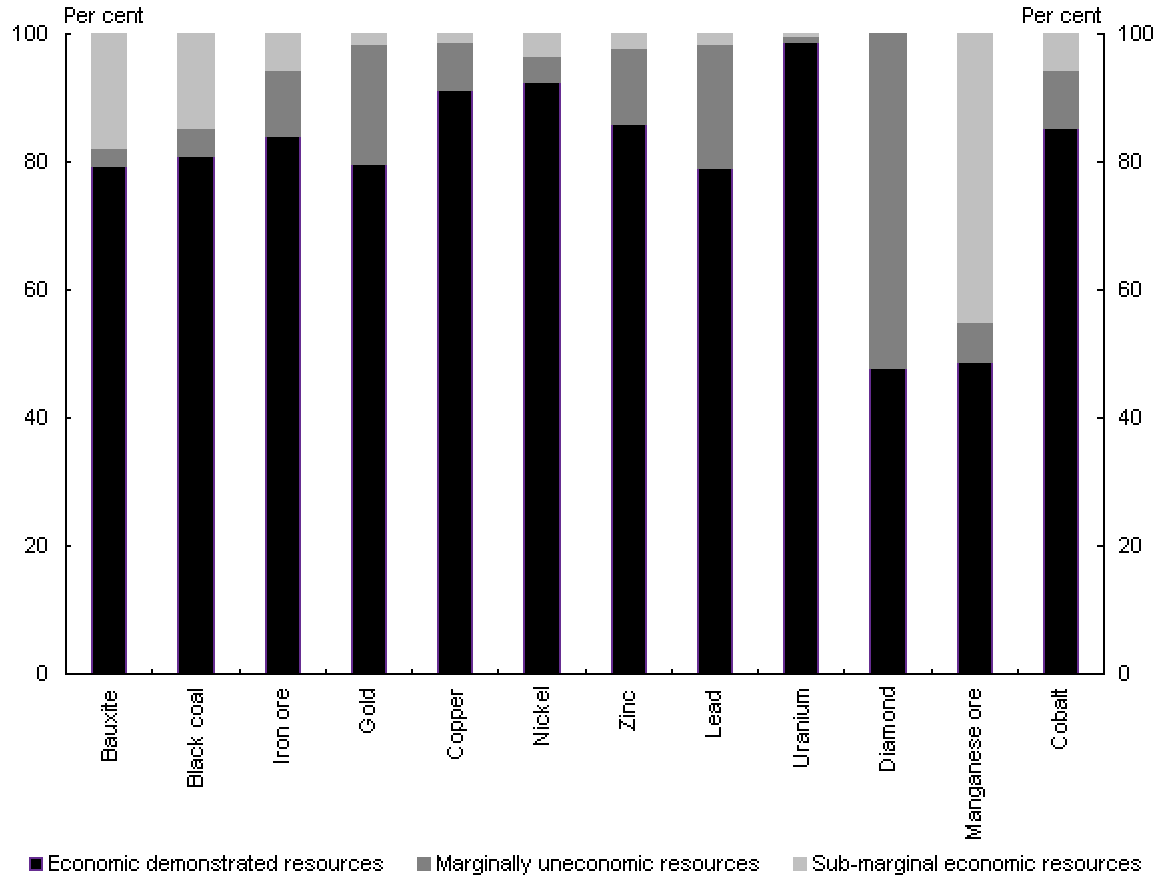
Royalties are generally levied on revenue or the volume produced, whereas the Resource Super Profits Tax only taxes mines that earn super profits. This means start ups and projects that are more marginal will be relatively advantaged under our new system.

Cashing out royalties with the Resource Super Profits Tax will increase Australia's economic resources by allowing existing mines to operate longer or at higher capacity and by fostering investment in new mines.

As I like to say, this better tax treatment will put extra rungs on the bottom of the resource industry ladder, really helping those miners who struggle to get a solid start because of the combined impact of heavy upfront capital costs and royalties. And, put simply, if you can't grow small miners, they will never become big ones.

As this chart indicates, at any point in time, in addition to economically viable reserves there are likely to be significant known reserves that are marginally uneconomic. The Resource Super Profits Tax will reduce the cost of production for marginal projects, making some resources that are currently not economically viable, profitable to extract.

Estimated economic and marginally uneconomic resources in Australia



As at 31 December 2008. Source: Geoscience Australia. Marginally uneconomic demonstrated resources are those that could be produced given limited increases in commodity prices or cost-reducing advances in technology. Sub-marginal economic resources are those that would require a substantially higher commodity price or major cost-reducing advance in technology, to render them economic.

Independent modelling suggests that mining investment will be 4.5 per cent, jobs 7 per cent and mining production 5.5 per cent higher in the long run. These are not the Government's numbers, or even Treasury's; they are from the independent economic modellers KPMG Econtech.

Of course, there is always debate about the exact size of impacts predicted by economic models – I'll let the modellers sort that out amongst themselves. But what the models do consistently show is the direction – and that is that taxing resource companies on the profit they make, rather than just how much they dig out of the ground, should encourage more investment in mining.

This is not just theory, it has happened before.

The move to a super profits-based tax 20 years ago, the petroleum resource rent tax (PRRT), rejuvenated investment and production in offshore petroleum. Before PRRT, all the discussion was about the short remaining life of Bass Strait resources. Today Bass Strait is the largest producer of crude oil and second largest producer of LPG and condensate in Australia.

You will also hear quite a lot about sovereign risk – that is, that changing government policy can affect confidence and investment, particularly from overseas.

Any change generates uncertainty and can be portrayed as raising risk. That means we should not change our tax regime all the time but it does not mean we are stuck for all time with the system we have now.

In fact, in my view, the introduction of the Resource Super Profits Tax substantially reduces sovereign risk. Unlike seven different State and Territory royalty regimes which are subject to frequent change, this regime will be locked in.

The inefficiencies and complexities in the current system is the reason why the Minerals Council of Australia indicated support for profits-based taxation of Australia's resources in its submission to the independent tax review.

But we do also very acutely understand the need to get the transition right, especially for existing projects.

We moved very quickly on Sunday to set up our Resources Tax Consultation Panel, and have already begun discussions with companies. The Panel will be working intensively over coming weeks and months to sort through the technical details of transition to ensure the Resource Super Profits Tax is implemented smoothly from 1 July 2012.

A Fair Share

I want to finish with some thoughts on perhaps the central concern the resources industry has had with our new tax arrangements.

I'm not going to deny the obvious – the most profitable mines in this country will pay more tax under the Resource Super Profits Tax. I'm also not going for a minute to deny that the owners of those mines will object to that. It's a free country, and they're absolutely entitled to voice their displeasure.

They will, as they should, prosecute their interests. As I should prosecute the national interest.

Let me talk about that national interest for a minute.

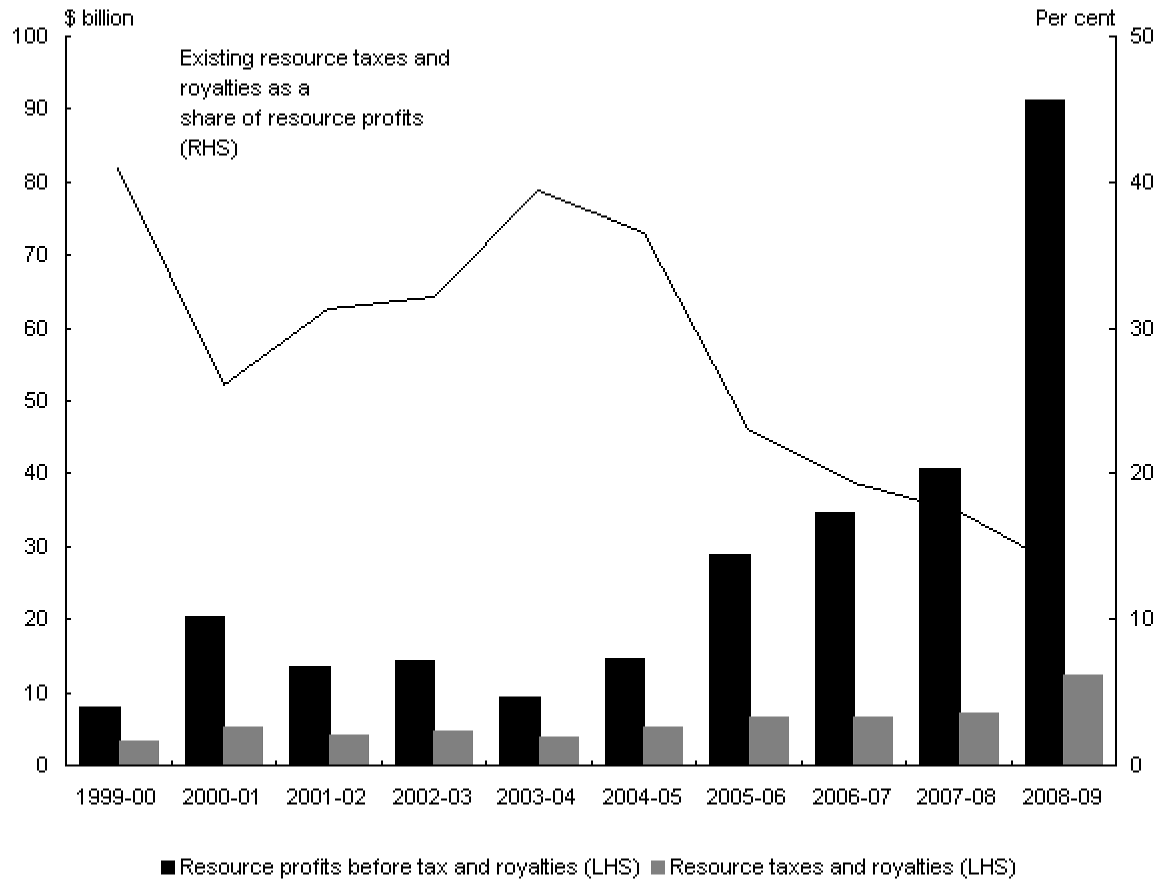
Let's look at how the Australian people have benefited from the most recent mining boom. In 2008-09, the resource sector is estimated to have generated close to $90 billion of 'super profits' – by this I mean profits above what a competitive business would normally expect to earn – while the current resource charging arrangements – State royalties and Commonwealth excises – only collected $12.3 billion.

Because the royalties and excises tend to be based on volume or value, they do not rise with profits. While resource super profits have been booming, royalty receipts have been flat.

The effective rate of resource charges in 2008-09 was less than half its average over the first half of the decade. Royalties as a percentage of super profits have fallen from an average of 34 per cent over the first half of this decade to less than 14 per cent in 2008-09.

The case for a resource tax regime based on profits, not production, is illustrated by this chart – as the profits from our nation's resources have increased, the taxpayer's share of those earnings has decreased.

Existing resource profits and taxes



There is no reason why this should be the case. If the taxpayer's share of resource rents had remained constant over the past decade or so, Australian governments would have collected $35 billion in additional revenue. That's $35 billion that could have funded:

- The shortening of hospital queues by financing an additional 8.5 million hospital visits; or
- An additional 87,000 residential aged care places.

In coming weeks you will see and feel a lot of heat and light around the Resource Super Profits Tax, but at its core is exactly this point – that the share of profits the Australian people get from the development of resources (resources they own 100 per cent) should not fall as those profits increase.

Australia's non-renewable resources have simply been underpriced for too long.

Conclusion

This, my friends, is my vision for finally addressing Australia's historical legacy of being luckier than we have been smart.

Like any vision, it will have its detractors – it does already. But I want to challenge everyone to recapture the national unity we showed in shielding Australia from the global recession and harness that unity to manage the mining boom.

And as I said at the start, the boom does need to be managed. If we think it is simply a matter of sitting back and watching the largesse roll in, we will be guilty of the same failings as our predecessors.

Even the most fortuitous events need to be managed. We didn't sit back and watch the recession happen, we mustn't sit back and allow the boom to be wasted.

I used the metaphor earlier in this speech of my tale of two summers – the first confronting global recession, the second a renewed mining boom. Let me finish on another summery metaphor – one that as a very part-time but very enthusiastic surfer is close to my heart.

I hope that through far-sighted reforms like the ones I have outlined today, we may get beyond being a nation which can ride a wave or two for a minute or two, only to be dumped and begin the hard paddle in search of another wave. I hope we can ride this wave – building now – all the way into the shore.

Thank you.