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Competition Policy

By **Professor Allan Fels**
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Here is a typical true cartel story. For twenty years two major firms dominated the Australian freight express business – which transports parcels and packages from one city to another. They had a secret agreement that assigned customers (called 'pets') exclusively to one or the other. They agreed not to poach pets from one another. If customers tried to switch suppliers, the competitor would quote a high price and that would usually be the end of the matter. Occasionally, however, a customer would switch supplier but then receive very bad service: urgent overnight deliveries from Melbourne to Sydney would arrive several thousand miles away in Darwin a few days later or get lost. In the jargon of the companies they were trying to 'burn' customers to induce them to switch back. If burning failed the firm would try to compensate its competitor by getting rid of one of its existing customers of like size by sharply rising prices or by reducing service quality. Occasionally financial compensation was paid instead. All this was done to avoid competition and raise prices.

The Australian Competition and Consumer Commission (ACCC) successfully broke up the arrangement and with much fanfare had the firms fined about $AUD13million.

There were occasional attempts by new competitors to enter the profitable market. However, whenever this happened, at least one of the firms would quote prices well below that of the new entrant. They often quoted prices that were well below their costs: if the variable or marginal cost of overnight delivery between Melbourne and Sydney was $50 then they would quote at $30. This drove most competitors out of the market. Legal action to recover damages under the competition law was eventually taken by one of the surviving competitors.

After the cartel was broken up one of the players came to the Commission and claimed that there was only room for one firm in the market. Could they merge? If so a great deal of duplication would be eliminated, cost savings would occur and the customer ultimately would benefit from lower prices. The combined firm would also have the scale to enter into overseas markets. However, from the ACCC's perspective, such a merger seemed anticompetitive, and would have been likely to cause higher prices. So the ACCC opposed the suggestion.

Yet as serious competition broke out the ACCC received some information from people within one of the firms which suggested that the advertised claims that packages were transported by *air* from one capital city to another were incorrect. The ACCC tested this by sending some packages of its own which included altimeters. On collecting the packages the altimeters showed that at no stage had the parcel been more than 300 metres above sea level indicating either that the planes tended to fly rather low or that there was misleading and deceptive conduct in breach of the consumer protection provisions of the Trade Practices Act.

Let Us Draw Some General Conclusions

Cartels – secret agreements between competitors not to compete, to raise prices, to restrict service – are a great temptation for business. The gains can be large. The global vitamins cartel ran for nine years, raised prices by seventy five per cent and made billions around the world for the conspirators. Cartels are also hard to detect increasing the incentive to operate them. However, they do great economic harm – to business customers and consumers – bring no offsetting economic or social benefits and are unethical. In most OECD countries including Australia it is unlawful for competitors to agree to share a market so that they do not compete against one another. It is also unlawful for them to agree on prices or to rig bids. Anticartel laws are a core component of competition law.

To cut prices in response to a new competitor is not generally unlawful. This is competition at work. However, to cut prices persistently below variable cost to eliminate a competitor is usually 'predatory' and unlawful. Predatory behaviour breaches abuse of market power (or abuse of dominance) provisions of competition law. In Australia it is unlawful for a firm with a substantial degree of power in a market to take advantage of that power in order to eliminate competitors or deter them from competing where this harms competition. There is nothing wrong with being a monopoly under competition law – monopoly may be the result of a business being more efficient than its competitors. It is, however, unlawful in most OECD countries to engage in acts of 'monopolisation' or 'abuse of dominance' that is to use market power illegitimately to prevent competition, for example:

- by systematically pricing below variable cost to destroy small players or new entrants;
- by refusing to supply where the purpose or effect is to lessen competition;
- by engaging in a range of restrictive practices such as exclusive dealing (supplying a customer on the condition that it does not purchase from a competitor) where this is anticompetitive;
- by engaging in resale price maintenance (requiring a retail purchaser not to sell below a specified minimum price).

Such anticompetitive behaviour by business harms competition, efficiency, business opportunity and innovation. Such behaviour ('monopolisation' in US jargon) has been unlawful in North America since the time of Rockefeller and is still so as Mr Gates has discovered in the Microsoft case. It is, however, a field in which difficult judgements are often required: when is pricing below cost a sign of intense competition and when it is a sign of damaging anticompetitive behaviour? Up to a point, an abuse of dominance law has a powerful pro-competitive effect. Carried too far it can chill competition.

The merger proposal incident described above highlights the fact that some mergers can be anticompetitive and that this can often be their real motivation. When Australia introduced a trade practices law in 1965 it prohibited anticompetitive agreements but not mergers. This put an end to some price-fixing arrangements between competitors but they then nearly all merged, achieving the same effect as the former anticompetitive arrangements. This is one reason why merger provisions are needed and since 1974 have been part of Australian competition law – to prevent outlawed cartels from merging to become a monopoly.

Not all mergers are anticompetitive. Moreover, unlike cartels, they can bring efficiency benefits. Indeed it is possible under Australian law if a merger is anticompetitive to have it 'authorised' if the applicants can demonstrate that the benefit to the public exceeds the harm. The job of the ACCC and its appeal body – the Australian Competition Tribunal – is to distinguish between those mergers between competitors which are of benefit to the public and those which are merely trumped up excuses for reducing competition in the Australian market.

Regarding the false claims about air transport, not only was this behaviour misleading and deceptive with respect to customers, it was also unfair for others in the industry who were ethical. It was a form of unfair competition. It did not enhance the industry's reputation. It also meant that competition did not work well: competition only works well if consumers are informed properly or at least not wrongly informed about the nature of the products or services being offered on the market. Laws about misleading and deceptive conduct, and consumer protection more generally, are best regarded as a part of competition law, and in about half of the OECD countries, including Australia, they are administered and enforced by competition regulators.

STUDENT ACTIVITIES

1. Visit the ACCC website <http://www.accc.gov.au/content/index.phtml/itemId/816373> and find definitions/explanations of the following terms: Cartel, Monopoly, Predatory Pricing, Merger, Exclusive Dealing, Resale Price Maintenance and the Trade Practices Act?
2. List some examples of the techniques used by businesses to reduce competition.
3. What are some of the claimed benefits associated with company mergers?
4. How might mergers bring about an anti competitive market?
5. What were the ACCC's reasons for banning the proposed airfreight merger? Do you agree with them?
6. Why does competition law allow for the existence of monopolies?
7. Explain why 'monopolisation' is seen as unlawful.

The preceding discussion leads us to a very brief summary of the basic elements of competition law.

Competition law applies to businesses (usually including publicly owned ones) and is designed to break up cartels, anticompetitive mergers, the abuse of market power (or dominance) and misleading and deceptive conduct. It takes the form of statutory prohibition both of:

a) a general nature, for example all arrangements between businesses which substantially lessen competition are prohibited by law; and

b) a specific nature, for example price fixing arrangements between competitors are automatically prohibited, irrespective of whether they affect competition. The reason for automatic prohibition is that the arrangements are assumed nearly always to be harmful to the economy and are rarely or ever offset by any benefits to the economy. Accordingly it is considered best to ban them automatically rather than consider the economic effects of each arrangement individually before banning them. Resale price maintenance is treated similarly.

Competition law is administered and applied by an independent regulator which has powers to investigate behaviour it believes may be unlawful.

In North America and Australia such regulators play a prosecutorial role: they collect evidence, seek to prove their case in court, and obtain court orders. In Europe the regulator itself may have power to make orders, including fines (although appeals may usually be made to a court).

Competition law can only work effectively if there are credible, adequate sanctions. Courts can impose injunctions, fines, gaol sentences, damages and other orders.

The penalties under the Trade Practices Act have until 2009 taken the form of fines and sometimes damages can be added on. But are fines sufficient in all situations? Recently Australia decided to join a number of other countries in having the possibility of jail sentences for collusion on prices, market sharing and bid rigging because fines alone were an insufficient deterrent.

An important feature of competition law in North America and Australia is that it is also possible for individuals, including individual businesses, to take action themselves. They can sue for damages and injunctions (but not fines) in a court. This is a very important and powerful backup to competition law that usually works well.

Some features of competition law are:

- Most often the direct beneficiaries of enforcement action under the Trade Practices Act are businesses (especially small businesses) rather than consumers. On balance most businesses gain from competition law.
- In some areas, there is a fine line between competitive and anticompetitive behaviour. An example is when a monopolist reduces prices in response to entry by a new competitor.
- In other areas, there may be a trade off between competition and efficiency, for example, some mergers may allow

the achievement of scale economies at the expense of competition.

- The treatment of monopoly has some special features. As noted, monopoly itself is not unlawful. Monopoly may, after all, result from a firm being more efficient than any other competitor or potential competitor and thereby eliminating them.
- In Australia there is no power to break up monopolies. In the United States the law goes a step further. There is power to break up a monopoly where it has actually acted anticompetitively in breach of competition law. There is, however, no power to break up a monopoly without there having been some anticompetitive behaviour.
- In competition law, there is normally no prohibition on the prices which a monopoly charges even if they are considered excessive.
- The law applies to all or nearly all forms of business. However, the millions of small businesses are generally unaffected by the law and/or are exempt when there is some possibility that a technicality might catch them. Of greater importance, however, is the fact that there is pressure from nearly every sector to gain exemptions from the law on the grounds that their circumstances are special.
- In Australia we have an interesting way of dealing with claims for exemption. If someone believes that the law should not apply to them they may apply in public to the independent regulator (the ACCC) which holds a public hearing before deciding whether they should have so called 'authorisation' to continue to engage in anticompetitive behaviour. This is an alarming sounding exception to the competition law but in practice the regulator has been extremely strict and does not grant many authorisations.
- Anticompetitive behaviour can occur on a global scale but there is no global competition law or regulator. When a global cartel is detected, however, it is usually possible to obtain fines and damages at national levels: this is a reason why a domestic competition law is desirable. If the US, for example, uncovers a global cartel, a local regulator can often piggyback on its actions to obtain fines and damages where local harm has occurred providing there is a local law.
- A considerable administrative and legal apparatus is needed to apply competition law. It can take years to build up.
- Around the world the law has limited relevance to some important state-owned utilities in areas such as telecommunications, public transport, energy and water. Very often these are monopolies protected by statute from entry by competitors. Being a monopoly there is no competition to collude with, to take over or to take monopolisation action against. But having a protected monopoly can be economically harmful. To deal with it requires more than the application of competition law.
- Competition law regulates anticompetitive behaviour by businesses. It does not apply to, nor override, the many actions of governments that limit competition.

STUDENT ACTIVITIES

8. Outline the purpose of competition law.
9. What does this law prohibit?
10. What penalties can be applied under these laws? Explain some of the limitations of these penalties.
11. Why would possible gaol sentences be a greater deterrent than fines?
12. Explain why preventing mergers and the existence of monopolies could bring about a 'less efficient' economy?
13. What is the main weakness of trying to enforce competition law on a global basis?
14. Why is this law of limited relevance to some important state owned corporations?

Media Watch

Visit the ACCC Media Centre by clicking on the following link:

<http://www.accc.gov.au/content/index.phtml/itemId/2328>

Select one of the cases shown and prepare an oral presentation to your class which outlines why the business is being investigated or the subject of a report.

You may also use newspapers, other media and sites such as You Tube to collect evidence of other businesses which may be under investigation for breaching competition laws.

You Decide

A large paint retailer has approached you in your role as Chair of the ACCC about a proposed merger with another paint retailer. The result would be that the merged group would control over 50 per cent of the retail market in most of the major cities and towns around the country. The argument that they present is that this will result in them being able to acquire economies of scale, increased efficiency in buying power and reduced distribution costs for their goods and ultimately lower prices for consumers. Submissions from those opposed to the merger argue that it will lessen competition as the larger chains will force smaller competitors out of the market and ultimately result in higher prices for consumers.

What would you decide? In your answer include evidence from the article to support your views.

Further Reading

Brenchley. F, 2003, *Allan Fels: A Portrait of Power*, John Wiley & Sons, Milton.

Miller, R., 2010, *Miller's Annotated Trade Practices Act – Australian Competition & Consumer Law*, Thomson Reuters Lawbook Co., Australia.

The Australian Competition and Consumer Commission (ACCC) 1999–2009, *Annual Reports*, ACCC, Canberra, available at < http://www.accc.gov.au/content/index.phtml/itemId/668577>

Taxes And Charges On Nature's Bounties

By **Thilak Mallawaarachchi,**
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Resource Rent Tax became an issue of controversy and intense national debate after the 2 May 2010 National Budget, which culminated in the replacement of Australia's Prime Minister. In this article, we outline the incidence of economic rent in natural resources in relation to a non-renewable (iron ore and coal) and a renewable natural resource (surface water). The rationale for imposing taxes and user charges to capture those rents in the public interest is then examined.

The concept of resource rent has its roots in the history of economic thought. Ricardo stated in the *Principles of Political Economy and Taxation* that rent is a payment for the 'use of the original and indestructible powers of the soil'. Here, the term 'soil' implies all the natural resources embodied in land, unimproved by human effort. And in the current context, it would include the uses of land in relation to agriculture, energy, minerals, water, forestry, fisheries and for conservation.

Land, as a natural endowment, or a gift of nature, has no production cost; it exists irrespective of its use and is immovable and indivisible in the sense that its supply is fixed. The price we pay for a parcel of land is for its ownership, and to secure access for its use. Because a parcel of land can be put to alternative uses, and its purpose varies between parcels, the price of land will vary reflecting its earning capacity and the level of demand. In rural uses, more fertile land and those carrying mineral deposits would fetch a higher price than those which are infertile or have no mineral deposits. On the other hand, in urban areas those close to amenities fetch higher prices, than those away from places of interest. Location, location!

Therefore, economists generally consider rent as a premium due to scarcity, owing to properties of the land that determine its productive potential in alternative uses. The price of land may therefore be expressed as a transfer price which permits the owner access to a stream of income, equivalent to its annual rent in perpetuity. This then is the capitalised value of the annual rent estimated by dividing the annual rent by the rate of interest.

Some properties of land that earn this premium are indestructible – such as the location, topography, and some physical features; while others may not be depending on the nature of use.

In regard to this capacity for land to undergo changes through use, economists consider resources in different categories. *Renewable resources* such as surface water or a fishery can regenerate themselves under a sustainable management regime. On the other hand, a mineral stock, such as coal or iron ore is *non-renewable* and *exhaustible*, as extraction can only be done once.

For a landowner considering alternative options to use a parcel of land, recognition of these resource characteristics are important in making better decisions.

The object of sustainable management of resources is to ensure an efficient flow of goods and services from the available fixed assets. For a resource owner this involves maximising the net benefits.

In considering one use, over other alternatives, the resource owner needs to consider the benefits in the best alternative use – the opportunity cost. The difference between these two entities – the rent and the opportunity cost, represents pure profits or economic rent from this allocation.

Once the asset is allocated to a particular use, say mining or agriculture, the operation enters the *production* phase. Production involves the services of capital, labour and other 'sacrificial' inputs. The cost of these inputs and the supply price of the goods and services derived from production, say iron ore or farm outputs, will determine the nature of profits from production. Given world prices and competitive markets for inputs, the profitability of production is determined by the entrepreneurship, the way businesses are structured and risks are managed. Because the object of production is to maximise returns to production inputs, profitability is not predicated on the level of rent paid for transferring land into production. Of course, rent paid will have an impact on the level of net surplus that accrues to the mining operator, and they will ordinarily try hard to keep it.

The question is: who is the legitimate owner of these rents?

As the supply of land is fixed, and it being a gift of nature, rent derived from land is often regarded as a pure profit. As this portion of profit is not related to the entrepreneurial ability or the risk taking behaviour of investors, but purely reflects scarcity, it should fall in to the hands of the resource owner. It is a compensation for the resource owner for the loss of wealth from the depletion of the resource as a result of extraction.

The rent can therefore be appropriated by the owner of the resource, or the taxation authority where the natural resources are held in public ownership, without affecting the level of investment or production. As the Australian Constitution accords mineral rights to the States, taxes and royalties are levied by each State to recover these rents.

Then the next question is: how best to impose these taxes, in ways to meet the best social gain? The challenge is to let the goose that lays the golden eggs do her job.

Similar to a good old farmer who carefully nurtures his flock of geese, taxation authorities generally follow a number of accepted principles to minimise the tax burden on individuals and businesses:

- *Equity* – the principle of equality, whereby those taxpayers of similar financial means should pay similar amounts of tax. This includes progressive taxation where taxpayers of greater financial means pay at a higher rate than those with lower financial ability.

- *Benefit* – the concept of mutual benefits, that there should be some relationship between the tax paid and the benefits received by the taxpayer.
- *Capacity to pay* – involves a degree of fairness, with regard to the ability of the taxpayer to pay the tax, taking account of the financial circumstances.
- *Efficiency* – in regard to the desirability of the tax in terms of affecting taxpayers' economic behaviour, such as business continuity and incentive for risk bearing.
- *Simplicity* – in its definition so that the tax is readily understood and acceptable, and unambiguous, enabling ease of collection and administration.

Having considered the above, a resource rent tax on minerals is widely accepted as an efficient tax, as is well-argued in the Henry Tax Review. The Review remarked that the new tax:

> '… would enable the community to collect a greater and constant share of the return on its non-renewable resources. It would also promote an efficient level of output by reducing distortions to investment and production decisions as well as reducing sovereign risk over the long term.'

As Ross Garnaut[1] has emphasized in his recent lecture, 'mineral taxation is an area in which the identification of rent has a clear and practical meaning', because improper identification and specification of the tax can violate the above stated principles and diminish its policy credentials.

As identified earlier, because the rent represents the loss of wealth from the extraction of the resource, the most efficient way to tax mineral resources is by levying it on the value of the minerals at the mine gate.

It appears that the proposed Mineral Resource Tax is consistent with these principles. With the demand for mineral resources forecast to increase, in keeping with recent trends (Figure 1), the timing of the tax seems appropriate.

STUDENT ACTIVITIES

1. Use the article and your text to find definitions and examples of the following terms:
   - Natural resources
   - Renewable and non-renewable resources
   - Public interest
   - Transfer price
2. Explain in your own words what David Ricardo meant by the term resource rent.
3. According to the writer, why does the value of land vary?
4. Explain why the 'price of land can be expressed as a transfer price'.
5. What do pure profits or economic rents represent?
6. Why would the States prefer the current system of taxes and royalties to the proposed Federal Government Mining Resource Tax?
7. Why is the Henry Resource Rent Tax claimed to be a more 'efficient' system of taxing the mining industry?

Water Allocation In The Murray-Darling Basin

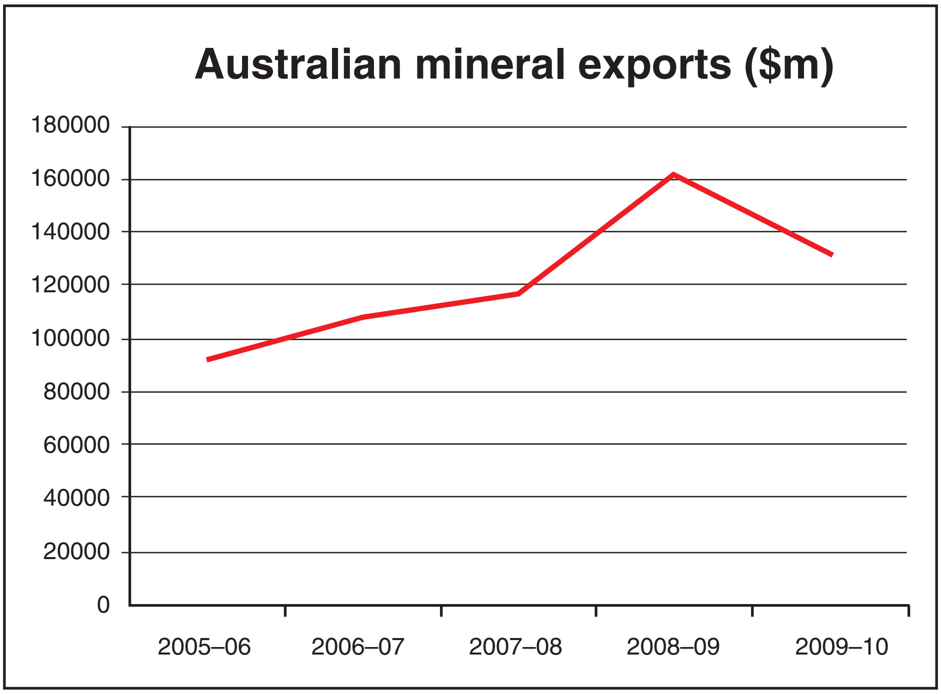
Water has been another issue of public controversy over recent years as growing demand and supply constraints under climate variability have increased the scarcity of water across all uses.

Now let's look at the way in which irrigation water has been allocated in Australia, and how recent reform has affected the way it is being priced.

In contrast to other minerals, water is movable, as it flows naturally, and can be used repeatedly, albeit with some losses and depletion in quality. For practical purposes, water is considered a renewable resource.

Because water is naturally mobile, property rights to water were traditionally attached to land where water was used. In the Murray-Darling Basin, for example, irrigation licences have been tied to the land making them exclusive and non-transferable as a separate asset, but providing a source of

Figure 1: Recent mineral exports



Source: ABARE

reliable supply enabling a guaranteed source of income. This was consistent with the social objectives of development of irrigated agriculture as a central component of the policies of closer settlement and national development that were adopted from the nineteenth century to the late twentieth century.

Around 1980, serious concerns about the social costs of land degradation and river salinity, toxic algal blooms and rising budgetary costs in maintaining public irrigation systems led to a rethinking of ways to manage water resources to improve net social benefits. In particular, the Council of Australian Governments (CoAG)-led National Competition Reforms in 1993/94 sought to make the water industry more competitive by introducing a series of institutional reforms. The focus was to achieve an efficient allocation and management of water by allowing markets to play a greater role in providing signals about the value of water.

The key steps in this reform were:

a. separation of titles allowing flexibility for the transfer of water licences independent of the land title;

b. introducing a cap on diversions at catchment levels;

c. creation of water markets that allow the sale of water allocations and water licences; and

d. a move to full cost recovery pricing, whereby implied subsidies on water are removed.

These reforms were also accompanied by investment in irrigation infrastructure and incentives for improving water use efficiency. In more recent times, a program to buy back water entitlements and a Basin Plan that defines sustainable diversion limits have provided a means to define an exclusive environmental allocation.

While a move toward full cost recovery has provided better price signals to users, at present these charges do not include an explicit resource rent tax component. However, the differences in water charges levied on irrigators and the prices realised through water trading provide a useful indictor of the nature of rents available to water entitlement holders. Future increases in demand for water and greater restrictions being imposed with the introduction of sustainable diversion limits will likely increase these rents.

While there is no resource rent tax on water, in a number of jurisdictions explicit environmental management charges are levied on water consumed. But it is not clear whether the levels of these charges are proportional to the external costs imposed by water users on other parties. The new Basin water planning and management charge rules that will apply from 1 July 2011 may provide greater transparency in the application of these charges.

However, environmental charges may not be suitable for all water-related externalities and there are numerous difficulties in appropriately defining such charges in a way that provides incentives for private parties to act in the social interest. For these reasons it is unlikely that taxes that relate to resource rents or those directly addressing environmental externalities would become preferred policy choices in sustainable water management.

Rather, as scarcity of water continues to intensify there will be greater pressure to eliminate existing barriers for water trade and to use explicit measures to address environmental considerations. Water allocation is clearly an area where the use of economic instruments is proving to be more effective in meeting efficiency and equity considerations in natural resource management.

The volume of interstate trade increased from around 70 gigalitres in 2004–05 to 235 gigalitres in 2007–08, representing 18 per cent of the total traded volume. The price of water allocations was highly variable in 2007–08, both within and between trading zones, ranging from around $200 to $1200 per megalitre, about 4 to 15 times the administered water charges.

Recent experience with water trading has highlighted the benefits of water trading in improving overall water productivity. The benefits of conserving water have increased because of the drought and the resulting increase in temporary water prices. As irrigators widely recognise the scarcity of water, efforts to improve on-farm water use efficiency have enabled many irrigators to avoid serious losses in severe drought conditions.

STUDENT ACTIVITIES

8. Why is water considered to be a renewable resource?
9. By 1980, it became necessary to rethink the way we manage water resources. Why was this so?
10. Why were the key water reforms introduced?
11. How has the use of water changed since these reforms have been put in place?

Class Debate

'Our minerals belong to all Australians – not just the mining companies and their shareholders'.

Divide into teams to debate the above proposition. To assist you in preparing your arguments visit the following websites:

The Minerals Council of Australia website and read its views about the proposed tax changes <www.minerals.org.au/>

Prime Ministers statement on proposed Mining Resource Rent Tax <http://www.pm.gov.au/node/6868> and <www.futuretax.gov.au/pages/default.aspx>

Notes

[1] The new Australian Resource Rent Tax, www.rossgarnaut.com.au ;
Also check www.johnquiggin.com for commentaries on both the resource tax and water management issues.

The Australian Economy 2010–11 (Martin *et al*) and Australian Economic Statistics 2010–11 (Robert Prince) available online at www.warringalpublications.com.au

Media Watch

by **Ted Kramer**

Reserve Bank Of Australia, Speeches, Recent Developments

By **Glenn Stevens***, 9 June 2010*
Extract from Page 2, paragraphs 6, 7and 8
www.rba.gov.au/speeches/2010/

Turning then to the recent events in Europe, it is worth asking at the outset how these countries arrived at their current position. The story has many nuances by country but broadly, the public debt relative to GDP has long tended to be on the high side in Europe. It generally ratcheted up in successive economic downturns over the past three or four decades and efforts to get it down in the good times had only modest success. For some countries that joined the euro area the substantial fall in borrowing costs they enjoyed masked a degree of vulnerability, in that their fiscal sustainability depended partly on being able to continue borrowing cheaply. Demographic trends – pronounced in Europe, with some countries already experiencing declining populations – further highlight the problem. A high debt burden is much more easily managed in countries with higher potential growth prospects, one driver of which is population growth.

This problem was slowly but steadily accumulating over many years. Then the financial crisis occurred. There was a deep recession from which recovery is not yet entrenched. Budget deficits rose sharply as a result – reaching 10 per cent of annual GDP or more in a number of instances. The prospect of adding that much to the debt stock each year for even just a few years can make a difference to assessments of sustainability even for strong countries. For the not-quite-so-strong cases, markets began to signal unease. Borrowing costs rose for those countries, which of course makes the fiscal situation worse. And so on.

Initially the effect of these developments on financial markets was very much confined to Europe. Wider effects were observed in May as global investors became more cautious. Uncertainty over the nature of the policy response, and fears that it could be un-coordinated across countries, saw a marked increase in volatility in share prices and exchange rates. Our own markets have been affected along with everyone else's.

STUDENT ACTIVITIES

1. Identify one reason why the countries of Europe have 'arrived at their current position'.
2. Explain why a 'substantial fall in borrowing costs'can lead to problems in a country's fiscal sustainability.
3. Explain how demographic trends can affect a country's fiscal sustainability.
4. Explain how the financial crisis exacerbated the situation.
5. Analyse the effect of these events in Europe on the global economy.

Rio Profit Boost A Hint At Tax Millions To Come

By **Malcolm Maiden***, August 7, 2010*
Sydney Morning Herald, Weekend Business, Page 3 (Extract)

We are going to have to wait a few years to see exactly how successful Labor's downsized mining tax is, or, to take the opposite view, how much damage it does to mining profits.

But this week's June half-profit result from a rebounding Rio Tinto gave some clues. If the tax had already been in, Rio would have paid more. But it's not clear whether the big miners are generating the income the government expects in a couple of year's time.

The final, fine detail of the tax is a work in progress and will depend to an extent on choices each mining company makes.

The campaign against the 'mini-me' tax that is coming from smaller iron ore miners in the west could see it trimmed even further, through the exclusion of magnetite iron ore operations, for example.

Unlike the rich haematite deposits in the Pilbara, magnetite is not just dug up and shipped. It is subjected to a magnetic separation process first and can be compared with the conversion of bauxite to alumina, minerals excluded in the mining tax re-write.

The revised tax applies only to iron ore, coal and, in a parallel stream, oil and gas. Its base rate is 22.5 per cent – 30 per cent of 75 per cent of the gross operating profits of the mines – and the amount miners pay will depend on their mining costs, how much they are investing and on which of two options they choose when they enter the tax regime in 2012–13.

The miners can leave the balance-sheet value of their mining assets unchanged, in which case they will be able to depreciate them over five years, and they will be taxed only on profits that exceed a hurdle rate equal to the long-term Commonwealth bond rate plus 7 per cent (about 12 per cent currently).

Or they can rebook their assets to market value. If they do that there will be no hurdle rate and they will be required to depreciate the mine assets much more gradually, up to a 25-year mine life.

The Rio profit and the preponderance of earnings in the two divisions targeted by the tax suggests that the government is in the hunt to get the $10.5 billion it is budgeting for from the tax – $4 billion in 2012–13 and $6.5 billion in 2013–14 – three-quarters or more of which will come from the two majors.

STUDENT ACTIVITIES

1. What are the main companies and resources affected by the new tax?
2. What are the resources that are already taxed in a similar way?
3. Explain, in general terms, how the tax can be calculated.
4. How much revenue is likely to be generated by the new tax?

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