GOLD TAX A PARADOX
EXEMPTION 'CRUTCH' UNNECESSARY

by GERRY GUTMAN

The Federal Government is looking again at the long-standing tax exemption for the gold mining industry — only months after public assurances that the exemption would remain for at least three years. Can the industry survive without its special tax status?

The gold industry, which had been in the doldrums for several decades, has during the past 10 years regained some of its ancient glamour and has become our fastest growing mineral export during the later 1980s. This is a review of two aspects — one is the taxation of gold production in Australia, the other the longer term outlook for the demand and price of gold.

The question of taxation of gold has long been a hot political potato and became of consuming interest to the industry when just over two years ago Mr Keating, the Treasurer, proposed at the 1985 tax summit that the long-standing tax exemption for gold mining should be lifted. The Government rejected that proposal and decided an independent inquiry should examine the matter.

The independent inquiry, which I headed, was set up late in 1985 and recommended to the Treasurer in August 1986, just over a year ago, that the exemption should be withdrawn. The Government, after reflecting on the matter for four months, rejected the advice and announced that decision just before Christmas last year. Subsequently, in the context of this year's July election, the Prime Minister and the Leader of the Opposition both gave written assurances to the industry that the tax exemption would remain in place for at least another three years.

The question of whether or not gold should be taxed is reviewed at length in the inquiry's report. That question, in the light of what has happened, is a dead horse. But hypotheticals are topical nowadays and I may draw attention to the hypothetical question: what would have happened if the Government had decided to make gold production taxable? Would the industry have gone into a tailspin? Would share prices have collapsed? On that critical point, evidence put before the inquiry by the WA Government and by the industry's own lobby (the Australian Gold Industry Council) indicated that no operating gold mine would have ceased or substantially lowered production; and that no gold mine that was on the drawing board in 1985/6 would have failed to go ahead merely because company tax was to apply.

The imposition of tax would, of course, have made the industry less profitable but it would not, according to those estimates, have had a significant impact on gold production in the shorter or medium term. It would however, have reduced some exploration activity and would have delayed or prevented, in the longer term, the development of some low-grade reserves.

All this, of course, has not happened. And it is worth looking briefly at what did happen; and also at what is likely to happen to the industry in the longer run as a consequence of the

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Government's decision to maintain its tax exemption.

As to what happened as a result of the Government's announcement on December 21, 1986, you may have read some wildly exaggerated claims. Some of those have emanated from a paper issued by the Australian Gold Mining Industry Council which is heavily flawed by confused thinking and the misleading use of statistics. The paper argues that the Government's decision of December 1986 gave huge windfall gains to shareholders; and that these capital gains will yield tax revenues far beyond those that might have been raised from taxing gold production.

One difficulty with that comparison is that any capital gain from tax exemption is a once-and-for-all windfall; whereas company tax would provide a permanent broadening of the tax base and expanding tax revenues. The revenue windfall would in fact appear to do little more than compensate for the loss of six months of company tax revenue from gold.

In saying this, I am not denying that taxation is excessive and should be reduced, or even that there is a good case for eliminating company tax altogether. But these propositions are quite separate from the question of whether gold mining should be exempted from a company tax which applies to all other mineral and, indeed, non-mineral industries.

The evidence, moreover, suggests that the big boom in gold-mining shares this year was only partly due to the Government's decision not to tax gold production. Over the six months from December 1986 to May 1987 the All Ordinary Share Index rose by about 33 per cent, while the gold share index rose by 117 per cent, outperforming the all-ordinary by a factor of 3.5. However, during the six months before the Government's announcement (May to December 1986), gold shares prices had risen rapidly (by 88 per cent), outperforming the all-ordinary index by a factor of 6.

It can be easily calculated that the grant of tax exemption would not raise the after-tax profits of mining companies by more than 40 per cent, and probably by rather less. And, of course, many investors had long anticipated that the tax exemption would remain and had punted accordingly. It seems unlikely therefore, that much more than 20 per cent of this year's rise in gold share prices could be assigned to the impact of the Government's announcement. What is more, such windfalls are not taxable until realised; and many of them are not taxable at all if they accrue to tax exempt institutions, for example, or to shareholders who owned their shares before September 1985.

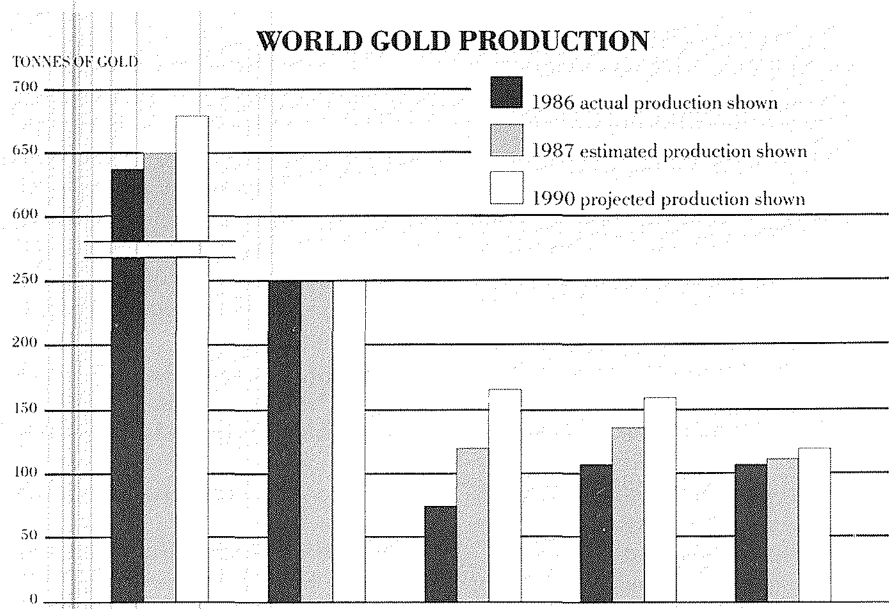
Altogether, the various arguments advanced for the proposition that the Government has pulled a major fiscal coup by not taxing gold are fanciful. On the latest figures, the Government's decision sacrifices annual tax revenues of between $300m and $400m, only a small proportion of which is likely to be compensated for by the once-only windfall from the boost to share prices.

In the long run, however, the impact could be different. Much will depend on whether producers and investors believe that after their three-year grace period, the Government will continue tax exemption or whether it will, at that stage, impose a tax. If investors and gold producers feel that all they have is another three years' grace, they will have a strong incentive to shift the largest possible proportion of projects' income streams into the current tax exempt period. They will seek to escalate production and mine the highest grade and produce the largest income during that period.

That fact, oddly enough, has largely been ignored by Government policymakers. The Industry Assistance Commission, in two separate reports on the question of gold mining taxation, recommended phased introduction of gold taxation with levels only attaining normal company tax rates over a period of five years. Such a scheme, of course, encourages high grading and defeats the Government's fiscal intention by depleting future taxable income in favour of present tax-exempt income.

The reverse consequence applies where producers believe that future taxation will be lower than at present. If, for example, it looked as though the oil tax levy might be reduced over a period, oil producers would need to consider whether shareholders' interests would be better served by slowing down production so that a larger proportion of reserves could be produced during future periods of less-oppressive taxes. Naturally, many other factors, technical and economic, enter into such calculations.

Reference to the oil industry highlights a broader point. The economic justification put forward by the Government for maintaining tax exemption for gold mining put much emphasis on gold's important role as a fast-growing export-earner and the need to encourage it in view of the precarious balance of payments position. Yet oil production makes a considerably larger contribution to Australia's balance of payments than gold. Also, the impending run-down of domestic oil reserves, as everyone agrees, is one of the country's most critical problems. Nevertheless, successive Governments have imposed special taxation on oil which, as we have been told, weighs heavily upon producers, reduces cash flows and undermines the capacity and incentive to explore. This situation has been aggravated by declining energy prices and declining profitability.



SOURCE: WGC 1987, CGF 1987, NAL

There is something paradoxical in the Government's continuing an ever-increasing tax incentive to the gold industry, which has seen its product price double, while imposing special taxes on oil and coal, where prices have slipped. It is as though the Government were pursuing a new macho policy of reserving its fiscal largesse primarily for those mineral industries which ride high on the crest of the wave while placing special imposts on those floundering in the cross-currents or temporarily becalmed.

This policy, as applied to the gold industry, is bound to have unintended long-run consequences. Our Governments have had a long history of attempting to create or expand domestic industries with assistance in the form of tariffs, subsidies, tax concessions and so forth. Very few of the industries so assisted have ever come to stand on their own feet and to dispense with the crutches provided by Government.

The gold industry, currently, is highly efficient. At current gold prices and cost levels, all existing and developing mines can operate profitably. The industry needs no crutches. Yet given crutches, it will eventually grow to depend on them.

What that means in economic terms is that once investors assume that tax exemption is here to stay they will put on the drawing board mines which will be viable under a regime of tax exemption but not without it. The perpetuation of tax exemption may thus create a segment of the gold-mining industry (a segment not yet in existence) which would depend on tax exemption for its survival and would become sub-marginal if the exemption were ever lifted.

In this situation, increasingly the cost of withdrawing the subsidy would outweigh its benefits. The option of changing the tax regime would thus have been foreclosed. The outcome might be similar if the Government continues to keep the industry on tenterhooks by hinting at the possibility that gold producers may in the foreseeable future have to pay tax. This situation would encourage accelerated exploitation, especially of higher-grade material, and thus would diminish potential benefit from any withdrawal of tax exemption.

The line of thinking suggests that the Federal Government may already have missed the bus on taxing gold production. By conceding continued tax exemption now, it may well have relinquished the strategic option of withdrawing it in the future.

Let me turn to a different subject — the price of gold.

When people come to talk about gold, what is uppermost in their minds is what is going to happen with its price. It reminds me of the lady who once cornered J.P. Morgan at a party and said: "What will happen to the market, will it go up or down?" Morgan replied: "Both, my dear lady, both." The same nowadays applies to gold in a way that J.P. Morgan, who lived in the age of gold standards and fixed exchange, would never have thought of. Over the past three or so years, the price of gold in Australia has risen by 50 per cent while in Japan it has dropped by 25 per cent. In an age of floating currencies the price of gold has become harder to define.

In recent years, moreover, there have been indications that the price of gold no longer responds to threats of economic and political upheaval in the extremely volatile fashion we have seen in the past.

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Gold is unlike other commodities whose prices are largely dominated by expectations about future production and consumption. The reason is that gold is so durable that some of what was produced by miners in the employment of the Queen of Sheba can in all probability still be found in the jewellery worn by a Japanese film star or buried in a Swiss bank vault.

As a result, the annual output of gold represents only a minute fraction, less than 1.5 per cent, of the world's total stock. Roughly one third of that stock is held by international monetary authorities, i.e. Governments, central banks, the IMF and so on, whose total gold holdings at present prices might be valued at roughly \$500 billion or roughly the equivalent of 25 years of current mine production of gold. A large proportion of the remainder is held by investors who are prepared to relinquish or add to their stock in the light of market conditions.

The annual supply of gold comes from different sources. One is the mine production of new gold, which has been rising rapidly in recent years though supplies from South Africa, the world's largest producer, have been stagnant or declining. Mine production, according to the prestigious annual report of Consolidated Goldfields, is rising "apparently inexorably". Another source is the net sales of Communist countries. These may come either from current production or from stocks — we do not precisely know — and can fluctuate heavily. In 1986, for example, new mine production was 1,281 tonnes (roughly half of it from South Africa). Communist sales were about 400 tonnes. A third element was from the sale of gold scrap which amounted to 465 tonnes.

Out of these supplies, well over 2,000 tonnes, the lion's share went to fabricators, people who make jewellery, dentures, medals and so forth. Of the remaining 500 tonnes, roughly 60 per cent, went to investors and hoarders of gold bars while the remainder was bought by the so-called official sector, i.e. the various monetary authorities.

This pattern of annual supply and demand fluctuates from year to year. The official sector sometimes figures as a buyer, as it did last year, and sometimes as seller, as it seems to have done in 1983/4. Substantial amounts disappear to the vaults of investors outside Europe and North America. Western investors tend to be active operators, sometimes buying and sometimes selling as much as a quarter of annual world supply.

Without attempting here to analyse this bewildering pattern of gold supply and gold investment and dis-investment, it is clear that determinants of supply differ greatly among the various types of suppliers, e.g. miners, Communist Bloc sellers, scrap merchants etc., if only because of the sharply different pattern of prices that confronts each in its domestic market. Similarly, the structure of gold demand differs among fabricators and between wealthy hoarders in Asia and short-term investors and speculators in Western market economies. One salient factor is the huge stocks which are available to supply any shortfall in production or absorb any shortfall in annual demand.

The situation should theoretically make for a very elastic supply and a relatively stable price, even in the face of changing interest rates and inflationary expectations. □