Impact of the FairTax on Mining

In 1992, the U.S. mining industry, totaling approximately 37,000 enterprises, reported $2.7 billion in net income, nearly $113 billion in gross receipts, and paid just under one billion in taxes (Table 1). The mining industry is therefore an important contributor both to the U.S. economy and to federal tax revenues.

Industry Average	Mining (billions)
Gross Receipts	$112.80
Net Income	$2.70
Income Subject to Tax	$4.30
Income Tax After Credits	$1.00
Effective Tax Rate (on net income)	35.80%
Net Income as Percentage of Gross Receipts	2.40%

Table 1: This table represents mining industry averages for 1992, as reported in the 1992 Statistics of Income, Corporation Income Tax Returns. All dollar figures are in billions.

The mining industry suffers under current tax law for several reasons:

1. Mining is a high-risk business, extremely sensitive to tax and other cost variations. The current tax code changes frequently, often with disastrous and unforeseen effects on mining. The complex nature and often subjective interpretation of the law makes tax planning difficult. Also, the alternative minimum tax penalizes risk-taking.
2. Mining is a capital-intensive industry, with traditionally long term fixed costs, and therefore, is very sensitive to variations in and lack of economic growth.
3. Current tax law is particularly burdensome for mining because of unfavorable capital cost recovery rules. Under current law, mining exploration costs are generally non-deductible capital expenditures. Through an exception, some taxpayers may elect to take what is known as a "percentage depletion" with respect to certain exploratory costs, depending upon the product being mined. Moreover, taxpayers who incur expenditures for development of minerals after successful exploration may deduct them in the year incurred or paid.[1] However, these expenses must be recaptured as ordinary income on the disposal of the property. Intangible oil and gas geothermal well drilling and development costs are also capital expenditures.[2] Upon the sale of the commodity, ordinary income usually results, which means that the taxpayer is taxed at graduated individual or corporate rates.[3]

[1] Partnerships, in particular, are also required to "state separately" several classes of income and deductions that can be passed through. Mining exploration expenses are one such item.
[2] However, the law allows capitalization and amortization (i.e., cost recovery) over a period of five years.
[3] An exception exists for coal or iron-ore in certain circumstances. When iron-ore is sold with retained economic interest, for instance, it is afforded IRC section 1231 treatment and is entitled to favorable capital gains tax rates.

The sales tax would advantage mining in several respects. First, the simplicity of the sales tax would facilitate the decision making process associated with long range financial planning. Second, mining would benefit, as would all domestic industries, from sustained growth in the economy. All known economic studies predict growth by replacing the income tax with a consumption tax; indeed, economists typically estimate additional growth 10 to 12 percent greater within a decade.[4] Harvard economist Dale Jorgenson estimates that, after implementation of the sales tax, yearly real investment would initially increase by 80 percent relative to the investment that would be made under present law. Jorgenson's research shows that this increase would gradually decline over the period of a decade to 20 percent.[5] Boston University economist Laurence Kotlikoff also predicts an investment boom. Measuring the change in the size of the overall capital invested (rather than annual investment), he predicts that, within 10 years, invested capital will be 17 percent larger than it would be under the present tax system.[6] Because the economy will grow, industrial production will grow, and demand for mined goods will increase.

Third, the mining industry would benefit by never again having to pay U.S. corporate income taxes on either domestic or foreign production. Since all business-to-business transactions would fall out of the taxing net, and the industry makes virtually no sales to consumers, it would not be required to collect and remit significant sales tax. Mining operations in the U.S. would become extremely attractive.

Fourth, the industry would also be advantaged by more favorable interest rates. Interest rates are expected to be reduced by 25 to 30 percent under a national sales tax.[7] Although the costs of borrowing would no longer be "deductible", interest income would be paid from pre-tax earnings. Interest would also not be taxed to the recipient.[8] As a result, investors will no longer need to charge a tax premium to achieve a particular after-tax rate of return, and interest rates will fall toward the current tax-exempt rate.

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[4] Dale W. Jorgenson, Harvard University, "The Economic Impact of the National Retail Sales Tax," unpublished report to Americans for Fair Taxation, November 25, 1996 estimates a 10.5 percent GDP increase; Laurence J. Kotlikoff, Boston University, "Replacing the U.S. Federal Tax System with a Retail Sales Tax – The Macroeconomic and Distributional Impacts," unpublished report to Americans for Fair Taxation, December, 1996, estimates a 12 increase in GDP.

[5] Dale W. Jorgenson, Harvard University, "The Impact of Taxing Consumption," Testimony before the Committee on Ways and Means, U.S. House of Representatives, March 27, 1996.

[6] Laurence J. Kotlikoff, Boston University, Testimony before the Committee on Ways and Means, U.S. House of Representatives, June 6, 1995. See also, "The Economic Impact of Replacing Federal Income Taxes with a Sales Tax", Laurence J. Kotlikoff, April 15, 1993, Cato Institute.

[7] For a more detailed discussion of the impact on a national sales tax on interest rates, see John E. Gobb, *Economic Review*, Federal Reserve Bank of Kansas City, "How Would Tax Reform Affect Financial Markets?" Fourth Quarter, 1995. He estimates a 25-35 percent drop (p. 27). See also, Martin Feldstein, "Effect of a Consumption Tax on the Rate of Interest," National Bureau of Economic Research, Working Paper No. 5397 (December, 1995).

[8] A deduction in an income tax allows taxpayers to make interest payments from pre-tax dollars. Similarly, under a sales tax people will make interest payments from pre-tax dollars, but when received the interest is also not taxable.

Fifth, mining would also have reduced transactional and compliance costs. For example, mining companies engaged in international transactions will no longer need to be concerned with foreign sourcing rules, whether a foreign charge is an income tax or the calculation of the foreign tax credit. They will no longer be concerned with disfavorable capital cost recovery or alternative minimum tax rules. They will not have to endure the unnecessary record-keeping and other paperwork requirements, tax accounting and audits costs associated with the corporate income tax.

Finally, some mining companies are family-owned. The FairTax would dramatically reduce the burden on family-owned businesses by repealing the estate and gift tax. This would eliminate the need for family owned businesses to be sold out of the family to pay the estate tax and eliminate the need to engage in expensive estate planning.