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## **Submission to House of Representatives Standing Committee on Economics: Inquiry into the Implications of Removing Refundable Franking Credits**

Dear Committee Members,

We would like to offer input for the Committee's consideration of the potential impacts of removing access to refundable franking credits for those in retirement. Our submission comprises three items. The first is this letter, which sets out some thoughts on the potential effects of changing the policy. The second is our research paper titled "What Dividend Imputation Means for Retirement Savers" (revised on 4 October 2018), which focuses on the value of imputation credits to retirees and what it may mean for their portfolios. While this paper does not directly address the removal of access to refundable franking credits, by its design it is very relevant for the issue at hand. We also expand on this research within this letter, specifically using our model to estimate the potential implications of the policy proposed by the opposition Labor Party. Third, we provide a working paper titled "Do Franking Credits Matter? Exploring the Financial Implications of Dividend Imputation" (Centre for International Finance and Regulation, June 2015), which was authored by one of us along with some University of Sydney academics. This paper provides a comprehensive review of the literature and arguments regarding the financial implications of the imputation system. We thought it might be useful background material for the Committee.

### **A Quick Overview of Our Research Paper**

Our working paper models both the value that an Australian single male retiree receives from having access to refundable franking credits, as well as potential impacts on asset allocation within their pension account. We do this by modelling the experience through retirement for a range of initial balances at age 65, allowing for access to the age pension and applying minimum drawdown rules. We model two types of retirees with differing preferences. One type has a target spending level, based around either the 'comfortable' or 'modest' retirement spending standards of the Association of Superannuation Funds of Australia (reference dependent utility). The other type does not have a target spending level, but prefers a higher level of spending spread over the course of their retirement (power utility). We initially model the optimal behaviour ignoring franking credits, repeat the modelling assuming that the retiree has access to refundable franking credits, and then compare the difference.

The first point that the Committee might take from our analysis is that the estimated value for retirees from having access to refundable franking credits is quite significant. We express our estimates in terms of three measures that can be interpreted in economic terms. While the results vary with the modelling set-up—including utility function, initial balance and age—the average value generated is equivalent to:

- An increase in total spending over the course of retirement of 5%-6%;
- Entering retirement at age 65 with an initial balance that is 8%-9% higher; which might equally be interpreted as requiring an 8%-9% lower balance to support the same level of spending;
- Being able to access an additional risk-free return of 0.6%-0.8% per annum over the course of retirement.

The second point to take from our analysis is that access to refundable franking credits makes it rational to hold a portfolio with a considerable 'home bias' to Australian equities, largely at the expense of lower exposure to world equities. Again, while the exact portfolio breakdown depends on the modelling set-up, the effects tend to be substantial. To illustrate the tenor of the results, take a retiree starting with a balance of \$500,000 at age 65, who targets spending at AFSA comfortable of \$42,764 per annum. Excluding imputation credits, our modelling



suggests that this retiree should divide their portfolio on average over the course retirement into 26% in Australian equities, 33% in world equities and 41% in fixed income. When imputation credits are included in the analysis, the portfolio breakdown comes out as 46% in Australian equities, 15% in world equities and 39% in fixed income – a notable home bias.

It is important to note that this result comes out of modelling optimal behaviour, taking into account risk versus return. The main reason for the shift in asset weights is that refundable franking credits allow Australian retirees to earn substantially higher returns by substituting Australian equities for world equities, without a meaningful increase in overall portfolio risk. The limited impact on portfolio risk arises because Australian and world equities are substitutes to a large extent: one form of equity market risk is just being swapped for another. Basically, access in refundable franking credits allows retirees to build superior portfolios on a risk/return basis.

We also highlight the net cost to the government of providing access to imputation tax credits to retirees, accounting for the fact that there will be some offset through reduced age pension payments. We estimate a total expected net cost per individual over the course of their retirement of about \$20,000 for those retiring with a \$100,000 balance, with the net cost tending to grow with balance up to around \$130,000 for those retiring with a \$1.6 million balance (in 2017-8 dollars).

### **Impacts from Labor's Proposed Policy Under our Model**

We have re-run our model under the proposed Labor policy, under which retirees have full access to franking credit refunds only if they are receiving at least a partial pension. We then compare these result with those under the case where all retirees have access to franking credit refunds. The table on the next page reports these results for initial balances at age 65 ranging from \$200,000 to \$1.6 million, noting that there is virtually no effect at balances less than \$200,000. Underpinning our analysis is the assumption that retirees with higher balances may switch their portfolio towards Australian equities once they become able to access franking credit refunds if their balance declines below the pension eligibility threshold during their retirement journey. We have not accounted for any costs associated with such a switch; and it is entirely possible that older retirees in such a position may not make such a switch in practice. For these reasons, we may have underestimated the impacts, but probably only to a modest extent. Notable points to arise from this additional analysis include the following:

- Meaningful effects start to kick in at around an initial balance of \$500,000, and build progressively as the initial balance increases. Virtually all the benefit of access to refundable franking credits is unwound for retirees with an initial balance of \$1 million or more.
- Effects are felt *below* an initial balance of \$700,000-\$800,000 (the level above which access to any age pension is lost). This arises because, under our stochastic modelling, there are some states of the world where retirees with lower balances lose access to franking credit refunds if good investment returns happen to boost their balance above the pension threshold. Conversely, those starting above the pension threshold may at some stage gain access to the pension and hence franking credit refunds as their balance declines due to either drawdowns and/or poor investment performance. Hence the potential effects are somewhat 'fuzzy' along with a dynamic element, and do not just apply to those that retire with a balance above the pension eligibility threshold.
- We extract the average number of years sooner that retirees end up on the age pension as a consequence of losing access to refundable franking credits. This effect starts to kick at an initial balance of above \$600,000, and peaks at around 3-4 years at a balance of \$950,000. That is, a retiree starting with a balance of \$950,000 at age 65 could end up claiming some pension 3-4 years earlier than they would have under the current policy.
- We estimate the average change in both the total amount of franking credit refunds claimed and age pension received per individual over the course of their retirement (constant 2017-18 dollars). As expected, the dollar reduction in credits claimed increases with initial balance. There is some modest offset in terms of increased pension income, which peaks in dollar terms at an initial balance of around \$750,000 to \$800,000. These estimates provide an indication of the dollar-value impact on individuals at various balances.

### Average Impacts of Labor Imputation Policy per Initial Balance at Age 65

| CE Consumption          |               |                                  | Equivalent Initial Balance |       |                                  |       | Equivalent Risk-Free Return |                                  | Years Sooner on Pension |                                  | Franking Credits Claimed |                                  | Pension Received |                                  |
|-------------------------|---------------|----------------------------------|----------------------------|-------|----------------------------------|-------|-----------------------------|----------------------------------|-------------------------|----------------------------------|--------------------------|----------------------------------|------------------|----------------------------------|
| Utility Function        | Power Utility | Reference Dependent, Comfortable | Power Utility              |       | Reference Dependent, Comfortable |       | Power Utility               | Reference Dependent, Comfortable | Power Utility           | Reference Dependent, Comfortable | Power Utility            | Reference Dependent, Comfortable | Power Utility    | Reference Dependent, Comfortable |
| Units                   | %             | %                                | \$                         | %     | \$                               | %     | %                           | %                                | No. Years               | No. Years                        | \$                       | \$                               | \$               | \$                               |
| <i>Initial Balance:</i> |               |                                  |                            |       |                                  |       |                             |                                  |                         |                                  |                          |                                  |                  |                                  |
| \$200,000               | 0.0%          | 0.0%                             | -\$19                      | 0.0%  | \$0                              | 0.0%  | 0.00%                       | 0.00%                            | 0                       | 0                                | -\$104                   | \$0                              | \$40             | \$0                              |
| \$250,000               | 0.0%          | 0.0%                             | -\$64                      | 0.0%  | \$0                              | 0.0%  | 0.00%                       | 0.00%                            | 0                       | 0                                | -\$390                   | -\$5                             | \$145            | \$2                              |
| \$300,000               | -0.1%         | 0.0%                             | -\$179                     | -0.1% | \$0                              | 0.0%  | -0.01%                      | 0.00%                            | 0                       | 0                                | -\$1,082                 | -\$32                            | \$366            | \$41                             |
| \$350,000               | -0.2%         | 0.0%                             | -\$588                     | -0.2% | \$0                              | 0.0%  | -0.01%                      | 0.00%                            | 0                       | 0                                | -\$2,460                 | -\$104                           | \$830            | \$106                            |
| \$400,000               | -0.4%         | 0.0%                             | -\$1,474                   | -0.4% | -\$44                            | 0.0%  | -0.03%                      | 0.00%                            | 0                       | 0                                | -\$5,100                 | -\$446                           | \$1,726          | \$427                            |
| \$450,000               | -0.8%         | 0.0%                             | -\$3,612                   | -0.8% | -\$177                           | 0.0%  | -0.06%                      | 0.00%                            | 0                       | 0                                | -\$9,753                 | -\$1,528                         | \$3,113          | \$1,450                          |
| \$500,000               | -1.4%         | 0.0%                             | -\$6,862                   | -1.4% | -\$894                           | -0.2% | -0.11%                      | -0.01%                           | 0                       | 0                                | -\$17,112                | -\$4,652                         | \$5,121          | \$3,371                          |
| \$550,000               | -2.4%         | 0.0%                             | -\$12,983                  | -2.4% | -\$5,650                         | -1.0% | -0.21%                      | -0.07%                           | 0                       | 0                                | -\$33,312                | -\$15,026                        | \$9,346          | \$9,312                          |
| \$600,000               | -3.0%         | 0.0%                             | -\$18,239                  | -3.0% | -\$8,525                         | -1.4% | -0.29%                      | -0.09%                           | 0                       | 1                                | -\$45,489                | -\$24,714                        | \$11,367         | \$11,175                         |
| \$650,000               | -3.7%         | 0.0%                             | -\$24,262                  | -3.7% | -\$11,663                        | -1.8% | -0.36%                      | -0.12%                           | 1                       | 1                                | -\$58,092                | -\$35,471                        | \$12,508         | \$12,787                         |
| \$700,000               | -4.4%         | 0.0%                             | -\$30,465                  | -4.4% | -\$14,129                        | -2.0% | -0.42%                      | -0.14%                           | 2                       | 2                                | -\$70,371                | -\$47,780                        | \$13,241         | \$13,410                         |
| \$750,000               | -4.9%         | 0.0%                             | -\$36,829                  | -4.9% | -\$18,926                        | -2.5% | -0.49%                      | -0.17%                           | 2                       | 2                                | -\$82,223                | -\$62,293                        | \$13,601         | \$13,210                         |
| \$800,000               | -5.4%         | 0.0%                             | -\$43,074                  | -5.4% | -\$25,071                        | -3.1% | -0.54%                      | -0.21%                           | 2                       | 2                                | -\$93,602                | -\$79,161                        | \$13,666         | \$12,470                         |
| \$850,000               | -5.8%         | -2.0%                            | -\$49,527                  | -5.8% | -\$30,528                        | -3.6% | -0.58%                      | -0.25%                           | 2                       | 3                                | -\$104,361               | -\$97,786                        | \$13,564         | \$11,557                         |
| \$900,000               | -6.2%         | -4.1%                            | -\$55,912                  | -6.2% | -\$37,612                        | -4.2% | -0.62%                      | -0.29%                           | 2                       | 3                                | -\$114,546               | -\$117,482                       | \$13,206         | \$10,608                         |
| \$950,000               | -6.6%         | -5.6%                            | -\$62,664                  | -6.6% | -\$44,853                        | -4.7% | -0.65%                      | -0.32%                           | 3                       | 4                                | -\$124,143               | -\$136,815                       | \$12,745         | \$9,704                          |
| \$1,000,000             | -7.1%         | -6.7%                            | -\$71,252                  | -7.1% | -\$51,732                        | -5.2% | -0.68%                      | -0.36%                           | 2                       | 3                                | -\$133,288               | -\$156,102                       | \$12,247         | \$9,054                          |
| \$1,100,000             | -7.8%         | -7.9%                            | -\$86,118                  | -7.8% | -\$65,991                        | -6.0% | -0.75%                      | -0.43%                           | 2                       | 2                                | -\$149,783               | -\$193,796                       | \$11,238         | \$8,141                          |
| \$1,200,000             | -8.2%         | -8.4%                            | -\$98,075                  | -8.2% | -\$79,290                        | -6.6% | -0.78%                      | -0.48%                           | 2                       | 2                                | -\$164,285               | -\$229,799                       | \$10,061         | \$7,468                          |
| \$1,300,000             | -8.4%         | -8.7%                            | -\$109,549                 | -8.4% | -\$91,950                        | -7.1% | -0.80%                      | -0.52%                           | 2                       | 2                                | -\$177,694               | -\$263,529                       | \$8,943          | \$7,062                          |
| \$1,400,000             | -8.6%         | -8.8%                            | -\$120,638                 | -8.6% | -\$103,849                       | -7.4% | -0.82%                      | -0.56%                           | 2                       | 2                                | -\$190,171               | -\$294,674                       | \$7,910          | \$6,699                          |
| \$1,500,000             | -8.8%         | -8.7%                            | -\$131,470                 | -8.8% | -\$115,986                       | -7.7% | -0.83%                      | -0.59%                           | 2                       | 1                                | -\$201,962               | -\$324,623                       | \$6,959          | \$6,328                          |
| \$1,600,000             | -8.9%         | -8.7%                            | -\$141,658                 | -8.9% | -\$128,671                       | -8.0% | -0.84%                      | -0.62%                           | 2                       | 1                                | -\$213,219               | -\$353,363                       | \$6,187          | \$6,056                          |

The three measures to the left of the table are estimated with reference to the reduction in utility under Labor's policy, relative to the current policy. CE (certainty equivalent) consumption is the reduction in constant real spending over the course of retirement that arises from losing access to refundable franking credits. Equivalent initial balance is the reduction in balance at age 65 that has the same effect as losing access to refundable franking credits; or alternatively the additional balance required to generate the same utility during retirement. Equivalent risk-free return can be interpreted as the additional annual return required over the course of retirement to replace the reduced investment earnings from loss of access to refundable franking credits. Years sooner on pension is the number of years earlier that the retiree becomes eligible for at least some pension. The estimates to the right reflect the reduction in franking credits claimed and the increase in aged pension received in total over the course of retirement in constant (2017-8) dollars.



## Potential Implications of Removing Access to Refundable Franking Credits

Given the significant magnitude of the benefit from refundable franking credits for some retirees, their removal would likely have some substantive impacts for those who are affected. Our analysis as reported above confirms that the impact of the proposed Labor policy will be greatest for retirees on larger balances, with significant effects occurring at initial balances at age 65 ranging from \$800,000 up to the \$1.6 million limit on tax-free retirement accounts. We offer the following observations about the proposed policy:

- As the impact will be greatest for wealthier retirees, arguably the main argument in favour of the policy relates to the notion that it may be inappropriate to provide tax credits to those who are already well-off. This is essentially an equity argument.
- The role of the imputation system might be placed in a broader context of overall policy objectives and settings. Removing access to franking credit refunds would grate against the broad thrust of policy in two main ways:
  - Government policy has been directed at encouraging people to save for their own retirement. There are a range of settings that work towards this end, including the Superannuation Guarantee (SG), and concessional tax rates on superannuation funds (at least for individuals on incomes above \$37,000). Access to franking credit refunds contributes to this policy mix by providing a supplement to investment earnings during retirement. This makes it possible to achieve certain level of income with a lower balance (about 8%-9% lower, according to our estimates). Loss of access to franking credit refunds would cut against this policy objective, and/or reduce 'adequacy' in retirement. An alternative view is that franking credit refunds may be seen as a partial substitute for the need to increase the SG. A lower SG would have the benefit of increasing disposable income and hence potentially spending during the working phase.
  - Removing access to franking credit refunds for retirees would disrupt the purity and elegance of imputation system, which is underpinned by the principle that investors should be taxed on corporate earnings at their marginal tax rate. One class of investors would be singled out for differing treatment.
- Under the proposed Labor policy, the effects will largely apply to individuals with retirement balances of between about \$800,000 and \$1.6 million, recalling that those with more than \$1.6 million are required to invest in a taxable account. We make two points about this situation. First, it creates a class of retirees sitting in the middle-upper wealth range that are unable to claim franking credit refunds, when those below and above are able to do so. Such discontinuities are usually unhelpful, and may give rise to uneven behaviours and incentives across the range of retirees that could have unintended consequences. Second, as the superannuation system matures, more individuals will be affected by the policy. A balance of \$800,000 may be sizable at present, but a greater number of individuals may fall into this category over the course of time. For these reasons, the potential effects are much more complex than just a straightforward reduction in government support for currently-wealthy individuals.
- A change in policy would probably impact the investment behaviours of retirees to some degree. Some of those affected may be induced to decrease, or direct less funds towards, investment in Australian shares. This may reduce the funding available to Australian companies at the margin, although it is unlikely that the impact will be substantial as only one class of investor among many is being impacted. There will also be some inducement to rebalance portfolios as thresholds are crossed where access to the franking credit refunds becomes available or unavailable, with some cost and disruption being incurred. However, these effects are also unlikely to be major. Nevertheless, the ability to access franking credit refunds becomes considerably messier, which will only make portfolio management more complicated.

In summary, removing access to franking credit refunds would add to the overall complexity of the retirement savings system and could come with some adverse implications, with the major effects potentially related to singling out a particular group within the context of a broader policy agenda. Policy design of this type tends to impact adversely on efficiency. Hence the central issue seems to be how any negative impacts on efficiency is



balanced against the equity implications of reducing government support for a group that is relatively well-off, which arises as a result of the lack of any tax on investment earnings on retirees with balances up to \$1.6 million. If it were deemed appropriate to reduce support for the well-off, any change in policy might be better framed more holistically within the context of the broader policy agenda so as not to create uneven behaviours and incentives.

We trust this submission proves to be of value to the Committee in its deliberations.

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