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Submission to Inquiry into the implications of removing refundable franking credits

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Summary

We welcome the opportunity to present our views on the costs and benefits of removing the refundability of excess imputation credits.

Removing refunds for excess franking credits addresses a growing hole in Australia's tax base. Full dividend imputation – including refundability of excess franking credits – means profits distributed by a company or trust are taxed at the marginal tax rate of the individual receiving the distribution. A growing share of company profits are being taxed at a zero rate as an increasing share of Australians reach retirement and their *taxable* incomes (but not necessarily their actual incomes) fall because of tax-free super and the generous tax-free threshold for retirees.

Under current policy settings, the retirement of the baby boomer cohort with their substantial shareholdings – held directly and through Self-Managed Super Funds (SMSFs) – will place substantial pressures on tax revenues. The Parliamentary Budget Office estimates the revenue loss from excess franking credits will grow from $5.6 billion in 2020-21 to $6.9 billion in 2027-28.

More needs to be done to ensure that budgets are sustainable in the long-term. Net debt reached 18.6 per cent of GDP in 2017-18 after a decade of budget deficits. The government has forecast it will soon be running modest surpluses, but long-term spending pressures are increasing, and demographic change will exacerbate pressures on the tax base.

Removing refundability of excess franking credits mainly raises additional tax from older and wealthier Australians. Most excess franking credits flow to people with high-balance SMSFs and to the wealthiest 20 per cent of older Australians who own shares directly.

Nobody likes paying more tax, but richer and even just 'comfortably off' older Australians will need to make more of a contribution if budget repair is going to be fair. Tax changes in the past two decades have been hugely generous to this group. Older households pay $7,500 less in income tax in real terms today than older households 20 years ago, despite big increases in average incomes and wealth. Taxes on working-age households have risen over the same period.

But no tax increase is without economic costs. Removing refundability of excess credits is a partial winding back of dividend imputation policy and therefore a reduction in the economic benefits of the policy: promoting investment in domestic firms and encouraging tax compliance. It also increases the effective tax on savings. This is unlikely to have much effect on the amount people save, but will lead to switching from domestic shares to other investment types. It will also create some incentive to switch from SMSFs to industry funds.

Removing refundability of excess imputation credits is a fair way to help improve the budget and wind back the growing intergenerational transfers in our tax system. But there is a better way. The Grattan Institute has previously advocated more substantial reforms – such as taxing superannuation earnings in the pension phase at 15 per cent (super distributions would remain tax free) and winding back the Seniors and Pensioners Tax Offset – that would achieve the same benefits but without some of the investment-distorting effects of Labor's policy.

1 Labor's proposed policy to remove refundability of excess franking credits

On 19 September 2018, Treasurer Josh Frydenberg asked the Committee to inquire into the implications of removing refundable franking credits.

In March, the Australian Labor Party (Labor) announced a policy to remove tax refunds for excess franking credits. While Labor's policy is not specifically mentioned in the Terms of Reference, we assume this is what motivated the inquiry. The analysis in this submission is therefore based on the details of Labor's policy – rather than other proposals to change dividend imputation and refundability of franking credits.

Labor's proposed change would partially wind back Australia's dividend imputation system. Currently, "franking credits" are attached to dividends paid to shareholders, reflecting any company tax already paid. These franking credits can be used to offset any personal income tax the shareholder owes to the Tax Office, thus ensuring shareholders are not taxed twice on corporate profits.

In 2001, refunds for unused franking credits were introduced. The logic was simple: everyone should pay tax on distributed profits at their own marginal tax rate.[1] Any unused or "excess" franking credits left after someone had reduced their tax liability to zero were returned via a cheque from the government.

Labor's plan would restore the pre-2001 system. Most taxpayers could still use imputation credits to offset other tax owing to the Tax Office, but those with no income tax liability — mainly retirees and their SMSFs — would no longer be able to claim cash refunds.

Labor's policy also includes a "Pensioner Guarantee" that allows every recipient of an Australian Government pension or allowance with individual shareholdings to continue to receive cash refunds.[2]

[1] Costello (1998), p.115.

[2] It also allows SMSFs with at least one pensioner or allowance recipient before March 2018 to be exempt from the changes (Shorten 2018).

2 More needs to be done to ensure budgets are sustainable

Labor argues that its proposal to remove refundability of excess imputation credits is needed to help ensure the budget is sustainable over time.

On the numbers provided, the policy will make a substantial contribution to budget repair. The independent Parliamentary Budget Office (PBO) estimates the policy will contribute an extra $5 billion a year in government revenues when it comes into effect, and this figure will grow substantially over time.[3] Whether the $5 billion figure will be realised will depend on the extent of behavioural change compared to what the PBO has factored into its assumptions.[4]

There are good economic arguments for budget repair: the current budget position is not as strong as it should be given the point in the economic cycle, and there are substantial long-term budget challenges that governments are yet to prepare for.

2.1 The current budget position should be better

Fiscal policy over the past decade has not been obviously consistent with the Government's medium-term fiscal strategy "to achieve budget surpluses, on average, over the course of the economic cycle".[5] The Commonwealth Government has been running substantial deficits – mostly 2-3 per cent of GDP – since the Global Financial Crisis. The 2018-19 Budget effectively delayed reaching a surplus of 1 per cent of GDP from 2022-23 to 2026-27.[6] Given the point in the economic cycle – and the positive news on the revenue side of the budget – we should be running sizeable surpluses.

The slow consolidation of the Commonwealth's budget position leads to a slow reduction in the Commonwealth net debt position, from 18 per cent of GDP today to 4 per cent of GDP in 2028-29. Of course, this depends in part on the projected value of the Commonwealth's assets: gross debt is only projected to fall from $561 billion in 2018-19 to $532 billion by 2028-29.[7]

And these projected future surpluses and paying down of debt are premised on a decade of healthy economic growth and extraordinary spending restraint.[8] If growth falters or spending blows out, budget surpluses will be smaller (or non-existent) and net debt will be higher than projected.

The spending restraint assumptions look increasingly optimistic. It is unclear how a range of recent announcements – including $9 billion over the decade to change the GST formula to placate Western Australia,[9] $4.6 billion over the decade in additional

[3] The PBO estimates of the financial impact of the policy are summarised in Labor releases (Bowen 2018 and Labor 2018). Labor has not released the full PBO costing. Senator David Leyonhjelm requested a costing of a similar policy from the PBO and has made the full costing available (PBO 2018).
[4] A Treasury costing of the policy was somewhat lower – around $4.9 billion in revenue in 2021-22. This may have been due to differences in assumptions regarding behavioural change from the policy. The PBO has been clear that its estimates include a substantial behavioural response.
[5] Commonwealth Government (2018), pp.3-7.
[6] Commonwealth Government (2018), pp.3-15.
[7] Commonwealth Government (2018), pp.3-16.
[8] Coates and Wood (2018); Wilkinson (2018).
[9] Coorey (2018).

funding for independent and Catholic schools,[10] and a reported $7.6 billion road and rail infrastructure package[11] – are consistent with the Coalition's fiscal rule that new spending measures will be more than offset by reductions in spending elsewhere in the budget.[12] And this is before pre-election giveaways have begun in earnest.

Sustained budget deficits incur interest payments and limit future borrowings, reducing the capacity of governments to respond to economic shocks. The Australian economy is particularly exposed because, with interest rates at historical lows, the Reserve Bank has less firepower to stimulate the economy, and so the Commonwealth budget will be a primary defence in the event of an economic downturn.

2.2 Longer-term budget challenges remain

There are sizeable longer-term structural pressures on the budget.

The 2015 Intergenerational Report identified long-term fiscal pressures from the ageing population and increasing spending pressures, particularly for health.[13] It projected that without policy changes there would be an "unequivocal deterioration in fiscal sustainability" – four decades of deficits and net debt reaching more than 50 per cent of GDP.[14]

An ageing population creates pressure on government finances because older Australians are on average net drawers on the budget – they receive more in benefits and spending than they pay in taxes. Australians under 65 are on average net contributors (Figure 1). This is the 'generational bargain' – each generation helps support the one before it in retirement.

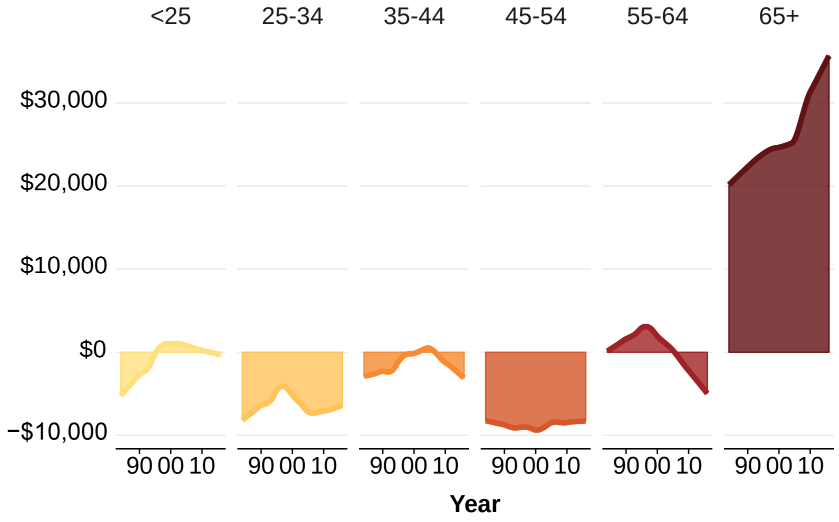
An ageing population means there are less working-age people for every person over 65: in 1975 there were 7.3 working-age Australians for every over-65, today it's 4.5, and Treasury projects that in the next 40 years it will fall to 2.7.[15] The fiscal pressures from an ageing population have been exacerbated by large increases in net transfers to older Australians – policy choices to reduce taxes and increase spending on this group (Figure 1 and Section 3).

Health spending continues to be the biggest contributor to spending growth – since the mid-1980s total health spending has increased by more than 3.5 percentage points of GDP and the Commonwealth contribution has increased by around 1.5 percentage points of GDP.[16] Most of the growth was from providing more and better health treatments, including using new technologies.[17] This strong non-demographic growth in health spending is forecast to continue[18] and will be compounded by the effects of an ageing population.[19]

[10] Karp (2018).
[11] Harris (2018).
[12] The Government's fiscal strategy is outlined in Commonwealth Government (2018), Budget 2018-19, Budget Paper 1, pp.3-7.
[13] Treasury (2015).
[14] Treasury (2015), pp.xiii-xv.
[15] Treasury (2015).
[16] Wilkinson (2018).
[17] PC (2013); Daley and Wood (2014).
[18] Ibid.
[19] Daley and Wood (2014).

Figure 1: Older households are net drawers on the budget, and the size of the drawdown has increased

Average net benefits received each year per household by age of head of household, 2016$



Notes: Net benefits are social assistance benefits in cash, plus support in kind minus income and sales taxes. Age is by age of household reference person – households headed by someone 35-44 receive higher net benefits than younger households because a greater number have children in school and therefore education spending is higher on these households.
Source: Grattan analysis of Survey of Income and Housing 2015-16.

Policy changes since the Intergenerational Report have quietly, but potentially significantly, compounded the long-term challenges. Huge amounts of infrastructure spending have been put off-budget, but will still need to be paid for if they don't make the promised commercial return.[20] Many of the structural improvements to the budget position from the 2014 Budget and factored into the Intergenerational Report proved politically unfeasible and have since been dropped.[21] The Government's Personal Income Tax Plan, announced in the 2018-19 Budget, commits the federal budget to a very substantial reduction in revenue over the next decade and beyond.[22]

Governments have given little indication that they have a plan or indeed a willingness to grapple with these longer-term challenges.

The best economic argument for removing refundability of excess credits is that it will put the budget on a more sustainable footing in the longer term. Specifically, it addresses one of the threats to the long-term budget position: the steady erosion of the corporate income tax base as an increasing share of profits are taxed in the hands of individuals with a zero marginal tax rate.

[20] Terrill and Wood (2018).
[21] Wood and Young (2016); Tingle (2017).
[22] Wood, Daley and Parsonage (2018).

3 The policy mainly affects older, wealthier Australians

There have been many claims and counter-claims about who will be affected by removing tax deductibility of excess franking credits. The policy mainly raises tax from older and wealthier Australians and will help wind back the growing intergenerational transfers in our tax system. Despite claims to the contrary, most people with SMSF balances above the transfer balance cap won't be able to avoid paying more by rearranging their affairs.

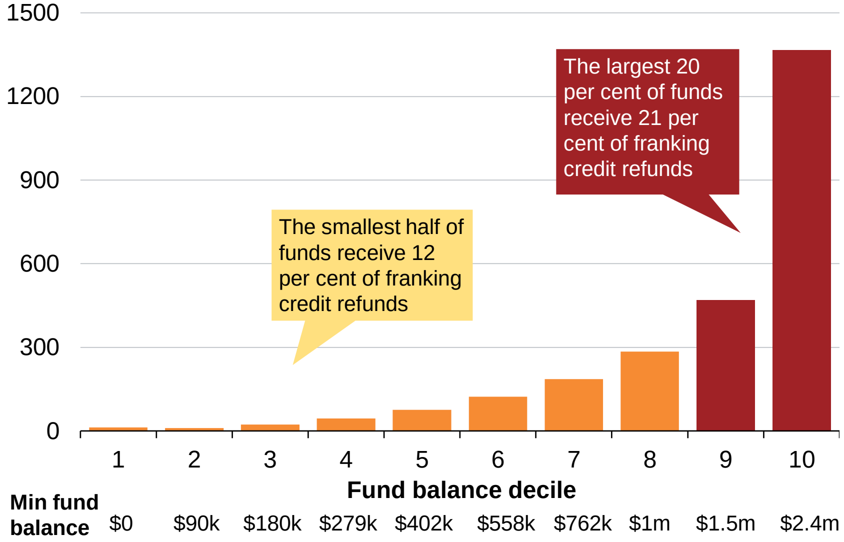
Nor is it likely that large numbers of retirees will respond to this change by rapidly spending down their retirement savings in order to become eligible for the pension (and franking credits). Retirees tend to aim to sustain a similar living standard through their retirement as they had during their working lives.[23] In fact most retirees today do not draw down substantially on their savings in retirement.

3.1 Removing excess franking credits primarily affects older, richer Australians

The PBO estimates that around 60 per cent of extra tax raised from ending the refundability of excess franking credits comes from Self-Managed Super Funds. Most of this comes from the 10 per cent of funds with balances of $2.4 million or more. The 50 per cent of SMSFs with balances of of less than $400,000 receive a small share of the total franking credits (Figure 2).

Figure 2: Higher-balance SMSFs get most of the cash refunds

Total excess franking credit refunds, $m by decile



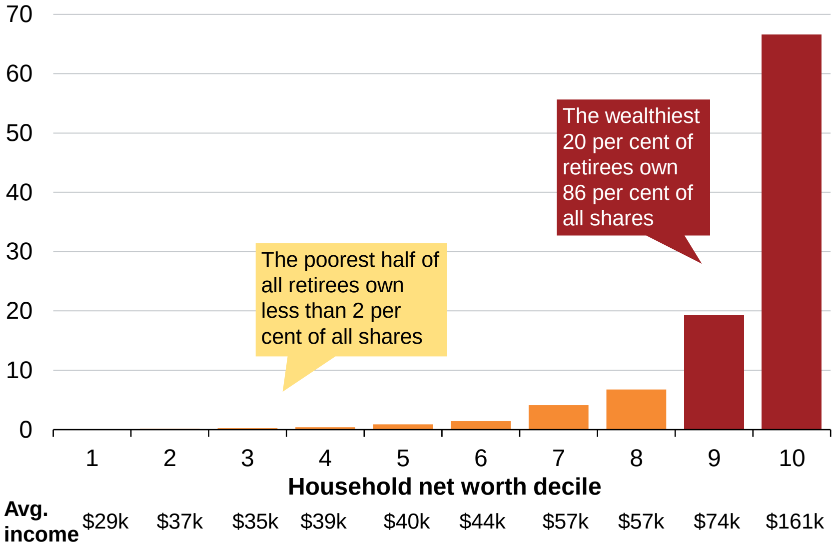
Source: PBO analysis using TaxStats 2014-15 for Australian Labor Party.

Another 33 per cent of the revenue from the policy change comes from people who own shares directly. Most of the excess credits going to shareholders flow to older Australians with otherwise low taxable incomes. Shareholdings among this group are highly skewed towards the wealthy: the richest 20 per cent of households over 65 own 86 per cent of the shares, while the poorest half of all retirees own less than 2 per cent of all shares held directly (Figure 3).

[23] Daley, Coates, Wiltshire, Emslie, Nolan, and Chen (2018).

Figure 3: Wealthier retirees own most shares, and have higher incomes

Share (per cent) of direct shareholdings for over-65s, by household wealth decile



Note: Total income includes superannuation withdrawals but excludes superannuation earnings.
Source: Grattan analysis of Survey of Income and Housing 2015-16.

Some of the public commentary on the distributional effects of this policy change has been highly misleading because it has focused on the low *taxable* incomes of those affected (Box 1).

Box 1: Why taxable income provides a misleading picture of the distributional effects of this policy change

Analysing the effects of the change to dividend imputation policy by focusing on taxable income does not shed light on the economic position of those affected. Many well-off retirees will have low taxable income because a hugely important source of income – earnings on superannuation in the pension phase – is not taxable.

Take the example of a self-funded retiree couple with a $3.2 million super balance, plus their own home, and $200,000 in Australian shares held outside super. Even drawing $130,000 a year in superannuation income, and $15,000 a year in dividend income, they would report a combined taxable income of just $15,000 and pay no income tax whatsoever.

Nor is it clear that incomes are the best way to judge just how well-off retirees are. People build up retirement savings during their working lives, which they then draw down to fund their retirement. Or at least that's the idea. One reason so many retirees report such low incomes is because they only draw down very slowly on their retirement savings, or not at all. Many are even net savers through much of their retirement. One recent study found that at death the median pensioner still had 90 per cent of their wealth as first observed.[24]

[24] Asher, Meyricke, Thorp, and Wu (2017).

The 'Pensioner Guarantee' – announced by Labor soon after the original policy announcement – ensures that every recipient of an Australian Government pension or allowance who has direct shareholdings or shareholdings in an SMSF before the cut-off date would continue to receive cash refunds (Section 1). The PBO estimates this change reduced the revenue from the policy by $300 million in 2021-22 – around 5 per cent. In other words, most of the revenue was never coming from those with low levels of income and wealth.

Of course, even with the Pensioner Guarantee not all people adversely affected by the policy change would consider themselves wealthy. But they have generally accumulated a reasonable nest egg – especially if they also own their own home.

People over 65 are not eligible for the pension if they have assets of at least $564,000 outside of their home for homeowners, or $771,000 for non-homeowners. For a retired couple, they will have assets of at least $848,000 (homeowners) or $1,055,000 (non-homeowners).[25]

In any case, being rich has never been the threshold for whether someone should contribute to the tax system – even for those in retirement. Refunds for excess franking credits are undoubtedly a welcome source of income for comfortably off older Australians, particularly if, like many retirees, they avoid drawing down on their assets. But the purpose of concessionally taxed superannuation is to help people support themselves in retirement, not to subsidise bequests.

3.2 Most people with high-balance super accounts will pay additional tax

Some have suggested the policy is unfair because it will spare people with large super account balances – those with balances above the $1.6 million transfer balance cap for individuals or $3.2 million for couples.[26] Under recent tax changes, retirees pay 15 per cent on super earnings above the cap, and therefore have some taxable income to use franking credits against.

This does not mean this group is unaffected by the policy change. Only Australian shares held in the accumulation account – for funds beyond the transfer balance cap – can actually be used to offset the 15 per cent earnings tax on those balances. Most investors with balances above $1.6 million – except for those with very high balances or those with almost no shares – will still lose some of their franking credits.

Consider for example a retiree with a $2 million super balance with 30 per cent invested in Australian equities, earning $42,000 in dividends. This retiree would have formerly claimed $12,600 in refundable imputation credits, because they paid no personal income tax. Under the ALP's policy, they could continue to benefit from imputation credits by shifting equities into the accumulation account.[27] But $400,000 is the maximum amount of domestic shares that they can receive imputation credits for. After restructuring their accounts, shares in the accumulation account would earn dividends of $28,000 and imputation credits worth $8,400, of which they could claim back only $4,200 against the 15 per cent tax paid on super fund earnings. The remaining shares

[25] They may also be ineligible because their incomes exceed the income test threshold of $172 a fortnight for singles or $304 for couples.
[26] Sloan (2018); Gottleibsen (2018).
[27] In practice, this could be achieved by selling domestic equities held in the pension phase account and purchasing them using funds held in the accumulation account.

stay in the pension account, paying dividends of $14,000. Overall, this retiree would lose around $8,400 a year in imputation credits.

People with the largest super balances – of more than $2.5 million for singles or $5 million for couples – probably won't be hit by the changes. They will be paying enough tax on super balances beyond $1.6 million to make full use of imputation credits. But they're already paying 15 per cent tax on their super earnings on all funds above the cap.

And some of these people will be affected *outside* of super. Many wealthy retirees with large super balances also tend to have large non-super savings such as shares, investment property or bank deposits.[28] Where retirees are not currently paying tax on the income from these investments because they fall below the generous tax-free threshold for retirees, they will also lose the benefit of refundable imputation credits on their direct shareholdings.

In this way the ALP's policy can be thought of as *complementary* to the transfer balance cap: it asks those with balances below $1.6 million to make some tax contribution, and it reduces the tax minimisation benefits of excess franking credits for those with balances over $1.6 million.

3.3 Spending the nest egg to go on the pension will not be desirable for most

Nor is it likely that large numbers of retirees will respond to this change by rapidly spending down their retirement savings in order to become eligible for the pension (and franking credits).

Retirees tend to aim to sustain a similar living standard through their retirement as they had during their working lives.[29] In fact many retirees today are net savers. Our analysis of the Survey of Income and Housing produced by the ABS shows that retirees typically maintain their non-housing wealth through their retirement.[30] Retirees aged 80-84 today have wealth of 4 per cent higher than they had when aged 70-74, even after adjusting for inflation. For those aged 75-79 today, their wealth is 12 per cent higher. These findings are consistent with a range of other studies all showing that many pensioners don't draw down on their retirement savings.[31]

Maintaining assets also provides insurance against longevity risk and unexpected health and aged care expenses. Concern about potential future health and aged care costs appear to be important drivers of precautionary saving by retirees.[32]

Some retirees who are close to the cut-off for receiving *some* Age Pension may draw down their savings to do so, but that incentive

[28] Daley and Coates (2018).
[29] Daley, Coates, Wiltshire, Emslie, Nolan, and Chen (2018).
[30] Daley, Coates, Wiltshire, Emslie, Nolan, and Chen (2018), Figure 3.8.
[31] Australian Government data show that less than half of all pensioners draw down on their assets, and more than 40 per cent are net savers (Morrison, 2015). Another study found that many Australian retired households – pensioners or otherwise – do not spend down much of their financial wealth as they age (Spicer, Stavrunova, Thorp, (2015)).
[32] In the US and UK, where many must fund their own aged care, retirees do not draw down much on their wealth. In contrast, retirees draw down on retirement savings much faster in countries with low out-of-pocket medical and aged care costs, such as Sweden, Norway, Denmark, Germany and Austria, where the median person aged 86-90 has only 21 per cent of the net wealth of younger retirees. See: Daley, Coates, Wiltshire, Emslie, Nolan, and Chen (2018), p.33.

has always existed since receiving a part-pension also makes retirees eligible for various concessions.[33] But substantial drawdown of assets in retirement remains rare, especially for wealthier retirees. Results from the ABS *Retirement and Retirement Intentions Survey* in 2012-13 suggest that around one quarter of superannuation lump sums taken are used to repay mortgages, purchase new homes or make home improvements, and a further 20 per cent of lump sums are used to retire other debt. But most lump-sum withdrawals appear to be made by lower-income earners who are likely to rely predominately on the Age Pension in retirement.[34]

3.4 Comfortably off older Australians should make a bigger contribution

Richer and even just 'comfortably off' older Australians will need to make more of a contribution for longer-term budget sustainability (Section 2).

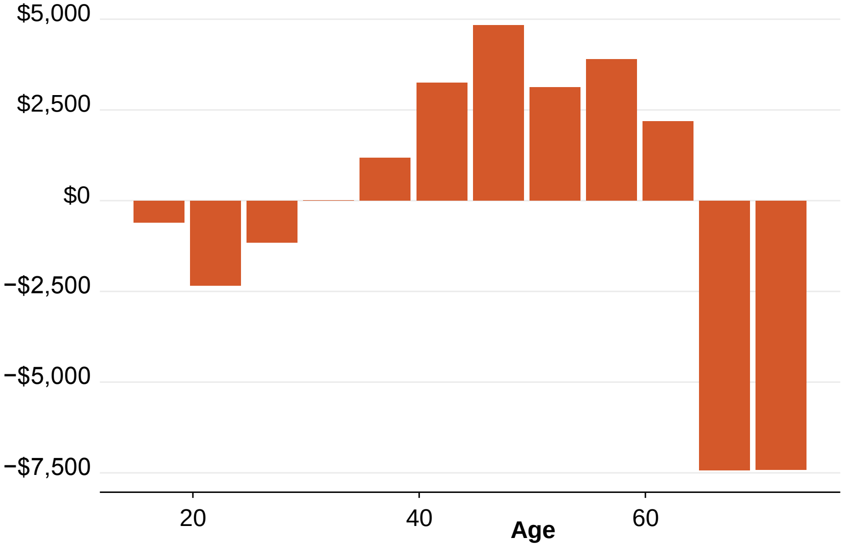
It is also fair to ask this group to contribute more. For more than a decade, superannuation tax concessions have been hugely generous to these households. These concessions – along with special tax offsets introduced for older Australians[35] – mean households headed by someone over 65 pay $7,500 less in income tax in real terms today than older households 20 years ago (Figure 4), despite the fact that their incomes and wealth are much higher.

Indeed, the proportion of Australian seniors paying any income tax has almost halved in 20 years, from 27 per cent in 1995 to 16 per cent in 2014 (Figure 5).

At the same time, the government is spending much more per person on services, especially health services, for over-65s.[36]

Figure 4: The average older Australian pays less income tax now than 20 years ago

Real change in average personal income tax paid by age, 2004-2016



Source: Grattan analysis of ATO 2 per cent sample file. See Parsonage (2018).

[33] For example, pensioners are eligible for various discounts, such as on council rates, that non-pensioners are ineligible for. In contrast, public transport concessions typically apply to all retirees – not just those on the pension. DHS (2018).

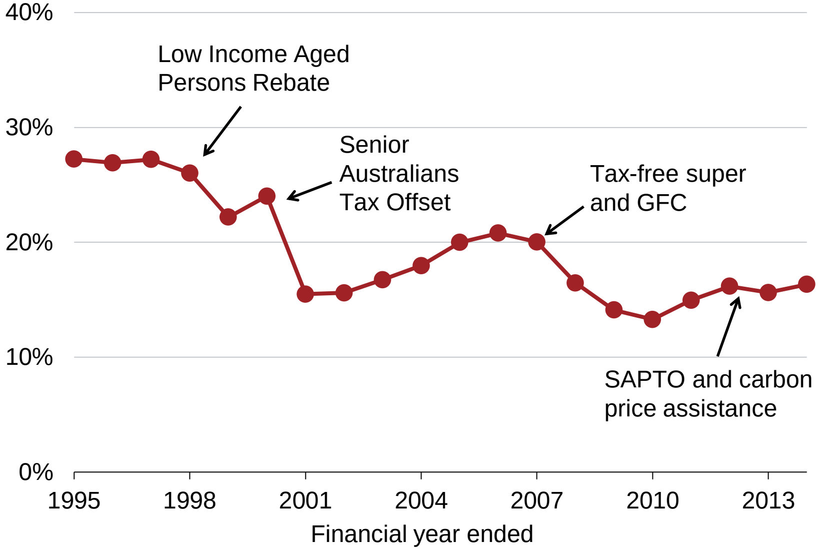
[34] Productivity Commission (2015), p. 87.

[35] Daley, Coates, Young and Parsonage (2016).

[36] Daley and Wood (2014).

Figure 5: The proportion of older Australians paying income tax has almost halved

Proportion of people over 65 paying personal income tax



Source: Grattan analysis of ATO 2 per cent sample files.

These growing net transfers to older households (Figure 1) are being financed partly by higher income taxes on working-age Australians (Figure 4) and partly by a decade of sizeable deficits that today's young (and perhaps their children) will be left to repay.

Restricting the access to tax-free dividends from companies and trusts is a fair way to help improve the budget and wind back the growing intergenerational transfers in our tax system.

4 The economic effects of removing excess franking credits

All tax increases impose some costs on the economy and will make some Australians worse off. The best governments can do is seek out the policies that have the smallest possible economic fallout and don't disadvantage the most vulnerable.

There are three potential economic costs from Labor's policy. First, a reduction of the overall benefits of dividend imputation in promoting investment for domestic firms and encouraging tax compliance and financial stability. Second, the policy increases the overall tax on savings – it is unlikely to have much effect on the amount people save, but may cause switching from domestic shares to other savings vehicles. Third, it creates an incentive to switch from SMSFs to industry funds – but it is unclear how substantial this switching is likely to be.

4.1 Reduction in economic benefits from dividend imputation (but the size of these are contested)

Any policy to remove excess franking credits will erode some of the economic benefits of Australia's dividend imputation system.

The main economic rationale for the dividend imputation system is that it promotes investment by lowering the cost of capital for domestic firms. But economists fiercely debate how significant this benefit is. At the two extremes:[37]

- Some argue that domestic investors bid up the price of stocks to fully reflect the tax benefit from dividend imputation. The effect is to lower the required rate of return by Australian companies and to promote investment (**domestic segregation hypothesis**).
- Others suggests it has no effect because the cost of equity is set in international markets, so imputation simply results in domestic investors getting a 'free-kick' – an after-tax rate of return higher than the equilibrium funded by the taxpayer (**international integration hypothesis**).

Wherever we started, Australia is moving closer to the second world as the economy becomes more open, weakening the case to retain dividend imputation.[38] Nonetheless, Labor's policy is likely to modestly increase the cost of equity funding, particularly for smaller domestically-focused firms that are less connected to international capital markets.

Dividend imputation also has other (less contested) economic benefits. It improves financial stability because it encourages firms to use equity rather than debt funding, and to offer higher dividend payouts. It also reduces the incentive for domestic firms to avoid tax, since their Australian shareholders pay tax at their marginal rate regardless of the rate the business pays.[39] These benefits will also be reduced, but not eliminated, by Labor's policy.

4.2 Reduction in the return on savings and in the incentive to invest in domestic shares

Removing excess imputation credits will also reduce the effective return on savings for certain investors. Removing the refund on

[37] A summary of the literature and the studies that support these contrasting views is provided in Davis (2016).

[38] Treasury (2014), pp.17, 278.

[39] McClure et al. (2018).

excess franking credits puts a floor under the tax rate on income earned via distributions from companies. The best evidence suggests a change of this type will not have much effect on the *total amount* people save, but will have some effect on *where* they choose to save it.[40]

The policy reduces incentives to invest in domestic shares for people with low taxable income, particularly retirees. This may not be a bad thing. The drive to harvest imputation credits has led some retirees to place a lot of their savings in a handful of high-yielding Australia stocks, reducing portfolio diversity and increasing risk.

Equities account for more than 50 per cent of total investments in superannuation portfolios in Australia, well above the OECD average. Conversely, bonds account for just 10 per cent of investments in Australian superannuation funds, the lowest of any OECD country.[41] This favouritism of domestic equities in Australia's huge savings pool is one factor that has hindered the growth of the corporate bond market in Australia.[42]

It is likely that the policy will induce some portfolio rebalancing away from domestic equities to bonds, as well as other investments including international shares, property, fixed-interest products and infrastructure assets.

4.3 Distortion in the choice between APRA-regulated funds and SMSFs

More concerning is the potential distortion in choice for superannuants between APRA-regulated funds and Self-Managed Super Funds (SMSFs). Very few APRA-regulated funds are affected by Labor's proposed policy because they have a sufficient stream of taxable income – new contributions that are taxed at 15 per cent – to use up their imputation credits.[43] In contrast, SMSFs in retirement phase pay no tax and so currently receive refunds for franking credits on Australian shares. The policy change will reduce the attractiveness of SMSFs relative to APRA-regulated funds.

How many people will actually switch from SMSFs to APRA-regulated funds is an open question. Ultimately it will depend on how much people value the other advantages of SMSFs: greater control over their investment options and avoiding management and administrative fees. The policy may also lead more retirees with an SMSF to encourage working-age family members to move their super from an APRA-regulated fund into the SMSF.

Some commentators have suggested there might be a lot of switching, reducing the amount of revenue raised from the policy. The PBO has assumed a sizeable behavioural response in preparing its costing – equivalent to around a quarter of listed Australian shares from SMSFs being moved into APRA-regulated funds that are in a net taxpaying position.[44]

[40] Daley, Coates and Wood (2015, pp.19-22) reviews the evidence on the link between tax incentives and retirement savings. The evidence suggests that people, particularly high-income earners, tend to save the same amount regardless of tax rates, but they tend to switch to whichever investment vehicle pays less tax.

[41] OECD (2017), p.157.
[42] Treasury (2014), p.16.
[43] PBO estimates suggest that only 10 per cent of refunds for excess franking credits go to APRA-regulated funds: Labor (2018).
[44] PBO response to Question on Notice No. 2 (PBO 2018).

5 Conclusion

Abolishing cash refunds as the ALP proposes, but keeping franking credits for those who do pay income tax, is probably not first-best policy. It abandons the principle that all company profits should be taxed at an investor's marginal rate of income tax. And it reduces the incentive for retirees to invest in companies from Australia rather than overseas.

On the other hand, abolishing cash refunds may well be a reasonable second-best policy in a tax system rife with distortions. The decisions not to tax superannuation withdrawals and to increase the effective tax-free threshold for older Australians have led to wealthy retirees contributing very little to government revenues relative to younger households. People over 65 pay less income tax per household in real terms than seniors did 20 years ago, despite their rising incomes and workforce participation rates. Labor's plan is arguably a fair way to help improve the budget and wind back the growing intergenerational transfers in our tax system.

A first-best policy would reintroduce a number of higher-income, higher-wealth older Australians to the tax system by taxing superannuation earnings and abolishing age-based tax rates.

First, earnings in retirement – currently untaxed for people with superannuation balances below $1.6 million – should be taxed at 15 per cent, the same as superannuation earnings before retirement. A 15 per cent tax on all super earnings would improve budget balances by around $2 billion a year today, and much more in future. A 15 per cent tax on super earnings would affect the retirement incomes of low- and middle-income earners a little, since the tax would apply to the first dollar of super earnings.[45] However retirement incomes for low- and middle-income earners would still be adequate.[46]

Second, the Seniors and Pensioners Tax Offset (SAPTO) should be wound back so that it is available only to pensioners, and so that those whose income bars them from receiving a full Age Pension pay some income tax.[47] Seniors should also start paying the Medicare levy at the point where they are liable to pay some income tax. They would then pay a similar amount of tax to younger workers with similar incomes. This package would improve budget balances by about $700 million a year.

These changes would achieve the same benefits but without some of the other investment-distorting effects of Labor's policy. Taxing super earnings would also bring older people into the tax net and enable Australia to stop the piecemeal tinkering to

[45] These replacement rates are conservative since they assume no behaviour change in response to the 15 per cent tax on super earnings. We assume that low-income earners are subject to the tax, because we assume people do not re-arrange their affairs to take advantage of the tax-free threshold outside super. Assuming no behaviour change, many people in lower-income deciles would pay around $1,000 in tax, and people in the highest income decile would pay an average of $11,000 in tax on their super earnings. But in reality those with super but on low and middle incomes could maintain a zero tax rate on earnings by moving savings out of super. Accounting for behavioural change, replacement rates are unlikely to fall for low- and middle-income earners.

[46] For a median-income earner, the replacement rate would be unchanged at 91 per cent. Daley, Coates, Wiltshire, Emslie, Nolan, and Chen (2018), Figure 10.2.

[47] Daley, Coates, Young, and Parsonage (2016).

retirement incomes policy we have seen from both sides of politics in recent years.

But in the absence of the political will to make these changes, abolishing cash refunds provides a big boost to the budget bottom line from more or less the same group.

In a world where there is no appetite for wholesale tax reform, where the government faces a long-term budget challenge, and where the income tax burden on working Australians continues to rise, a policy that indirectly requires richer older Australians to contribute may be the best we can do. Labor's policy is second-best policy in a third-best world.

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