Parliamentary
Budget Office

Request for budget analysis

Dividend imputation credit refunds – further information	
Person/party requesting the analysis:	The Hon Matt Thistlethwaite MP, Member for Kingsford Smith
Date analysis completed:	19 November 2018
Expiry date of the analysis:	Release of the next economic and fiscal outlook report.
Status at time of request:	☐ Confidential ☒ Not confidential
Summary of request: The request asked a series of questions in relation to the Parliamentary Budget Office's (PBO) publicly released response to Senator David Leyonhjelm's request, *Dividend imputation credit refunds* (PBO response of 4 May 2018, published on the PBO website 8 May 2018, PBO reference PR18/00145).	

Overview

This request seeks additional information in relation to Option 2 of the policy costing provided to Senator Leyonhjelm. The policy proposal outlined in Option 2 is to make franking credits non-refundable for individuals and superannuation funds, excluding Australian Government pension and allowance recipients. As this request seeks additional information in relation to the response provided to Senator Leyonhjelm, the PBO has confirmed that Senator Leyonhjelm agrees to the provision of the additional information. This approach is consistent with PBO Guidance 01/2013, which established the principle that PBO analysis of policies attributed to an individual parliamentarian or political party will only be conducted with the knowledge and active participation of the individual parliamentarian or political party.

The PBO's responses are based on 2014-15 administrative taxation data, which is the most recent year of data currently used by the PBO in its costing analysis. (In coming months, the PBO expects to update its models to the 2015-16 administrative taxation data.) It should be noted that a number of policy changes since 2014-15, including changes to superannuation arrangements and company tax rates, are not reflected in the 2014-15 or 2015-16 data. These policy changes would be expected to affect claims of excess franking credits. The PBO costing for Senator Leyonhjelm accounted for these policy changes as well as other changes in policy settings and economic parameters since 2014-15.

As noted in the response to Senator Leyonhjelm, there are significant uncertainties around the baseline data and the behavioural responses of individuals, superannuation funds and companies to the proposal. The PBO notes that all policy costings, no matter who they are prepared by, are subject to uncertainty.[1]

[1] For a more detailed discussion of the nature and sources of these uncertainties, see PBO information paper no. 01/2017, *Factors influencing the reliability of policy proposal costings.*

Responses to requests for further information

1. Based on the most recent data, can you provide the proportion of all excess franking credits claimed by each self-managed superannuation fund balance by SMSF balance decile?

Table 1 shows the distribution, by fund balance, of excess franking credits claimed by self-managed superannuation funds (SMSFs) in 2014-15. This table is based on SMSF tax returns for the 2014-15 financial year, and is consistent with Table C6 on page 11 of the costing response to Senator Leyonhjelm, completed 4 May 2018 and published on the PBO website 8 May 2018.

Table 1: Excess franking credits claimed by SMSFs — Distribution by fund balance — 2014-15[(a)]

Decile[(b)]	Fund balance range	Total excess franking credits claimed ($m)[(c)]	Percentage of all excess franking credits (%)
1	$0 to $90,276	12.0	0.5
2	$90,277 to $181,089	10.8	0.4
3	$181,090 to $279,252	22.5	0.9
4	$279,253 to $402,090	44.4	1.7
5	$402,091 to $558,140	75.8	2.9
6	$558,141 to $762,242	122.9	4.7
7	$762,243 to $1,044,621	186.3	7.2
8	$1,044,622 to $1,497,218	284.8	11.0
9	$1,497,219 to $2,443,843	468.7	18.1
10	$2,443,843 and over	1,366.2	52.7
Total SMSFs		**2,594.5**	**100**

(a) Figures may not sum to totals due to rounding.
(b) Based on the fund balance of all SMSFs in 2014-15.
(c) Calculated as *the number claiming excess franking credits* multiplied by the *average excess franking credits claimed in* Table C6 in the response to Senator Leyonhjelm.

2. Based on the most recent data, can you provide the percentage of individual taxpayers that do not claim excess franking credits?

Personal income tax return data for 2014-15 show that 1.13 million individual taxpayers claimed excess franking credits (refer to Table C5 in the response to Senator Leyonhjelm). Given that there were 13.94 million individual taxpayers in 2014-15, this means that 92 per cent of taxpayers did not claim excess franking credits through their personal income tax return.

3. Based on the most recent data, can you provide the proportion of shares held by each wealth decile in Australia?

Table 2 shows the distribution, by wealth decile, of the value of shares held by households in 2015-16. The data in this table are taken from the 2015-16 Household Expenditure Survey and Survey of Income and Housing collected by the Australian Bureau of Statistics. These surveys are based on a sample of households and involve respondents self-reporting the value of their shareholdings.

Table 2: Distribution of the value of shares held by households by net wealth decile – 2015-16[(a)(b)]

Decile[(c)]	Net wealth range	Proportion of the value of all shares held (%)
1	$36,000 and under	..
2	$36,000 to $110,000	0.2
3	$110,000 to $235,000	0.7
4	$235,000 to $374,000	1.5
5	$374,000 to $525,000	0.8
6	$525,000 to $697,000	1.4
7	$697,000 to $944,000	3.1
8	$944,000 to $1,291,000	6.3
9	$1,291,000 to $1,974,000	14.3
10	$1,974,000 and over	71.8
Total		**100.0**

Source: Household Expenditure Survey and Survey of Income and Housing 2015-16. Australian Bureau of Statistics.

(a) Figures may not sum to totals due to rounding.

(b) Net wealth is defined as the value of total household assets less total household liabilities. Net wealth decile ranges have been rounded to the nearest $1,000.

(c) Deciles are allocated based on total households.

.. Not zero but rounded to zero.

4. Can you confirm that, despite the Government's transfer balance cap, people will still be affected by the proposal?

Yes. This policy proposal will affect individuals and superannuation funds who would be expected to receive refunds from the Government because the value of franking credits they receive is in excess of their tax liability after 1 July 2019. The transfer balance cap will have reduced the impact of the proposal on some superannuation funds as it has increased the tax that is owed on the earnings of these funds. Even after the introduction of the transfer balance cap, however, many of these funds are still expected to be in a net-refund position and hence would be affected by this policy proposal.

5. Can you provide the extent to which the transfer balance cap will affect the revenue raised in the costing?

In the absence of the transfer balance cap, the estimated revenue raised from superannuation funds under this proposal would be expected to be up to around 10 per cent higher over the period to 2027-28. This impact is relatively low because the transfer balance cap only affects a relatively small proportion of pension-phase superannuation assets.

6. Did the PBO provide the costing based on the most recent budget policy baseline? For example, did the costing account for the Government's transfer balance cap policy?

The PBO always takes current government policy settings into account when preparing its policy costings. The response to Senator Leyonhjelm was provided on 4 May 2018, so the baseline set of policies and economic parameters used in this costing were those that had been legislated or committed to as at the 2017-18 Mid-Year Economic and Fiscal Outlook. The policies that formed the baseline from which this policy proposal was costed included the superannuation changes announced in the 2016-17 Budget and the scheduled company tax cuts (some of which are now not proceeding). The superannuation changes announced in the 2016-17 Budget included the introduction of the transfer balance cap along with a number of other changes.

7. In relation to Option 2 of the costing (released on 8 May 2018 by Senator Leyonhjelm) which excludes Australian Government pensioner and allowance recipients, how many Government pensioners and allowance recipients will not be affected due to this aspect of the proposal?

The number of pensioners and allowance recipients who would have been affected by this policy proposal had they not been provided an exemption is shown in Tables C1 and C2 of the response provided to Senator Leyonhjelm. These tables show 320,000 Australian Government pension and allowance recipients would have been directly affected by Option 1 of the proposal (which does not apply an exemption) in 2019-20. In addition, 20,000 SMSFs with a member receiving an Australian Government pension or allowance as at 28 March 2018 would have been directly affected by Option 1 of the proposal in 2019-20. These individuals and funds would be provided an exemption from the policy under Option 2 of the policy proposal.

8. Some have criticised the PBO for its use of the 2014-15 Australian Taxation Office (ATO) dataset because it implies the PBO did not account for the Government's more recent (2016-17 Budget measure) transfer balance cap. Can you please respond to that criticism?

As noted in our response to Question 6, the PBO always takes current and future government policy commitments into account when preparing its policy costings. A key input used in preparing costings is the most recent available data, which in this case was the 2014-15 administrative taxation data for superannuation funds and individuals. These data included detailed member account level data for SMSFs. The transfer balance cap was not in place in 2014-15, so these baseline data had to be adjusted to account for the impact of the changes in policy announced in the 2016-17 Budget before they could be used to cost the new policy proposal.

It is a common costing practice for all agencies preparing costings to use, as their baseline data, the most recent year of available data adjusted for policy changes and changes in economic parameters that have occurred since the year of the data.

9. Can you provide, based on the most recent data, the cost to the budget of allowing franking credits to be refunded where people have not paid any income tax? How does this compare with the cost to the budget of when excess franking credit refunds were introduced back in 2000?

The PBO estimates that in 2014-15, $4.9 billion franking credits were refunded to individuals and superannuation funds. However, the budget impact of making franking credits non-refundable would be smaller than this, as it would need to take into account the adjustments that individuals and superannuation funds would make to their investment strategies if franking credits were made non-refundable.

In the publication *Tax Reform: not a new tax, a new tax system*, published in August 1998 (page 34), making franking credits refundable was estimated to decrease the budget balance by $550 million in 2001-02. Policy changes to individual tax rates and thresholds, changes to the taxation of superannuation earnings and contribution limits, and changes to coverage of the superannuation system have been material since 2001-02 and will have affected the budget impact of allowing refunds of franking credits. Note that the figures for 2001-02 and 2014-15 are nominal figures and do not take into account inflation.

10. Can you outline the extent of the behavioural response you have factored into the costing? To what extent would the costing have generated more revenue if these behavioural changes had not been assumed?

The PBO considered a range of likely behavioural responses to the policy proposal by individuals, companies, Australian Prudential Regulation Authority (APRA) regulated superannuation funds, and SMSFs.

- For individuals, potential behavioural responses could include shifting from shares to alternative investment arrangements (including to investments within superannuation), and couples shifting the ownership of shares from the lower income earner to the higher income earner such that the higher income earner can utilise the franking credits as a non-refundable tax offset.
- For superannuation funds, potential behavioural responses could include rolling assets from a fund with negative net tax to a fund with positive net tax, changing funds' asset portfolio allocations, or changing the membership structure of the fund, in order to maximise the utilisation of franking credits.
- For companies, a potential behavioural response could include changing the amount of dividends distributed (and profits withheld) or the level of dividend franking due to the decrease in the value of franking credits for some shareholders.

In the absence of the assumed behavioural responses, the PBO estimates that the financial implications of the proposal would be about 15 per cent higher over the period to 2027-28.

The PBO considers that this incorporates a significant behavioural response to the proposal, particularly for trustees of SMSFs. The assumed behavioural response for SMSFs in 2019-20 is equivalent to these funds, in aggregate, moving around a quarter of the value of their listed Australian shares into APRA-regulated funds that are in a net tax-paying position.

11. Did the PBO consider the possibility that SMSFs might seek to increase the number of members within the fund to defray the costs associated with the costed measure? What factors might restrain this occurring?

Yes. At the time the costing was prepared the maximum number of fund members in an SMSF was four[2] and the PBO considered that a potential behavioural response to the proposal would be for additional tax-paying members to be added to SMSFs. For instance, a couple with an SMSF in the pension phase could invite two additional working-aged children into their fund, allowing them to use their excess franking credits to offset the contributions and earnings tax payable on the assets owned by their children.

In 2015-16, more than 90 per cent of SMSFs contained only one or two members, suggesting that individuals with SMSFs have a strong preference to manage their superannuation between just themselves and their partner. This strong preference is likely to reflect a number of factors to do with privacy and complexity. While the proposal may lead to an increase in the number of SMSFs with more than two members, the PBO's judgement is that this is likely to have a reasonably small impact on the costing.

12. Can you provide the extent to which you have factored in that some SMSFs might transfer their balances to APRA funds?

One of the most likely responses that the PBO considered is that individuals with SMSFs may choose to transfer their balances – either entirely, or just the proportion invested in Australian shares – to an APRA-regulated fund in a net tax-paying position. This response would offset the revenue gain from these individuals. An alternative response for these SMSFs would be to change the composition of their portfolio to reduce their holdings of Australian shares. The impact on the budget of this latter response would depend on the tax position of the purchaser of these shares – if they were entirely purchased by foreign investors, for example, there would be no offset to revenue.

The PBO notes that around 20 per cent of Australian equities held by SMSFs are unlisted. We have assumed that this policy proposal would have relatively little impact on SMSF holdings of unlisted shares as these are relatively illiquid and are assumed to be held by SMSFs for a number of different reasons.

Overall, in the absence of the assumed behavioural responses, the revenue gain from SMSFs would be around 20 per cent higher in the first year of the policy. The magnitude of the behavioural response is assumed to decline over time when the company tax rate declines, as the incentive for SMSFs to adjust their arrangements would be lower when the company tax rate, and hence the value of franking credits, is lower.

While the PBO did not separately quantify the impacts of different behavioural responses for SMSFs, the PBO's judgement is that this particular behavioural response – SMSFs transferring Australian-listed shareholdings to APRA-regulated funds – would have the most significant impact on the costing.

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[2] The Government subsequently announced its intention to increase the maximum number of members to six in the 2018-19 Budget.

13. Did you factor in a behavioural assumption that people might reduce their assets so that they're eligible for the age pension and therefore no longer subject to the policy?

The PBO's assessment is that, under current policy settings, there are already strong incentives for individuals to reduce their assets in order to qualify for the Age Pension, particularly for those with assets just above the threshold for the Age Pension asset test. For most individuals, the proposal would have little impact on these incentives. While a small number of individuals may choose to reduce their assets and qualify for the Age Pension as a result of the proposal, this would be unlikely to materially affect the costing.

14. The current budget baseline includes the 25 per cent company tax rate for all businesses. Ceteris paribus, what would the likely direction (+/-) of the budget impact be of the balance of the Enterprise Tax Plan being backed out of the budget bottom line?

The proposed policy would be expected to raise additional revenue if the previously scheduled company tax cuts did not proceed. This is because franking credits are linked to the company tax rate. The Government's decision not to proceed with a lowering of the company tax rate for larger firms would increase the expected revenue impact of the proposal by around 10 per cent over the period to 2027-28. This estimate includes an adjustment to the assumed behavioural response to the proposal, which would be expected to be larger if the company tax rate was higher.

15. The Parliamentary Budget Officer, Ms Jenny Wilkinson, in evidence to the Senate Finance and Public Administration Estimates Committee (21 May 2018) agreed that the approach the PBO took with this costing was 'conservative' and has included a substantial impact in terms of the behavioural assumptions used. Can the PBO please elaborate on this in terms of the net impact of the behavioural assumptions that were factored in?

The PBO considers that the assumed behavioural responses to the policy proposal are significant, particularly for trustees of SMSFs. The assumed behavioural responses by SMSFs in 2019-20 are equivalent to these funds, in aggregate, moving around a quarter of the value of their listed Australian shares into APRA-regulated superannuation funds that are in a net tax-paying position. To effect this outcome, a significant number of SMSF trustees will need to substantially adjust their investment strategy. Given that there is evidence that there are a number of different reasons why individuals choose to manage their superannuation through an SMSF, and not all of these relate to maximising returns, it is difficult to determine how open SMSF trustees will be to transferring a proportion of their assets to an APRA-regulated superannuation fund. The PBO's assumptions are 'conservative' in the sense that they lead to estimates of revenue gain that are lower than would be generated if smaller behavioural responses were assumed.

The behavioural responses assumed in this costing are similar to the illustrative behavioural responses discussed by Rice Warner in regards to SMSFs.[3] Rice Warner's illustrative analysis implied a similar impact on revenue as the PBO's behavioural assumptions.

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[3] See Rice Warner letter to Andrew Green and John Maroney, Coalition for Self-Funded Retirees, 2 May 2018.