Debates around retirement income policy can get ugly quickly. The issues involved are complex, not just economically but ethically as well. So is it any wonder that two months after Labor announced it would abolish refunds for excess franking credits, arguments still rage about whether it is a tax grab from retirees or a principled way to tackle intergenerational inequality?

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. Any unused or "excess" franking credits left after someone had reduced their taxable income 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 ATO, but those with no income tax liability — mainly retirees and their self-managed super funds — would no longer be able to claim cash refunds.

A plan to repair the budget

Labor argues that the changes are needed to help ensure the budget is sustainable. And on the numbers provided, the policy will make a substantial contribution to budget repair. The independent Parliamentary Budget Office estimates the policy will contribute an extra $5 billion in extra government revenues a year, growing over time. While some commentators have suggested the PBO has overcooked the figures – more on that later – the policy will certainly help the budget bottom line.

The economic arguments for repairing the budget are strong. The Commonwealth Government has been running substantial deficits – mostly 2-3 per cent of GDP – since the Global Financial Crisis. 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 can do little more to stimulate the economy, and so the Commonwealth budget will be the primary defence in an economic downturn.

Unfortunately any action on the budget deficit – whether cutting spending or boosting revenue – will generate some drag on economic activity and make some Australians worse off. The best governments can do is seek out the policies that have the smallest possible economic fallout and that don't disadvantage the most vulnerable.

So how does Labor's policy fare on these criteria?

Labor's policy will distort some investment decisions

Labor's policy has two main economic impacts.

First, it will erode some of the benefits of Australia's dividend imputation system. Economists fiercely debate how much the dividend imputation system lowers the cost of capital and promotes investment. As more Australian firms access international capital markets, the investment benefits from the dividend imputation system shrink. But some benefit remain, at

least for smaller and more domestically-focussed firms, and Labor's policy will increase the cost of equity funding for these businesses.

Dividend imputation has other economic benefits, too. 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. These benefits will also be reduced, but not eliminated, by Labor's policy.

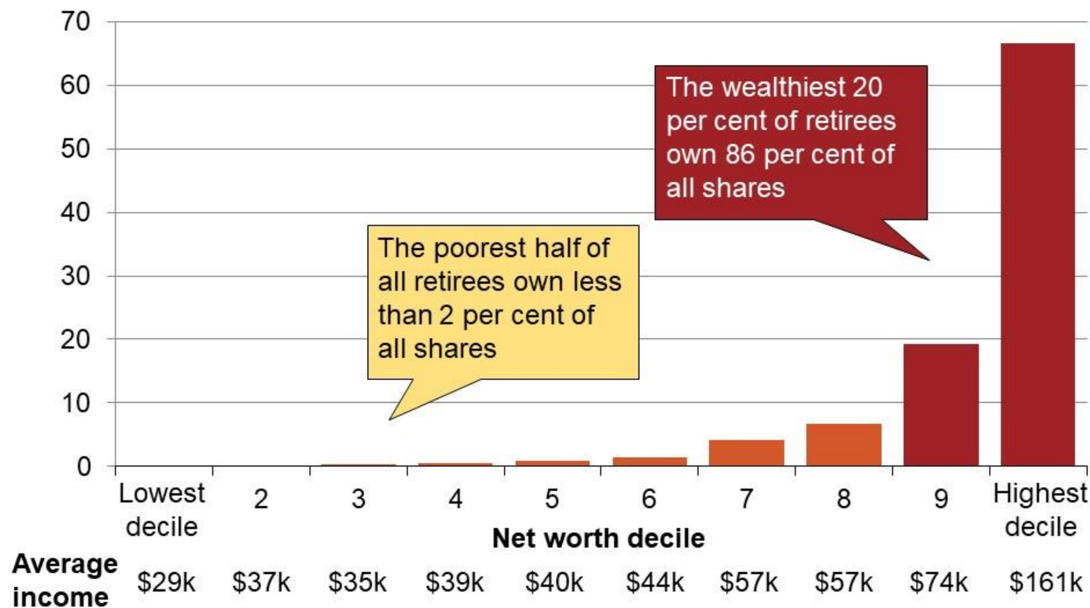
Second, the policy reduces the return on savings. Removing the refund on excess franking credits puts a floor under the tax rate on income earned via distributions from companies. The best evidence suggests the change will not have much effect on the *total amount* people save, but will affect *where* they choose to save it. The policy reduces incentives to invest in domestic shares for people with low taxable income, particularly retirees. Expect to see some switching into property or international shares among this group. For some people this might be a healthy rebalancing of their portfolio – the drive to harvest imputation credits has led some retirees to place a lot of their savings in a handful of high-yielding stocks.

More concerning is the 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. 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 control over their investment options that SMSFs provide. Some commentators have suggested there might be a lot of switching, reducing the amount of revenue raised from the policy. The PBO takes this type of behavioural change into account in its costings. But Labor has not made the costing public, so we are not able to see and test the assumptions used.

The policy mainly affects older and wealthier Australians

Labor's policy largely spares the most vulnerable. It mainly raises tax from older and wealthier Australians. Around 60 per cent of extra tax raised from the policy comes from Self-Managed Super Funds, and most of that is estimated to come from the 10 per cent of funds with balances of $2.4 million or more. Another 33 per cent of the revenue comes from people on low taxable income who own shares directly. Again, this is highly skewed towards the wealthy: the richest 20 per cent of older households own 86 per cent of the shares held by that age group, while the poorest half of all retirees own less than 2 per cent of all shares held directly.



Of course not all people affected would consider themselves wealthy: some people who have smaller parcels of shares or SMSFs will also lose their refunds. For these people franking credits can be an important source of income, particularly if like many retirees, they want to avoid drawing down on their assets. But the purpose of concessionally taxed superannuation is to help people support themselves in retirement, not to underpin bequests.

Richer and even just ‘comfortably off’ older Australians will need to make more of a contribution if budget repair is going to be fair. For more than a decade, superannuation tax concessions have been hugely generous to this group. These concessions – along with special tax offsets introduced for older Australians – mean older households pay less income tax in real terms today than older households 20 years ago, despite the fact that their incomes are much higher. Indeed, the proportion of Australian seniors paying any tax has almost halved in 20 years, from 27 per cent in 1995 to 16 per cent in 2014.

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

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

These policy decisions are making a bad situation worse for today’s young: in 1975 there were 7.3 working-age Australians for every person over 65, today it’s 4.5 in the next 40 years it will fall to 2.7. In other words, we are pushing a heavier burden onto younger taxpayers at precisely the time we have proportionately fewer of them.

Labor’s policy is a fair way to help improve the budget and wind back the growing intergenerational transfers built into our tax system over the past two decades. But there is a

better way. The Grattan Institute has previously advocated more substantial reforms – such as taxing superannuation earnings in pension phase at 15 per cent (distributions from super accounts 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.

Taxing super earnings would bring older people into the tax net and enable Australia to stop the piecemeal tinkering to retirement incomes policy we have seen from both sides of politics in recent years. Retirement income debates may be heated, but surely more policy certainty, a better economy, and less intergenerational inequality are things we can all get behind.