The big economic risks in Labor's imputation plan

The tax battle
It's not just a fight over fairness. Scrapping franking credit refunds would tilt companies towards excessive debt rather than equity.

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In the Trumpian tradition that if you repeat something often enough it will become an alternative truth, Labor keep repeating a false morality tale: imputation credit refunds for retired people who don’t pay tax is “so unfair”, it is “such a loophole”, “millionaires are getting thousands of refunds for retired people who don’t pay tax – you know, like those Panama Papers people.”

SMSF retirees are “tax exempt” not because of Panama, but because the government made them so, to structure the life cycle of superannuation. All Aussie equity investors (equally) provide dollars of tax-free retirement. It will be imposed retrospectively, making a mockery of the policies that were the basis of lifetime saving and asset allocation decisions – a real no-no of pension policy thinking in the OECD. It undermines the principle of choice based on a level playing field.

And it’s yet another example of politicians from both sides wanting to dip into the super honey pot – this tantalising transparent pool of cash right in front of their eyes.

As one OECD expert colleague told me: “I know we are supposed to say contribution schemes are best, but politicians always want to dip into them. I am very glad I won’t have one.”

This “dipping-in” undermines the public legitimacy of contributions schemes. Politicians have no idea of the future world retirees may face: low returns, climate change, the reconfiguration of world trade, or military conflict.

But I want to focus on the serious macro issues raised by this proposal.

Company investment is funded from shareholders’ equity – retained earnings and new equity issuance. If the investment fails, this equity is wiped out. Debt, on the other hand, is not wiped out, pushing up a company’s non-survival risk.

Financial fragility risk is associated with excessive debt. It is already an acute risk with low interest rates. For some years credit has been an issuers’ market. This is because investors are scrambling for yield, and riskier companies are more able to issue lower-coupon, covenant-lite securities.

Denying imputation refunds for tax-exempt will cause the tax bias to shift in favour of debt and away from equity. This wouldn’t matter if SMSFs were small. But SMSFs are large. In September 2018 SMSFs had $755 billion in assets (41 per cent of GDP); $256 billion of this is in Australian equities and listed trusts (14 per cent of GDP) (see chart). The potential asset allocation shift towards debt, property and alternative securities permits riskier company debt.

The annual withheld amount is then provided as a tax rebate to fund the superannuation of SMSF retirees. This is a redistribution of income – income that was not taxed in the first place. In my OECD research has shown that the role of taxing families to cover their old age is what’s truly unfair.

First, the increased demand for debt products permits riskier company debt issuance. These companies would be less well equipped to deal with the next recession.

Second, the incentives towards dividends will decline. Instead, the tendency to use excess cash to carry out share buybacks will rise, also facilitating reduced equity holdings by tax exemptions. This reduces the tax base for dividends, as the number of outstanding shares declines. It may also cut into productive investment.

Third, financial innovations involving debt and alternative products will rise to cater to the new relative return incentives – my OECD research has shown that the role of tax in the GFC was poorly understood.

Fourth, reducing the incentive to hold equities in SMSFs leads to selling. Foreigners own around one-third of the market capitalisation.

Raising their share risks pushing the (already rising) net primary income deficit towards pre-crisis levels (see chart).

Is the above “fake news” comment too harsh? You be the judge. Horizontal inequity and economic damage will result from the policy. The “fairness” justifications offered are specious: that it’s OK to attack a sub-sector of superannuation because they pay no tax – you know, like those Panama Papers people.

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The reward for this is the payment of dividends (taxed according to the income and the life cycle status of the recipients). For countries with a sensible imputation regime, like Australia, company tax only makes sense as a type of “withholding tax”. It reduces the incentive for companies to delay dividend distributions for tax-planning reasons.

The annual withheld amount is then reconciled with that owed by the owners of the company according to their tax status. Labor’s proposal wants to hold on to the tax withheld on behalf of a retiree who didn’t have to pay it. The French expression “du n’importe quoi” (Google it) fits perfectly for this sort of thing.

Nor will the policy achieve the hoped-for revenue gains. It is precisely the sort of thing that financial markets are good at avoiding.

The elephant in the room here is that, notwithstanding the success of the past 25 years, politicians on both sides just can’t keep their hands off the honey pot. But at
least have the courage to do it fairly, in a way that will raise revenue with less economic damage: reduce super’s tax-attractiveness in the accumulation phase (no retrospectivity) and (above all) leave imputation alone.

Then again, maybe my former colleague at the OECD was right after all.

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