CIFR Research Project

The Financial Implications of the Dividend Imputation System - F004

Area of Interest: Market and Regulatory Performance, Completed Projects **Lead Institution:** Centre for International Finance and Regulation
Assessment Round: March 2015 Completion **Date:** 2016

Project Summary
This project adds to the policy debate over the efficacy of the dividend imputation system, which was raised by the Financial System Inquiry and the Tax Discussion Paper.

The research:
(i) Examines the financial implications of the imputation system, addressing its impact on stock prices and returns, cost of capital, project evaluation, capital structure, payout policy and investor portfolios;

(ii) Discusses the potential impacts if the imputation system were to be dismantled or adjusted, perhaps in conjunction with a reduction in the corporate tax rate; and

(iii) Documents the international experience with dividend imputation systems, specifically the circumstances and motivations surrounding their removal by nine countries; and discusses the implications for Australia.

The key findings are that:

(i) The effects of imputation are debatable, both in theory and in practice, along most dimensions. The implications of imputation for stock prices and returns, cost of capital, capital structure and investor portfolios are all unclear. The notable exception is payout policy, where higher payout ratios have clearly been encouraged by the desire to distribute imputation credits.

(ii) Both theory and empirical evidence provide very mixed indications on whether imputation is priced into the market. Against this mixed evidence, the stance that the cost of capital is set in international markets stands as an extreme position. Allowance should be made for the possibility that imputation might be priced partially, or even fully, in some situations.

(iii) Imputation may matter for small, domestic companies, where it is more likely that local investors who value imputation credits may determine prices, as well as being chiefly responsible for providing funding. Any adverse impact from removing imputation may well be concentrated in this (economically significant) segment.

(iv) It is important to understand how imputation influences behaviour, and how these behaviours might change if the imputation system was adjusted or removed. Investors and company management often do not formally build the value of imputation into share price valuations, cost of capital estimates, or evaluations of investment projects. Nevertheless, these players may still acknowledge that imputation credits are valuable to many shareholders, and behave accordingly. Imputation can thus have an important influence on some decisions.

(v) The relation between imputation and payout policy deserves most attention. There is strong evidence that the imputation system has encouraged higher payout ratios, which has been one of its main benefits by contributing to more disciplined use of capital. From this perspective, dismantling the imputation system could have detrimental effects for both shareholders and the Australian economy through less efficient deployment of capital.

(vi) Imputation may not have much impact on corporate capital structure or investment decisions. The link between imputation and both capital structure and project evaluation is more tenuous. The case is stronger for a relation with capital structure, given that imputation increases the net return available to many shareholders. However, the evidence suggests that few companies take imputation into account when estimating cost of capital and evaluating projects. Rather, corporate investment decisions appear to be primarily based on more subjective considerations.

(vii) Imputation is influential in regulatory decisions. Regulation of utilities is one area where the value of imputation is explicitly built into the computations, and has real effects in terms of output prices.

(viii) The influence of imputation on investor portfolios is unclear; but any resulting domestic bias should not be a major policy concern. It is argued that a bias towards Australian equities paying high fully-franked dividends provides no significant danger to the Australian economy or financial system. Also, it is doubtful that this bias would be substantially addressed through changes to the imputation system.

(ix) The potential effects from removing or adjusting the imputation system are conditional on what other tax changes occur. Most relevant is any concurrent reduction in the corporate tax rate. This could provide a full or partial offset to some effects; and would be particularly important for the tenor of any share price reaction, and any encouragement to change capital structure. A major exception is payout policy, where reducing the availability of imputation credits would dull the incentive to distribute earnings regardless of any other changes to the tax system.

(x) Motivations for removing imputation in other countries do not seem directly applicable to Australia for the most part. They include aiming to improve investment by encouraging retention, reducing costs, improving flexibility, tax rebalancing, and the stance of the European Court of Justice. There is no clear case to remove imputation in Australia based on following the lead from overseas.

In summary, this research argues against removal of the dividend imputation system. Dividend imputation is seen to have had beneficial effects on balance, in addition to reducing the distortions that are associated with the double taxation of corporate income.

This research has been presented at:
CIFR/ACFS Seminars - DIVIDEND IMPUTATION: What effects has it had; and should it be dismantled?

Sydney and Melbourne (March 2016)

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Project Outputs:

- **Working Paper**

  June 2015

  Do Franking Credits Matter?
  Exploring the Financial Implications of Dividend Imputation

- **Working Paper**

  March 2016

  Dividend Imputation: The International Experience

- **Journal Article**

  June 2016

  The Impact of Dividend Imputation on Share Prices, the Cost of Capital and Corporate Behaviour
  JASSA, Issue 1, 2016

- **Op-ed**

  February 2016

  Axing dividend imputation may not be worth the risks
  The Australian Financial Review, February 2016

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