Capital Research

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Mr Garth Crawford
Executive Director, Economic Regulation
Energy Networks Australia
Unit 4, 110 Giles Street
KINGSTON ACT 2604

Dear Sir

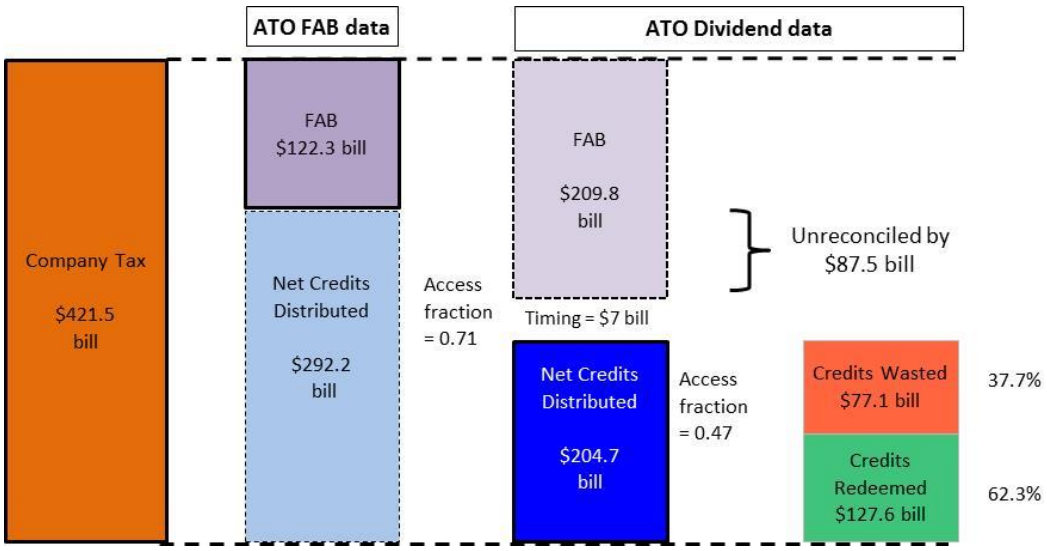
This is my response to the three questions you have put to me. I understand the three questions to be:

1. What is the relative reliability of the estimates of the three items of Company Tax Paid, Franking Credits Distributed and Franking Credits Redeemed derived from the ATO tax data referred to in my 2013 report "Imputation Credit Redemption ATO data 1988-2011"?
2. Which data items are needed to provide an estimate of gamma?
3. Can ATO tax statistics be used to provide a reliable estimate of gamma?

This is my response to the first question**: The relative reliability of the estimates of Company Tax Paid, Franking Credits Distributed and Franking Credits Redeemed derived from the ATO data**.

In order to address this I reproduce the following diagram from my 2013 Report.

Figure 1: Summary of ATO tax flow data: 2004-2011



The Company Tax total payment of $421.5 billion and the Credits Redeemed of $127.6 billion are both data generated from the ATO processing taxation filings. There is no other source than the ATO who essentially create these data. The Company Tax item is the total company tax collected by the ATO during the relevant period and the Credits Redeemed item is the total amount of credits redeemed via the filing of personal tax returns. These two data items are 100% reliable as they are figures that relate directly to ATO tax collections. There is no reason to question the ATO's records of the amount of corporate and personal tax it has collected.

These two data items immediately produce a national average gamma of 0.3 calculated as gamma equals credits redeemed divided by company tax (or credits created), namely gamma = $127.6 billion/$421.5 billion = 0.3. The other two data items are created by companies reporting their data to the ATO. They report their dividends paid, their franking credits distributed and the Franking Account Balance (FAB). These are the two data items that do not reconcile with one another. I have trouble deciding which one of these two items is the "culprit" for this lack of reconciliation. Neither of these items is required for the ATO to compute the amount of corporate or personal tax payable; they are provided for information only. The fact that they do not reconcile has no impact on ATO tax collection at the corporate or personal level.

We only need these two items if we are constructing gamma indirectly from its two component parts: the proportion of company tax distributed as franking credits and the proportion of those distributed credits that get utilised against tax liabilities.

Gamma = (Credits redeemed/Credits distributed)*(Credits distributed/Credits created).

The Credits distributed data can either be estimated from the FAB data or the franked dividend data. The FAB data tells us the tax paid and credited to the FAB that has not been distributed as franking credits. The estimate for the above period of the factor of Credits distributed/Credits created is 69% = $292.2 billion/$421.5 billion. (The plot above indicates 71% but this was after I adjusted for an estimated timing drag). Using the FAB data, the factor of credits redeemed/Credits distributed = $127.6 billion/$292.2 billion = 0.44. The product of these two factors is an estimate for gamma = 0.44*0.69 = 0.30.

Using the dividend data, the gamma estimate is as follows:

Gamma = ($127.6 billion/$204.7 billion)*($204.7 billion/$421.5 billion) = (0.623)*(0.49) = 0.30

Provided one is *consistent*, it does not matter which of these estimating processes is used for gamma.

In summary, clearly the Credits Distributed estimate is the least reliable of the three data items but consistency in estimation always gives the same national gamma estimate.

My response to the second question**, Which data items are needed to provide an estimate of gamma?** , is as follows.

I have essentially addressed this with respect to taxation statistics in my response to question 1. In essence, the minimal data requirements are Company Taxation Paid and the subsequent Franking Credits Redeemed. The combination of these two data items directly estimates gamma as the proportion of company tax that is in practice pre-payment of personal tax.

My response to the third question**, Can ATO tax statistics be used to provide a reliable estimate of gamma?,** is as follows.

The answer is clearly "yes" provided one is very cautious in being consistent with an estimation method. Unfortunately such consistency does not always happen. I have heard too many instances where people confuse

the two estimation methods, leading to inappropriate estimates of gamma. This was what was behind my expression of caution within my 2013 Report.

I find it frustrating that I cannot reconcile the two items of FAB and Franked Credit Distribution. I was conceited enough to suggest in my Report that the problem was within the ATO data. It could very well be within my logic for analysing the ATO data. So far no-one has indicated to me that I made an error of logic so I will keep on examining the ATO data as it is released.

Yours sincerely

Neville Hathaway
Capital Research

Phone (613) 9846 4474
Mob 0409 428 112
Email: njh@capitalresearch.com.au