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ECONOMIC RENEWAL WITH LABOUR

A talk by Andrew Smith MP, Shadow Chief Secretary to the Treasury, to members of the Economic Research Council on Tuesday 12th September 1995

I welcome the chance to address the Economic Research Council, and set out the thinking behind Labour's economic approach. The need for a new approach to managing Britain's economy is now more pressing than ever, as is evident from both the torrent of bad news statistics which have been pouring out of the Central Statistical Office in recent weeks and months, and the subsequent acres of newsprint analysing the faltering UK economy.

A Faltering Economy

It has become increasingly apparent that contrary to Kenneth Clarke's claims of *"a healthy economic recovery"* (HoC Summer Economic Debate, c. 971), the recovery is, in fact faltering. This is borne out by the latest figures showing that:

- Unemployment rose in July for the first time in two years, reaching a level of 2.3 million people without jobs.
- growth is slowing down with GDP growth in the second quarter of this year at 0.5%, reaching a level of 2.8% higher than a year earlier. This compares with 0.7% and 3.8% respectively in the first quarter.
- total investment increased by only 1.3% in the second quarter of 1995 and is 2.4% higher than a year ago. This is much less than at the same stage in previous recoveries.
- the PSBR was £0.7 billion in July 1995, reaching a total of £12 billion for the first 4 months of 1995–96, already over halfway to the £23 billion original forecast for the whole financial year 1995–96.
- The balance of trade deficit was £0.9 billion in May compared with £0.5 billion for March.

Labour's argument is that, with responsibility for the two deepest recessions since the war, and failure to secure sufficient profitable and productive investment, Government economic policy must carry a large share of responsibility for Britain's relative economic failure.

- Average growth rate across the Tory years has been only 1.7%.
- Employment is less secure, with total employment still lower now than it was in 1979.
- Living standards have fallen as family finances are hit by job insecurity, low pay and record tax increases. A typical family is now paying over £800 a year more in taxes since the last general election, and the tax burden is higher now than it was in 1979.

Two central weaknesses of this recovery have been investment and job creation.

When comparing this stage of economic recovery with that in the early 1980s it is clear that both investment and employment are at significantly lower levels now than then.

The outlook for the future is no more promising: the Treasury's Summer Economic Forecast, published in June, scaled back business investment forecasts for 1995 to 4.75%; that is less than half the forecast made at the time of the November 1994 Budget. Instead the Treasury hopes that the surge in business investment pencilled in for 1995 will now take place in 1996. If business investment fails to materialise there will be no offsetting rise in property based investment and public investment is forecast to fall significantly. With growth falling and unemployment rising, the economic environment is not looking favourable. Firms who were cautious and pessimistic in 1994 are unlikely to have revised their expectations up in 1995, and this in turn must place a considerable question mark over a major business investment upsurge in 1996.

Cause and Cure

Labour's strategy is rooted in clear analysis. The chronic problem of the British economy is that it is too small, with too few successful firms and too narrow a range of technologies and skills, for the levels of employment and prosperity we want.

It has a clear explanation – that our low levels of capacity arise from under-investment in people, industry and our social and economic fabric.

The heart of Labour's case is that government has a responsibility to act to rebuild the economy, to secure investment in jobs, skills, plant and infrastructure, with fair taxation, the minimum wage and quality public services to promote social justice and partnership.

Our approach offers a clear alternative: investing for the future, employing the talents of all, and tackling the underlying causes of mass unemployment and growing inequality.

The essential insight of new Labour's approach to the macroeconomic framework is that we have a proper understanding of the role for, as well as the limits of, government.

We recognise that government has responsibilities in preparing for the longterm. But we also recognise that governments must not let their narrow political considerations drive short term decision making. Inevitably this damages the credibility of the government's economic policy.

There are three main pillars to Labour's macroeconomic approach which flow from this analysis and which I will outline:

First, Labour will put in place an explicitly long-term macroeconomic strategy: an objective to raise the trend rate of growth with clear rules for borrowing and public spending which reflect the need to invest for the future.

The underlying problem is that the Conservatives have failed to take the medium-term action to ensure that their inflation target is met. They have failed to tackle the

underlying weaknesses in the British economy or establish a medium-term framework for tackling these problems.

There is an underlying cause of Britain's economic failures – of the repeated cycles of growth quickly derailed by accelerating inflation. We have an economic base which is too small to deliver sustained, non-inflationary growth – too few successful firms, not enough skilled workers, too little research into the development and exploitation of new technologies.

Britain has a slower trend rate of sustainable growth than any other G7 country. Our investment and productivity levels are also lower than any of our main competitors. These are the causes of Britain's relative economic decline.

It is these problems of under-investment and limited capacity which explain why the Government finds itself unable to convince people it has solved the inflation problem, and why the Bank of England predicts the Government will miss its target.

Labour's central objective is to deliver the highest possible level of sustainable growth consistent with low and stable inflation and meet the 1944 White Paper commitment to achieve high and stable levels of employment.

Our emphasis on strengthening the supply-side foundations of the economy, with a sound financial basis for sustainable increases in demand, is the route to both low inflation and low unemployment in the medium-term.

We believe that government has a critical role to play, using its ability to take action in the medium-term to influence the underlying strength of the economy – in particular the level of investment and capacity.

In order to meet our objectives, Labour will continue to have an inflation target. In addition, for the first time the next Labour government will make raising the trend rate of economic growth an explicit long-term objective.

Fiscal Responsibility

On fiscal policy, Labour has consistently made clear our commitment to prudence, responsibility and taking an explicitly long-term view.

We will be the party of wise spenders not big spenders. Our strategy is not based on an irresponsible programme of tax, spend and borrow, but of prudent investment for growth.

Two rules for borrowing will guide our approach in government:

- Labour will be committed to meeting the golden rule of borrowing – over the economic cycle, government will only borrow to finance public investment and not to fund public consumption.
- Alongside this golden rule commitment, we will keep the ratio of government debt to GDP stable on average over the economic cycle and at a prudent and sensible level.

In addition, because we want to see sensible investment in public services, we will lay down rules promoting value-for-money and cost effectiveness.

A strengthened programme review will be built into the public spending process so that waste and inefficiency in existing public spending is stamped out. I have already asked my Shadow Cabinet colleagues to exercise vigilance of the departmental budgets which they shadow, looking to identify potential savings and areas of wasted public money.

We will also place an onus on departments to seek partnerships with the private sector where appropriate.

The second pillar to our macroeconomic framework will be to underpin our medium-term approach with a tough anti-inflation policy based on stable and credible institutional foundations.

This requires a careful assessment of the relationship between the government and the Bank of England, as well as reform of the Bank to ensure greater accountability.

The process of meetings and decision-making is too unpredictable and haphazard: the dates of meetings are set on a month-by-month basis, leading to understandable suspicions that meetings are moved because of particular political events.

Decisions to change rates are not always announced – or even agreed – on the day of the meeting. For example, the decision to raise rates last September was only finally made in a telephone call between the Chancellor and the Governor two days after the Wednesday meeting, and only enacted on the following Monday.

This expedient and short-term approach to announcements means that the markets often anticipate rate changes for a number of days after meetings have taken place. This damages both credibility and stability.

The Conservatives have failed to live up to their own promise of ensuring that short-term economic decision-making is both removed, and seen to be removed, from narrow political considerations.

Therefore Labour has put forward proposals to guard against such dangers. We want to move the process forward, rebuilding confidence in the structure and proving that decisions are not being made on political grounds.

So, the timetable of meetings should be announced up to a year in advance and action must be taken to avoid market uncertainty in the days following the monthly meeting. That is why decisions about interest rates must be made at the meeting, announced immediately afterwards and properly justified to the public.

Adding to the instability is the overly personalised nature of decision-making which can appear insufficiently related to the medium-term strength of the economy.

The Treasury and the Bank of England

The relationship between the Treasury and the Bank of England is cast as a relationship solely between the Chancellor and the Governor. This calls into question the stability of the decision-making process and risks undermining the credibility of policy.

Information given to the Governor and Chancellor at their meeting – such as the inflation report – must be published as soon as is possible after they meet. But, in

order for the Bank to fulfil its current advisory role, and to move away from the damaging personalisation of what is described in the press as 'the Ken and Eddie show', the Bank should also be reformed so that decision making is objective, representative and accountable.

Labour has put forward a number of proposals to achieve this:

- We would establish a Monetary Policy Committee to decide on the advice to be given to the government on monetary policy. It would be made up of the Governor, Deputy Governor, both appointed by the Government, and six directors including the Chief Economist also appointed by the government in consultation with the Governor and Deputy Governor. The meetings of this Committee should record the opinions of the members about decisions taken.
- The current Court must also be expanded to reflect a wider range of interests from the City, both sides of industry and the regions. In addition to its current responsibilities, the Court would hold the monetary policy committee accountable to its mandate, commenting publicly on its decisions.
- The Bank's accountability to Parliament must be enhanced within a proper statutory framework. The Committee should be held accountable, with the Governor and Deputy Governor being required to give evidence to the Treasury and Civil Service Select Committee on a more regular basis.
- The Bank's inflation report should be subject to scrutiny and to review by the panel of independent experts.

We believe these reforms will transform the policy-making process into a more open and credible process, stamping out the short-termism which still dominates at the moment.

Macro-Economic Policy

This brings me to the third pillar of our macro-economic framework which will enhance the openness and credibility which we are committed to achieving.

There must be credible policies which convince people that they can expect stable non-inflationary growth. But government must also build a consensus and national purpose about economic policy if its objectives are to be realised, and confidence is to be instilled in individuals and businesses so they feel able to invest and plan for the long-term.

People at work and in their families must feel some ownership and involvement in national economic policy. Government can contribute to building a sense of understanding and national purpose around economic decision-making by opening up the process, and thereby helping individuals to share in a dialogue and understand the basis and rationale for decisions.

So the veil of secrecy which currently shrouds the operation of policy-making within the Treasury must be lifted. A number of reforms are possible without prejudicing financial stability, but by generating instead a new sense of national economic purpose which will actually enhance it.

It is clear, for example, that the Budget process is unnecessarily secretive. It must be opened up. Of course, government must be careful about making sensitive announcements on tax rates in advance, but a more open Budget process can help bring consensus.

In the run-up to the Budget, therefore, we will conduct a national economic debate, a consultative process on all aspects of economic policy-making. We will publish a Green Paper which will spell out the state of the economy, the success in achieving the government's objectives and the forecast for the coming year. In addition we will encourage a wide-ranging debate about the monetary and fiscal action necessary over the next twelve months and the sustainable rate of increase in wage costs which can be afforded without loss of competitiveness.

The remit and membership of the Treasury's panel of external economic advisors will be broadened to reflect a wider range of economic expertise. They will be asked to continue to present a pre-budget report. Moreover, to ensure that fiscal discipline is being maintained, the panel of advisors will also be asked to comment on the sustainability of the public finances in the light of our rules for borrowing.

We also want to see a more open debate on taxation. People have a right to know how their money is spent. There should be no taxation without explanation and no taxation without justification. We want every taxpayer to receive simple, easily understood and regular information on how the tax system is working and how their money is being spent. If local government can provide a detailed breakdown of how it spends residents' money, national government should be able to do even more for its citizens.

These are reforms which we believe will enhance our commitment to delivering macroeconomic stability, building a shared national economic purpose and confidence.

Investment, the Key to Growth

As I have made clear, it is the present government's failure to encourage sufficient investment and thereby expand the capacity of the economy, in order to deliver long-term sustainable growth which brings with it jobs, while at the same time ensuring a stable low trend rate of inflation.

Integral to our macroeconomic framework, is the commitment to implement policies to expand demand which will be met with improvements in supply and the ability to compete effectively in global markets. The key to a dynamic and strong economy is sustained, long-term investment which brings high returns and creates jobs.

Britain needs to increase the quality and quantity of investment in industry, businesses large and small, innovation, communications, infrastructure, the environment – and above all investment in people. Labour will put in place policies for dynamism to achieve the changes Britain needs.

A dynamic economy preparing for a new century needs effective and fair

competition and a government that is champion of consumers. Labour understands that competition and the setting of the highest standards go hand in hand. The Thatcherite laissez faire policy of competition without regulation has, by contrast, produced monopoly and inefficiency. Labour's competition policy will be effective in protecting consumers against the monopoly vested interests that this present government has failed to tackle.

Labour believes also that a dynamic economy requires government to play a critical role as partner, co-ordinator and catalysts in encouraging higher levels of investment and encouraging an investment culture which supports longer term relationships between government, managers, shareholders and employees.

The challenge is to find a way to encourage a longer-term view from institutional investors so that they can properly exercise their responsibilities as owners of British public companies, in short to build a new culture of partnership and long-term relations which promotes the public interest and needs of all stakeholders.

And that means changes in our system of corporate governance – looking at greater incentives for long-term finance, opportunities for small businesses to gain start-up capital and more incentives for investment in skills, infrastructure and transferable technology.

Labour also believes that the corporate tax and financial system can encourage long-term investment, and is a route through which we can offer positive incentives for long-term investment. I am conducting a review of corporate taxation which is:

- examining legal and fiscal obstacles to long-term investment
- considering ways in which the tax and regulatory system can encourage long term, patient, partnerships between the suppliers and the users of investment capital through institutional and fiscal reform
- looking at measures for simplification of the tax system
- cutting the costs of compliance, especially for small companies
- taking a new modern approach to UK tax law, so that companies in similarly economic circumstances are taxed in a similar manner and fair treatment does not depend on an ability to negotiate a maze of semantic obstacles
- reviewing the tax treatment of expenditure on research and development to promote innovation
- seeking to encourage a virtuous pattern of investment towards high tech, high added value and greener activities across the regions of Britain and away from risk averse, low tech, property based investments
- examining, among others, the CBI's proposal to reward long term investment through the capital gains tax system.

A New Partnership in Investment

Alongside our corporate tax strategy is our widescale commitment to nurturing partnership between public and private sector, particularly with regard to partnerships in infrastructure investment, putting old battles between public and private behind us.

Despite the backwardness of our infrastructure, the Government has been cutting public investment, and has assumed that the private finance initiative can fill the gap. But the PFI has not, in any way, compensated for the cuts in public investment that have taken place.

Public sector asset creation has fallen from 6.4% to 4.1% of GDP since 1978/79. And over the years 1993/94 and 1994/95, public investment has been over £2 billion lower than in the previous two years.

By comparison, in its first two years the total of private finance levered into infrastructure projects through PFI has totalled just £500 million. This represents a fraction of the £12 billion worth of projects announced as either under way or under consideration by Kenneth Clarke in September 1993.

The Government's mistake is to see the PFI as an opportunity to abdicate Government responsibility for modernising the infrastructure rather than as a vehicle for a partnership between public and private sectors to increase overall levels of investment.

It is because Labour has a different view of the role of government that we believe we will be able to promote genuine and lasting partnerships between public and private sectors.

We have proposed some important new steps forward in the whole approach to public/private partnerships.

Under our proposals Government would identify its priorities for projects; it would state its financial commitment to projects; we would establish a public/private Taskforce whose role would be to move projects ahead and it would be responsible for brokering agreements between public and private sectors.

In addition we are consulting on proposals to deal with the problem of risk allocation through a possible role for Government as insurer rather than equity holder, where cover is needed against risks, for example on legislation and planning, which arise from government itself. We are also seeking views on the scope for operator companies, new independent companies, possibly with a Government share, with the remit of investing in and operating new infrastructure projects.

The potential for public/private partnerships goes beyond physical infrastructure projects. For example we believe there is scope for this approach to be applied to rebuilding our industries, through partnerships between regional development agencies and local companies.

In addition, the partnership approach will also be the key to building the technological infrastructure of the future. If we are to meet the challenges of the new world of information technology, interactive communications and the latest wave of new production techniques then we must develop an advanced communications infrastructure to match.

We must have a clear shared vision of a UK information superhighway that surpasses that of our competitors. It needs government action and imagination. It needs co-operation between telephone, television and computer companies and government: a public/private partnership to create that vision and to take it forward.

It is on that basis that our proposals for a University for Industry will bring together educators, broadcasters, telecommunications companies, both sides of industry and government in a new project – a university which brings the latest innovations in learning and technology to employees and does for workplace education in the 1990s what the Open University did for education from home in the 1960s.

This is just one element of our pledge to bring about the skills revolution for training and employment that Britain needs to succeed in the competitive global economy.

Better investment in people is crucial for Britain's future. To reverse the trend of mass unemployment which has become a symptom of Conservative policy failure, is to reverse the trend of under-investment in people which the government has persisted with.

Labour understands that unemployment – and the failure to use the energies of millions of people – is not just a consequence of economic problems but a cause of them. Our central economic objectives cannot simply be the reduction of inflation but need also to be the attainment of high levels of growth and high and stable levels of employment.

Social Justice and Economic Efficiency

To meet this aim we have set out our policies to initiate a skills revolution and boost training alongside our commitment to put in place a statutory national minimum wage, in order to tackle the rising inequality and poverty that riddles British society today.

Labour believes that economic efficiency goes hand in hand with social justice, as opposed to the Conservative philosophy which assumes that more inequality and poverty are essential in order to deliver economic growth and rising prosperity. The reality of the Conservative years has been that economic failure and poverty have gone hand in hand. The facts are clear: the 16 years which have seen the lowest average growth rate since the second world war has also seen the greatest growth in poverty and unfairness in our twentieth century history.

The task for a Labour government is to translate this analysis into practical policies and to deliver both economic efficiency and social justice. Our belief is that attacking poverty and lack of opportunity at their source is the route to both a fairer society and a more prosperous economy.

To tackle the mass unemployment that pervades Britain today we propose specific measures to reverse the long-term and youth unemployment which are especially corrosive. We propose that:

- after being unemployed for one year, everyone should have the offer of work or high quality retraining, with the aim of abolishing long-term unemployment.
- every young person leaving school without a job should have the opportunity of work with training or quality education and training, with the aim of abolishing youth unemployment.

In addition, we put forward further measures to speed job creation:

- the phased release of the £6 billion worth of capital receipts which Local Authorities hold as a result of land and property sales, but which the present government has put a freeze on. Labour would phase the release of these receipts in order to kick-start investment in housing, at the same time creating the jobs which go with that.
- the public/private partnerships to boost infrastructure which I have already outlined will inevitably result in the generation of jobs.
- a self-financing energy conservation programme.
- action to boost small businesses, including regional development agencies as well as our plans for corporate tax reform.
- a benefit transfer programme.
- Labour is consulting on the job-generating potential of tax rebates to employers who recruit the long term unemployed.

In order for people to be better equipped to take up the opportunities which these measures will provide, Labour believes that a training and skills revolution is urgently needed.

Recent surveys have reinforced our argument that people in Britain are less well-equipped in terms of skills and training than their international counterparts, putting them in a relatively weak position. Therefore lifelong learning which includes a long-term government strategy to develop Britain's training system, is essential.

I have already talked about our proposals for a University for Industry which forms an integral part of this strategy. Labour will also carry out a skills audit of the nation to identify which skills are in short supply, with a view to targeting training resources on removing bottlenecks and on providing those skills most likely to lead to employment.

In working to provide fairness of opportunity for all, enabling people to use their talents and potential, thereby contributing to the wider prosperity of the economy as a whole, we are conscious also that measures must be in place to enact a modern war on poverty and inequality.

To make this happen we need a new welfare to work programme and a full scale modernisation of the welfare state set in the context of our programme for economic modernisation. What is now clear is that poverty and inequality in Britain can only be tackled by dealing, at root, with their causes, and that in doing so, middle income as well as low income Britain will benefit.

The best way to attack poverty is by ensuring that people can get jobs which pay a decent wage. The Conservatives have perpetuated a society characterised by unfairness, with privilege at the top, as in the privatised utilities, and insecurity for the rest.

While top directors in the utilities award themselves huge pay packets, growing exploitation at work and rising wage inequality, together with high unemployment, has meant rising poverty and insecurity for many families.

That is why Labour maintains that a national minimum wage is essential for Britain, not simply to outlaw exploitatively low wages but to underpin the benefit system and help provide new incentives for the unemployed to take jobs at decent wages.

In conjunction with a national minimum wage, Labour will sign the Social Chapter which provides a framework of workplace standards across the European Union. Let's remember, it is just that, a framework; it does not mean we will be committed to every proposal which emanates from Brussels. But we do believe that economic progress can be reinforced by strengthening security at work, improving health and safety, increasing through public/private partnerships the availability of quality childcare and opening up pathways out of poverty in the reform of social security.

The Principles of Taxation

An important part of our new agenda for fairness, is a fair system of taxation. As has been made clear and will continue to be made clear, Labour will not make commitments on levels of taxation or public spending before our election manifesto because we need to know the economic circumstances in which we will honour our pledges, and because, unlike the Conservatives we will keep our promises.

But we make clear the principles which will govern our approach:

- tax should be fair: that means it should be progressive and based on ability to pay;
- the tax system should as far as possible be simple to understand, easy to collect and cheap to administer;
- tax should encourage work and opportunity and reward effort; we do not tax for taxation's sake;
- privileged treatment of windfall gains from monopoly profits is indefensible and must be ended;
- tax should promote long-term productive investments by companies which encourage real enterprise;
- we are committed to sound and stable public finances and to rooting out waste and inefficiency, meeting the "Golden Rule" by borrowing for investment not consumption on average over the economic cycle.

These specific principles apply not only to taxation but also on a broader scale to our whole economic approach. We are very aware of the changing international context in which a Labour government will have to work, which is why we believe that close co-operation and co-ordinated action at the national and international level is essential if we are to achieve our aims of sustainable growth, rising prosperity and social justice in Britain.

The International Context

We believe there are advantages too in moving towards economic and monetary union in Europe, through the creation of a European single currency. Such moves have the potential to bring significant benefits to the peoples of Europe. In particular, it would remove the costs of currency transactions currently estimated at £18.5 billion each year, boost inward investment by reducing exchange rate risks, create a more stable economic environment for industry and reduce currency speculation.

For Britain to join a European single currency there must be convergence of real economic performance across Europe, such as employment, productivity and growth. We must be confident that British industry will be able to compete effectively within the single currency area. The Council of Economic and Finance Ministers must be developed as the political counterpart of the proposed European Central Bank to give the public a voice in shaping economic policy.

But there are questions which must be confronted on the road to economic and monetary union. We must be sure that real as well as nominal convergence is evident. Is this convergence sustainable? How coherent and accountable is economic policy co-ordination within the European Union? What are the likely effects on the British economy and people of not joining full EMU if a core of countries decides to go ahead? And finally we must think of what the practical consequences of changing to a common currency will be.

These are important issues for our country and for Europe. The tragedy is that the present Government's approach and divisions on Europe have marginalised Britain's voice.

In conclusion, through the consultative process of drawing up our document for this year's Party Conference, in work we have done on public-private partnerships, in the discipline we are exerting over commitments of levels of tax and spending, and not least in reforming Clause 4 of the Party's Constitution, New Labour has radically repositioned Labour's economic approach.

We have put behind us old battles of public versus private, state versus market, old caricatures of Labour as the Party of indiscriminate tax, spend, borrow and devalue.

In their place we have positive policies for a modern dynamic economy. A stable macroeconomic framework for sustainable growth, public/private partnership, fair competition, Labour on the side of the people against vested interests, monopoly and privilege, Labour as the party of sensible cooperation in Europe.

Enduring values of fairness and opportunity are represented anew in our conviction that a strong and successful economy demands a strong and socially just society. We recognise and will act upon the duty of government to govern for all the people. Unlike the Conservatives, who as an article of faith have surrendered responsibility for much of the economy, we understand that the answer to Britain's economic problems is not no government but good government. We count it as central to the duty of government to play its part in creating conditions for lasting economic success.

We do not claim instant solutions. Some of our proposals will make a difference straight away. Many of course will take longer to have their full effect.

THE UNDERLYING ECONOMIC IMPACT OF THE UK CORPORATION TAX SYSTEM*

By Christopher Daws

Introduction

UK companies pay relatively little UK tax on their profits, by comparison with their overseas counterparts. This fact is obscured by the inclusion in the statistics of advance corporation tax ('ACT'). This article says that the ACT is not a tax on company profits. It also takes issue with the common perception that ACT discourages UK companies from investing overseas. Surplus ACT is not a problem. The UK already has an exceptionally lenient system of tax on company profits. But it needs to be presented differently.

Many British multinational groups have surplus advance corporation tax. Their perception of this surplus, and the accounting treatment of ACT, have led them to lobby forcefully for various reliefs from tax on the grounds that these reliefs would help to reduce the surplus. Investment analysts penalise companies where they expect the tax charge to be increased by surplus ACT.

In reality, surplus ACT is not a problem. The UK taxes company profits more lightly than most other industrial countries. It is only two major presentation faults that have persuaded finance directors and investors otherwise.

The Chancellor took advantage of this confusion in his March 1993 Budget. Under a pretence of alleviating the so-called surplus ACT problem, he significantly increased tax on distributed company profits.

The UK tax system – exceptionally low rates on company profits

Cast aside for a moment all your preconceptions about the UK tax system and the way it is treated in accounts and consider the following description.

Most countries apply a substantial rate of tax twice to company profits. The US Federal Government, for example, taxes companies at 34% on their profits. Then the shareholder pays taxes on any dividends from the company – his separate and additional responsibility, with no effect on the company's liability.

The UK Government, by comparison, taxes companies very lightly, on profits which are distributed as dividends, at a rate of only 13%. Of course, shareholders suffer their appropriate rate of tax on the dividends, just as in the US and elsewhere. But the combined company and shareholder tax burden on business profits remains one of the lowest in the world.

Pause for thought. 13%? Surely not? The explanation follows. But first – the overseas dimension.

* This article appeared recently in Taxation Practitioner, the official magazine of the Chartered Institute of Taxation

Heavy subsidies for investing overseas

For UK companies, the combination of 13% on distributed profits and 33% on retained profits is lenient enough. But multinationals are treated even more lightly, because there is no restriction on how much of a group's dividend can be used to gain entitlement to the 13% rate. Even if, in fact, part of the dividend is being sourced from overseas profits, the tax rules permit the whole dividend to be considered as coming from UK profits.

Table 1 illustrates this. It demonstrates how companies investing overseas are already obtaining a tax advantage by using dividends sourced from overseas to reduce their taxes on UK profits. Company V in the table has achieved a reduction from 23 to 13 in the tax on its UK profits of 100 by expanding and generating part of group profits from overseas. This subsidy of 10 gives it a decided advantage against a wholly domestic UK competitor, such as company U, or against a portfolio shareholder investing direct into overseas companies.

It is hard to believe that this large incentive for investing overseas was deliberate. UK companies are being subsidised to source a major part of their profits from overseas as a means of reducing their UK tax bills. The imputation system was supposed to encourage foreign companies to invest here, not the reverse.

This subsidy may be vulnerable to change. The law could easily be amended to restrict the entitlement to the low 13% rate, by compulsorily deeming part of the dividend to have been sourced from overseas.

Look again at the table. Company W has gone even further than the others and earns 80% of its profits overseas. Its dividend exceeds its UK profits. As well as being entitled to the 13% tax rate on all its UK profits, it can effectively carry the spare 150 of dividend backwards or forwards to gain this entitlement on a further 150 of UK profits in another year.

Table 1: Sheltering UK profits from tax by investing overseas

	Company U	*Company V*	*Company W*
Profits			
UK	100	100	100
Overseas	–	100	400
	100	200	500
Tax			
UK	23	13	13
Overseas	–	40	160
	23	53	173
Dividend			
Net	40	80	200
ACT	10	20	50
	50	100	250

What is ACT?

So what is the problem? It is clear from the above that UK companies investing overseas are highly favoured by the UK tax system. Yet we hear constant complaints about the 'burden' of surplus ACT.

These complaints stem from confusion about the imputation tax system. The nature of the two rate system – 33% on retained profits and 13% on distributed profits – is obscured by the mechanics of ACT. In other countries where two rates apply – Germany, for example – there is no confusion as the two rates are applied directly to profits.

When companies pay dividends, they deduct 20% on account of income tax from the gross amount and pay this to the Exchequer. The shareholder receives the net dividend and, if his liability differs from this rate, deals direct with the Revenue to settle the difference.

Here is the first presentation fault. Why, back in 1972, was the deduction from the dividend called ACT – advance corporation tax? It is not corporation tax, it is income tax on dividends and this is what it should be called. To call the tax withheld from dividends ACT is a misnomer – it merely describes the mechanics by which it is accounted for by the company, to the extent that the dividends do not exceed the UK profits. To the tune of £500m a year (the rate at which the 'ACT surplus' is estimated to be accumulating), this condition is not being satisfied and the name ACT is incorrect as well as misleading.

The confusion is reinforced by tax law, which defines "the dividend" as the net payment. To the man in the street, the amount of a dividend, like that of any other income, is the amount before tax rather than after tax. It is the net payment plus the associated ACT/income tax which was retained by the payer as a provisional payment on account of the shareholder's eventual liability.

Companies with "surplus ACT" protest that the payment of ACT is a cash drain. It is no more a cash drain than the net dividend paid to shareholders. ACT is an integral part of the gross dividend, not a tax on the company.

As an exempt investor, the Church Commissioners are only interested in the gross dividend, even though it arrives in two instalments. We are bemused that companies see the second instalment (the ACT) in a different light from the first.

SSAP 8 compounds the misunderstanding

The second presentation fault lies in the two Statements of Standard Accounting Practice which prescribe the treatment of tax and the calculation of earnings per share. The two statements – SSAP 8 and SSAP 3 – require the ACT payment to be included in the tax charge related to the company's profits.

SSAP 8 and SSAP 3 were last issued in 1974, in an age when analysts expected tax charges to remain steady from year to year and felt uneasy otherwise, even though a fluctuating charge might be the truer picture. So a golden opportunity was missed. If ACT had been recognised for what it was – part of the dividend – the tax rates on

UK profits shown in accounts would rightly have plummeted. UK companies would have shown lower tax rates in their published accounts than those in other countries, highlighting the attraction of the UK as a location for investment.

SSAP 3 implicitly recognised that the prescribed treatment would not always be satisfactory. It was updated following the introduction of the imputation system and ACT in 1972 and assumed that:

> "after the transitional period, only a small proportion of listed companies is likely to have irrecoverable ACT. These companies will be mainly those whose earnings arise overseas, or ..."

It is just those companies, many in number, whose published earnings per share are hit by the SSAP 3 treatment of ACT and who are driven to press for change to the underlying tax system.

Likewise, the authors of SSAP 8 decided to follow the mechanics of ACT accounting rather than the economic substance and treat the ACT as a tax on the company rather than on the shareholder.

Table 2 illustrates the difference between the tax charges excluding ACT and the SSAP 8 figures. As the table shows, if the ACT is excluded from the tax charge and treated as part of the gross dividend, the UK tax charge bears a realistic relationship to UK profits for all the example companies. Under the SSAP 8 rule, where part of the gross dividend is included in the tax charge, the charge is unreasonably high where the overseas element of profits is large.

Table 2: The tax charge and the SSAP 8 charge

	Company U	*Company V*	*Company W*
Tax			
UK	23	13	13
Overseas	–	40	160
Total tax on profits	23	53	173
ACT	10	20	50
SSAP 8 charge	33	73	223
Total tax as %			
UK	23%	13%	13%
Overseas	–	40%	40%
Total tax on profits	23%	26.5%	34.6%
SSAP 8 charge as %			
UK	33%	33%	63%
Overseas	–	40%	40%
SSAP 8 charge	33%	36.5%	44.6%

The economic effects

So far, so good. A change in name and a revision to SSAP 8 will take care of many of the complaints. But underneath the superficial problem, a more serious one lurks.

A London Business School survey established that companies with a "surplus ACT problem" are being led to take various actions, some of which were harmful to the UK economy. A "surplus ACT problem" is another way of stating that the company enjoys the low tax rate of 13% on all its UK profits, because it is paying dividends which exceed those UK profits. Typically, such companies will suffer tax on their overseas profits at 30% or more. They will inevitably be encouraged to move activities such as research and development overseas, into countries where the tax relief is higher. As long as they are taxed so lightly on their UK profits, the problem will persist.

The straightforward answer is to restrict the entitlement to the 13% rate of tax by allocating a group's overall dividend between its UK and its overseas profits. In the vast majority of cases, companies would then find that their UK profits exceeded the dividends which were deemed to have come from those profits, and would incur a marginal rate of tax of 33%. This would remove the tax incentive for shifting costs overseas. But not surprisingly, companies have not lobbied to have their tax liabilities increased in this way.

A similar answer is offered by the foreign income dividends. Widespread replacement of gross dividends which exceeded UK profits by equivalent foreign income dividends might come near to reinstating the 33% marginal rate. Such foreign income dividends would increase the net income of taxpaying shareholders. But there is little sign yet of their general adoption.

Scrip dividends

Companies go to absurd lengths to reduce the ACT charge in their accounts, on the grounds that it reduces reported earnings. If the ACT was shown as part of the dividend, such steps would be unnecessary.

For example, for some years scrip dividends have been offered, comprising (for those that so elect) cancellation of the cash dividend accompanied by a bonus issue of shares to the value of the net dividend. Harmless enough. But more recently we have seen the more sinister enhanced scrip dividend, where the bonus issue is as much as 150% of the net dividend it replaces. Like any bonus issue, it dilutes the value of existing shares: shareholders have received nothing except extra certificates to represent their unchanged proportionate interest in the company. But pity the investor who is so bemused by the paperwork that he declines the issue. And pity the higher rate taxpayer who finds that this sort of bonus issue comes with a tax sting in the tail. A classic example of shareholder value being lost because of misconceived accounting rules.

Is the imputation system at risk?

Few countries have followed the UK's lead and introduced an imputation system of taxing company profits. The system provides a generous reduction of the UK tax bill to companies paying a high level of dividend. In today's world of multinational business, the system weighs the scales in favour of overseas governments. At times the yield of UK corporation tax (other than the ACT withheld from dividends) has shrunk to being an insignificant contributor to the Exchequer.

Other countries may well have recognised the cost to national revenues and determined to preserve a full and fixed rate of tax on company profits, regardless of the dividend level.

UK companies should recognise how little tax they are contributing out of their profits and turn this to the UK's advantage. Instead of upsetting the system again, they should press for ACT to be renamed and for SSAPs 8 and 3 to be revised so that our low tax rates are obvious to all readers of accounts.

THE FOURTH REICH

By Brian Reading.
Published by Weidenfeld and Nicolson, London 1995, Price £20

Ostensibly a book about Germany, this is, in reality a book about the future of "Europe". The message is a refreshing and in many ways welcome one – that if we learn to understand the true nature of today's Germany in the context of its long term history we can embrace German leadership today for a democratic, liberal and progressive Europe. Such a claim clearly demands a major work of enthralling comprehensiveness to sustain it and this author deserves credit for his courage and scholarship for providing a text that is, for the most part, both compelling and persuasive.

Part one both enlivens and enlightens our thoughts on the early history of the German speaking peoples. Try some sample quotations: " By its end the Roman army was German in all but name"; "Rome collapsed when the Germans exercised for themselves the power they really held" (19th century) Germany united by allowing nationalism to triumph over liberalism and thus set a course for disaster". And so on through the first world war, the blame for which the author places almost as much on others as on Germany; through the hyper-inflation of 1923, due not so much to the burdens of reparation payments as to the burdens of servicing Germany's internal debts arising from war time armament expenditure bond issues. There is no sympathy nonetheless for Hitler's regime – born of assassinations and street battles, but the Third Reich Reading sees as the culmination of an aberration in Germany's nature rather than a display of its underlying characteristics.

Part 2 describes present day Germany – economic growth, the settling of borders, Eurosclerosis and the economics of post 1990 unification. It is particularly interesting to see Reading defending the decision to set West German and East German Marks at parity on the grounds that this amounted to a refusal to allow East Germany to become a "low wage, dependent economy – a mezzogiorno of Germany". Others might dispute this logic but at least the author cannot be accused of evading the issue.

The book then delves into a fascinating comparative study of alternative forms of modern capitalism. Germany has a so-called *social market economy* which in large part means that it is subject to a very great deal of government intervention and regulation. It is a model, he says, that served Germany well during periods of stable conditions but which, like its counterpart in Japan, has led to imbalances and rigidities. Naturally enough, this section leads us on to a look at the politics and economics of the past, and present workings of the European Union though the account at this stage could be skipped by those who have followed these issues elsewhere.

Part 3, "The World's Greatest Boom Ever" will already be familiar to readers of *Britain and Overseas* for it expands upon an article published there in the Autumn edition 1993. The thesis is that the world faces high economic growth during the next 15 years as many less developed countries catch up because "basically late starters grow faster" – and this is bound to have startling implications for world trade and for the structure of the job market in Europe. Reading notes that the battle for 1996 onwards is over jobs – a Fortress Europe to protect old ones or free trade to create new ones. Encouragingly he goes on to comment that in Britain we are well ahead because "most of the industries which could be wiped out by competition from developing countries have already been wiped out by competition from developed ones".

In the final chapters Reading embraces Federalism, or at least federalism subject to reform and dependent on Germany recognising that its common interests coincide with Britain rather than with France. He notes that British attitudes are ambivalent and public opinion hostile to Maastricht but claims (p. 231) "Were it (the Maastricht Treaty) seen as it really should be – as an extension of democratic control over Brussels and a reduction in 'elective dictatorship' at home, perhaps views would change". The real dangers for the future he identifies as protectionism and 'National Front' mentalities. Protectionism, he says, will come creeping in like the tide and so "the time has come for Germany to grow up as a nation and stand against the disastrous course which the French want Europe to pursue". Furthermore, Kohl should "call for a European Constitutional Convention to plan a democratic Europe and limit the powers of the European federal government within it". This convention should be one of "delegates representing people, not ministers representing governments". Finally he states, "Germany must turn to advantage its gruesome past in order to save Europe from a gruesome future. The profound irony of Kohl's Fourth Reich is that it has the power to teach Europe a lesson in democracy. It has the ability to keep Europe open and free".

One trembles to voice such wondrous hopes for there are surely so many more dimensions – American influences, our growing cosmopolitanism, the Viking (open seas) inheritance, the information revolution and the trauma of the Balkans following German recognition of Croatia and more – to take into account.

Nonetheless this is a rewarding and important book and deserves to be seriously and widely read.

J. B.

THE TRAP

By Sir James Goldsmith,
Published by Macmillan, London, 1994. Price £7.99

Touted on the back cover as the "Number One Best-seller in France", this seven section book records questions by a French journalist and the answers, often lengthy, given by the author.

It is a political prospectus designed to tell us what Goldsmith would like to do about international trade, about reform of the EU, about privatising the Welfare State, about returning to organic farming and about giving up nuclear energy. And perhaps it is important for us to know what he would do – given the impressive progress of his EU political party, "L'Autre Europe".

Although the book has many references usefully listed, it is a pity that the publishers decided to avoid the provision of an index. So many politicians, treaties, events, Commission plans and so on are mentioned in the text that it would surely have been useful to have had an index to find them when wanted.

More seriously, however, it seemed hard to link the title to the text. Just what "Trap" are we discussing? Your reviewer doesn't remember seeing the word anywhere in the text. Should one guess? Is global free trade a trap, or the constitutional arrangements of Europe a trap, or excessive welfare provision a trap, or modern agriculture a trap, or nuclear energy a trap? Or should the book be called "The Traps"? Or has something been missed in French-English translation?

One thus has some freedom for interpretation and this reviewer began to feel increasingly uneasy the more he read – and became fairly convinced by the end that the ideas and philosophy espoused by Goldsmith amounted to a trap for the reader – and particularly for any reader who is, for want of a better term, a UK "Euro-Sceptic". Goldsmith is attempting to place himself at the head of those who are critical of the EU – and he does so forcefully, but for the wrong reasons. Readers beware!

Goldsmith is opposed to the Maastrict Treaty, but he is opposed because, he says, it "enshrines the idea of free trade between members" – ie the single market which, one might say, has grown from EFTA rather than EEC roots. Furthermore he is deeply opposed to the work of GATT and its successor, the World Trade Organisation, on the grounds that cheap labour in foreign countries will destroy jobs in Europe – a fallacy, as Japan is now demonstrating and as Ricardo showed a century and a half ago. And he ignores totally the fact that if "rich" countries produce their wares by capital-intensive activities and poor countries produce theirs by labour-intensive activities, then everyone can be better off, *provided* that the owners and beneficiaries of capital in the "rich" countries pay sufficient taxes on this form of income. We need to know his reactions to various progressive income tax systems.

Goldsmith is opposed to a unified super-state based on the EU but he is opposed, not because its institutions are corporatist and protectionist (he would reform and strengthen these aspects, saying that certain functions are best dealt with at that level – especially bilateral trade negotiations with other trade blocks) but because he does not wish to promote the idea of a civil state composed of a variety of slowly integrating ethnic groups. He scorns the "cosmopolitan" and "multi-ethnic" melting pot of America and bangs the drum for the idea of separate racial development. This is philosophy in pre-World War One mode!

He is opposed to the Common Agricultural Policy but not because it keeps out the produce of more efficient food producers or the food on which poorer countries can earn a living by selling to us. He doesn't seem to be particularly bothered by food "mountains" or high prices or unfairly subsidised exports. His opposition is based on the idea of preserving rural life and returning to less capital intensive methods of farming, a cause rather better espoused by Sir Richard Body's excellent series of books. But unlike Body he fails to explain a *method* to achieve this, apart from yet more protectionism. Body, by contrast, would welcome the overseas food from the various countries and climates of the world, thus forcing down food prices to a point where high cost chemical and artificial means of food production would be uneconomic in Europe – a far more efficient, beneficial and peaceful approach to the problem. Goldsmith's approach amounts only to popularism without substance.

Thus in these and in many other ways, this book is misguided – even dangerous – and if this ever became the face of British Euro-scepticism, this reviewer for one might yet change sides.

J. B.

THE COMPACT CULTURE

By O'Young Lee, Kodansha Paperback, 1991.

Do you think in words or do you think in pictures? Do you remember names easily or do you remember faces? To understand a situation, do you draw a diagram or do you find exactly the right words to describe the concept? Are you a wordsmith or are you an artisan?

Perhaps you are both. If so well done … but many are not.

Senses compensate for deficiencies. A blind man will use his fingers to feel

Braille to a degree of accuracy that astonishes others more fortunate. Animals with small ears find their way with incredibly accurate abilities to smell. Bats use their ears to see!

But back to humans. It is surely possible to be dependent on both eyes and ears and still "think" mainly in one. Beethoven – and other great composers surely "thought" in sounds – indeed he even went on composing after becoming deaf. A person who becomes blind can still visualise things in his mind.

O'Young Lee in his book "The Compact Culture" referring to Japan argues that the Japanese have far greater abilities with thinking based on sight than they have on sound. This leads to their having created greater masterpieces of art, of garden arrangements, of pottery and of design than they have achieved in musical composition – or indeed in literature. Since sight is a means of summarising and sounds cannot be summarised, this leads to their being capable "reductionists" and immature "expansionists". During periods when Japan turns inward upon itself it achieves great works – as during the past 50 years. But at times when Japan is expansionist – as during wars abroad (or investment abroad?) the Japanese sometimes go haywire and seem immature, mistake-prone and even arrogant.

What makes the Japanese so? Living in Japan, I suppose, is the simple answer! Indeed, when I am in Japan, little of beauty reaches my ears – but I become hyper-aware of the sight of attractive things. For example I find the shapes of new cars much more interesting than I do when in London. Other foreigners find the same – and tend to feel an interest in buying such things more than they would at home.

This makes the Japanese acquisitive for material goods, makes them very able to produce attractive products, makes them aware of every detail of a product – and every blemish. It makes them more responsive to the visual impact type advertisement and makes them treat background music as something to ignore.

For those who wish to look behind the mere economics of Japan, this Korean author offers a fascinating and thought-provoking analysis.

J. B.

LETTER

A Further Response on 'Student Numbers' from Mr. C. Houghton Budd

Dear Sir,

I was intrigued by the correspondence on student numbers. I am myself a mature student (aged 47) in my final year of a degree and can vouch for the fact that performance levels can hardly be said to stretch one. But I would add that I am not 18, fresh away from home and party to the endless social round that my younger colleagues enjoy. Being focused and having life experience is of course a different thing than being half sober and clueless about life. On the other hand, it is a crude

generalisation to suggest that mature students are, as it were, indulging themselves.

I think many have reached a point in their lives when they either wish or need to change career and to rechallenge themselves with the rigours of academia. They do so in increasing numbers as part of the important trend of mature education – higher education that is student-driven and undertaken when one is ready, willing and able. I believe Sussex University pioneered mature studentship in 1966 with 9 places; they now offer some 1200. It was in the 60s also that the Open University began. The reality is that people are increasingly getting themselves educated when they feel they have a need to and most people I know who are either giving or receiving such education all recognise how cost effective it is. There is little downtime and much greater motivation.

This phenomenon, growing alongside the problems the question of 'student numbers' raises, has a tale to tell. It would seem that people are better able to make life decisions and to train themselves according to what society needs of them (which may not, of course, always be academic, creme de la creme stuff!) when they have passed their mid-twenties. It is the focus on those in their late teens, required to make career choices already at 14 or earlier that is the problem, therefore, and a major factor in the resultant decline in conventional education. It contradicts what is going on today and where people are at.

No amount of harking back to the old days will remedy the situation because it begins, paradoxically enough, with the very aim sought by the correspondents: that of equipping students to satisfy the job market. Modern education takes much of its shape from the 1959 California Plan for Higher Education which systematically designed universities to produce for the job market and shifted standards to achieve maximum seat occupation – that is, optimum operating economics. It is this paradigm that needs replacing.

A society that sought to educate its members as and when they were motivated to be educated, that did not try quixotically to prior-match student output to *projected* job requirements would, I am sure, be far more flexible and resilient in the face of constant change than the current one. It would also not pursue elitist streaming, but seek to educate the whole gamut of skill types and levels, since all are needed.

Young people would then not be forced onto a treadmill that channels their development before it is mature, or that promises jobs that everyone (and especially the young) knows cannot be delivered. Socially, and I would argue economically, too, society needs to take its cue from what people become, not from what the job market demands of them. After all it is the inadequacies of the job market itself, that, through retraining schemes and the like consequent on sudden changes in industry, is one of the greatest stimulants of the mature education phenomenon.

Can we not just add one and one and make two out of these phenomena?

Yours faithfully,
C Houghton Budd
Belke House, The Square
Chilham, CT4 8BY

NEW MEMBERS

The Council, as always, needs new members so that it can continue to serve the purposes for which it was formed; meet its obligations to existing members; and extend the benefits of members to others.

Members may propose persons for membership at any time. The only requirement is that applicants should be sympathetic with the objects of the Council.

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ii) To devote sympathetic and detailed study to presentations on monetary and economic subjects submitted by members and others, reporting thereon in the light of knowledge and experience.

iii) To explore with other bodies the fields of monetary and economic thought in order progressively to secure a maximum of common ground for purposes of public enlightenment.

iv) To take all necessary steps to increase the interest of the general public in the objects of the Council, by making known the results of study and research.

v) To publish reports and other documents embodying the results of study and research.

vi) To encourage the establishment by other countries of bodies having aims similar to those of the Council, and to collaborate with such bodies to the public advantage.

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To the Honorary Secretary
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Date ....

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ADDRESS ....

....

....

PROFESSION OR BUSINESS ....

REMITTANCE HEREWITH ....

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NAME OF PROPOSER (*in block letters*) ....

AND SIGNATURE OF PROPOSER ....