ELECTION BRIEFING 2001
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LABOUR AND BUSINESS TAXES
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IFS Election Briefing Note No. 6
May 2001
Funding

We would like to thank the Economic and Social Research Council (www.esrc.ac.uk) for supporting this work through funding for the ESRC Centre for the Microeconomic Analysis of Fiscal Policy (Grant number M544285002).

Labour and business taxes

Since winning the 1997 election, Labour has made a number of changes to business taxes. The first part of this Briefing Note will deal with general measures. This is followed by a discussion of measures aimed at smaller firms. Finally, the windfall levy and the climate change levy will be discussed. Box 1 lists the main changes that have occurred.

Box 1. Main changes to taxes paid by companies and shareholders since 1997

- Main corporation tax rate cut from 33% to 30%
- Dividend tax credits no longer repayable to tax-exempt shareholders
- Abolition of advance corporation tax (ACT)
- Introduction of quarterly corporation tax payments for large firms
- One-off ‘windfall’ tax on privatised utilities
- Introduction of climate change levy

1. Taxes on corporate profits

Corporation tax

Since 1997 the headline corporation tax rate has been reduced by three percentage points, but government revenues from corporation tax have continued to rise, as shown in Figure 1.

Figure 1. Corporation tax: revenues and headline rate

Corporate tax rates have fallen over the last decade in many OECD countries. In the UK, this trend dates back to Lord Lawson’s 1984 reform, which cut the main corporation tax rate from 52% to 35%. The UK’s current 30% main rate is one of the lowest in the OECD. The tax rate, however, is only one determinant of the tax bills that companies face: these also depend on the generosity of deductions, most notably capital allowances for depreciation. Figure 2 compares revenues from tax on corporate income, both as a share of GDP and as a proportion of total tax revenue, across the G7 countries. Despite the UK’s low corporation tax rate, corporate tax revenues are actually high compared with other G7 countries. In fact, according to the latest OECD figures, the UK takes a higher fraction of GDP in corporate taxes than any other G7 country.¹

**Figure 2. Taxes on income, profits and capital gains paid by corporations**

![Graph showing corporate tax revenues as a share of GDP and total tax revenues for G7 countries](image)

Notes: Figures are for 1999, except for US and Canada, where 1998 figures are shown. Figures show all taxes on income, profits and capital gains paid by corporations, and so include petroleum revenue tax (PRT) in the UK. In 1999, PRT was just 0.05% of GDP and 0.15% of total tax revenue, so its inclusion does not substantially alter the overall picture. Figures also include revenues from local corporate income taxes, which apply in all G7 countries except France and the UK.


Figure 1 showed that total corporation tax receipts have increased by £4.4bn, from £27.8bn in 1996–97 to £32.2bn in 2000–01, a 16% cash increase. This may seem surprising, given that the three-point reduction in the main corporation tax rate, from 33% to 30%, is estimated to have reduced receipts by £3.75bn in 2001–02.² But, in large part, the growth of revenues in Figure 1

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¹ This cross-sectional comparison fluctuates from year to year as countries experience different stages of their business cycles. For corporate tax revenues as a share of GDP, the UK has been among the top three countries in the G7 in every year since 1980.

reflects inflation: real revenues rose just 5%. Since real GDP has increased by considerably more than 5% over the four years of this Parliament, corporation tax receipts have actually declined as a share of GDP.

Still, the fact that corporation tax receipts rose at all in real terms may seem surprising, given the substantial cut in its main rate. In part, this reflects the buoyancy of the corporation tax base, itself a product of the relatively favourable economic climate during the 1997–2001 Parliament. But government policy has also been important, as structural reform of the tax’s payment mechanism has raised revenue over the period. In particular, advance corporation tax (ACT), under which tax was prepaid in relation to dividend pay-outs, has been abolished and replaced by a new system of quarterly instalments for large companies. In principle, this change could have been implemented in a revenue-neutral way if, on average, the timing of corporation tax payments had not been changed. But the reform was implemented in a way that, on average, brought forward corporation tax payments.

In the four-year transition period from 1999–2000 to 2002–03, companies are in effect required to pay rather more than a single year’s corporation tax bill in each tax year. Consequently, tax revenues are estimated to be around £2bn higher each year during this period. This effect is temporary: after 2002–03, the only disadvantage to large companies will be the timing disadvantage implied, on average, by the requirement to make corporation tax payments earlier than under the old system. Annual corporation tax receipts will be lower for this reason after 2002–03, but the transitional arrangement has made a handy contribution to tax revenue during the 1997–2001 Parliament.

The tax treatment of dividends

Profits are not only taxed at the company level. When they are paid out to shareholders as dividends, they may be subject to income tax as well. Before 1997, this ‘double taxation’ was partially mitigated for all shareholders, as part of the corporation tax liability was treated like a prepayment of income tax and imputed to shareholders via a refundable dividend tax credit. Whilst this remains the case for tax-paying shareholders, the 1997 Budget abolished the tax refund for most tax-exempt shareholders, including pension funds and pension schemes run by insurance companies. This resulted in a significant gain for the Exchequer, which the government estimated would rise to exceed £5bn by 1999–2000. Part of this revenue was returned to companies via the cut in corporation tax rates in the same Budget, and part was kept by the government.

The reform of dividend taxation in the July 1997 Budget, and the subsequent abolition of advance corporation tax, confirmed in the March 1998 Budget and implemented from April 1999, both addressed distortions in the tax system.

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2 Small and medium-sized companies, not subject to the quarterly instalments system, gained a timing advantage from the abolition of advance corporation tax if they pay dividends.
that may have affected dividend distribution decisions and business location decisions.

Under the old system, firms paid ACT when they paid dividends, but most firms could offset this ACT payment against their next corporation tax bill. Tax-exempt shareholders had a considerable tax advantage if profits were paid out as dividends, rather than retained by the firm: for those shareholders, dividend payments came with a partial refund of corporation tax, whilst retained profits did not. Given the dominant shareholding of tax-exempt institutional investors in many large companies, there was concern that this tax incentive resulted in excessive dividend pay-outs, possibly at the expense of investment. The abolition of repayable dividend tax credits removed this distortion.

Whilst most firms could set off ACT payments against their next corporation tax bill, some firms – those in a ‘surplus ACT’ position – could not, and for these firms the old system actually imposed a distortion against paying out dividends. This chiefly affected companies with substantial activities abroad, whose total profits and hence dividends may have been high, but who paid corporate taxes abroad and thus had a comparatively low UK corporation tax liability. For these firms, ACT was effectively an additional layer of tax that could be reduced by paying lower dividends. Again, the abolition of ACT will remove this distortion to their dividend decisions. To the extent that such firms located high-cost activities outside the UK and highly profitable activities inside the UK in order to reduce their surplus ACT problem, these distortions to location decisions will eventually be removed.6

Overall impact on government revenues

Estimates of the net effect of all these changes to the taxation of company profits and dividends are shown in Table 1. In contrast to the revenue charted in Figure 1, the significant impact of the dividend tax reform is included. This did not show up in Figure 1, as it represented an increase in income tax rather than corporation tax.

Overall, the table shows how, taken together, the reforms have increased revenues over the last four years: in each of the last two full fiscal years of this Parliament, the government’s changes to the tax treatment of profits leave receipts over £4bn higher than they otherwise would have been. This is partly due to the transition to quarterly corporation tax payments for large firms and partly due to the corporation tax rate reductions not fully offsetting the increase in taxes on dividends affecting tax-exempt institutional shareholders.

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6 Such distortions remain so long as firms have a stock of surplus ACT accumulated under the old system and not yet relieved under the ‘shadow ACT’ system that now determines the rate at which these past ACT payments can be set off against future corporation tax bills.
Table 1. Revenue effects of main changes to profit taxation (£ billion)

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<tbody>
<tr>
<td>Tax rate cuts, July 1997</td>
<td></td>
<td></td>
<td>−2.52</td>
<td></td>
</tr>
<tr>
<td>Tax rate cuts, March 1998</td>
<td>−1.6</td>
<td>−2.2</td>
<td></td>
<td>−0.78</td>
</tr>
<tr>
<td><strong>Tax rate cuts, total</strong></td>
<td>−1.6</td>
<td>−2.2</td>
<td>−3.3</td>
<td></td>
</tr>
<tr>
<td>Abolition of ACT /</td>
<td>0.1</td>
<td>1.6</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>introduction of instalments</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Changes to dividend taxation</td>
<td>2.3</td>
<td>3.95</td>
<td>5.4</td>
<td>5.4</td>
</tr>
<tr>
<td><strong>Total revenue effect</strong></td>
<td>2.3</td>
<td>2.45</td>
<td>4.8</td>
<td>4.1</td>
</tr>
</tbody>
</table>

Notes: Rate cuts include the revenue effects of cuts in the small companies’ rate. Figures from the Tax Ready Reckoner have been used whenever they provide more up-to-date estimates. The figure for revenue gained in 2000–01 by changes to dividend taxation, shown in italics, is conservatively extrapolated from the 1999–2000 estimate at a constant nominal value.


Labour has implemented reforms of dividend and corporate taxation in a way that has boosted government coffers during this Parliament. But the extra revenues produced by the transition to the new corporation tax payments system are, of course, temporary, and corporation tax receipts will be reduced by almost £3bn annually when the new payments system becomes fully operational after 2002–03.\(^7\) Together with the healthy economic climate, these structural reforms have helped to ensure that profit taxation has made a major contribution to the healthy public finances during this Parliament. If the next government were to rely on taxes on company profits to the same extent, it may need to find new ways to increase them.

2. **Tax measures for smaller companies**

Small companies, like large, have seen a three percentage point fall in their corporation tax rate since 1997, from 23% to 20%. But, to a large extent, the similarities end there. The Labour government has introduced a number of tax reforms that specifically benefit small and medium-sized enterprises (SMEs) and investors in those firms. The measures have included more generous capital allowances, the introduction of a research and development (R&D) tax credit for SMEs, and the Enterprise Management Incentives (EMIs) scheme, which provides tax relief on share options for employees in smaller, high-tech companies. Capital gains tax reforms have also benefited investors in small firms. Changes have also been made to the Venture Capital Trust and Enterprise Investment Schemes, and a new Corporate Venturing Scheme has been introduced which provides tax relief on investments by firms in smaller enterprises.

Table 2 lists some of the measures, together with the revenue the government has forgone in introducing them. While the list of measures introduced is long, their overall impact might be expected to be small, given their relatively low cost. For example, the table shows that the new 10% ‘starting rate’ of

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\(^7\) Inland Revenue Press Release 9, 17 March 1998.
corporation tax represents a tax cut of only £100m, because this rate applies only to the first £10,000 of taxable profits. No measure listed in the table involved the government forgoing much more than £0.5bn.

Table 2. Exchequer cost of selected tax reforms for SMEs, 1997–2001

<table>
<thead>
<tr>
<th></th>
<th>2001–02 £m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small companies’ corporation tax rate cut from 23% to 20%</td>
<td>−540</td>
</tr>
<tr>
<td>Permanent first-year capital allowances for SMEs at 40%</td>
<td>−190</td>
</tr>
<tr>
<td>10% corporation tax rate for the smallest companies from April 2000</td>
<td>−100</td>
</tr>
<tr>
<td>R&amp;D tax credit</td>
<td>−100</td>
</tr>
<tr>
<td>100% capital allowances for ICT investment for three years</td>
<td>−90</td>
</tr>
</tbody>
</table>

Notes: Figures are Budget measures costings from the Financial Statement and Budget Report, except that marked a, which is calculated from Tax Ready Reckoner and Tax Reliefs. Figures are full-year costs except those marked b or c.

a See note above.
b The initial cost will be partially clawed back over time.
c First-year cost. The full-year cost is £150m.


Some of the reforms are aimed at changing companies’ or individuals’ behaviour in specific ways. For example, it is widely accepted that R&D activity will be under-provided by the free market because a substantial part of the benefit it delivers is in the form of ‘spillovers’, which do not accrue to the firm undertaking the investment. The R&D tax credit for SMEs is designed to address this problem, by encouraging small firms to undertake more R&D. But in such cases where there are clear grounds for wishing to subsidise a particular activity, it is far less obvious why one would want to restrict this subsidy to smaller companies. Indeed, the government seems to have recognised this in the case of R&D: the 2001 Budget proposed the extension of some form of R&D tax credit to larger firms.

Against any advantages that these fiscal reforms achieve in altering firms’ behaviour in a desirable way must be weighed their negative effects. The number of measures implemented and the fact that they are restricted to specific classes of companies have added to the complexity of the tax system. Furthermore, complex fiscal reforms risk introducing unwelcome changes in behaviour – for example, in the case of the R&D tax credit, the risk is that companies may reclassify some expenditure as R&D purely to benefit from the credit.

In other cases – for example, in some of the employee share ownership schemes – there is no clear rationale recommending the introduction of the reform comparable to that in the R&D tax credit case. While the economic advantages of such schemes are less obvious, the risks of increasing complexity and distorting behaviour remain.

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8 Companies with taxable profits between £10,000 and £50,000 also derive some benefit from the 10% rate.
3. Windfall tax

The incoming Labour government implemented a one-off windfall levy on privatised utility companies in its first Budget in July 1997. Although ostensibly introduced to finance the New Deal welfare-to-work programme for young people, the merits of the tax should be considered separately from the merits of the expenditure with which it is notionally linked. Nothing of substance would have been different if the proceeds of the windfall levy had been allocated to (say) military spending while other taxes had been said to cover the New Deal.

The tax raised around £5.2bn in two instalments from a group of over 30 utilities that were privatised by flotation and subject to regulation. This included the water companies, regional electricity companies and electricity generators, as well as British Airports Authority, British Gas (BG and Centrica), British Telecom and Railtrack.

The tax was based on the difference between the value at which each firm was privatised and a ‘more realistic’ valuation based on after-tax profits in the first four years after privatisation. If the aim of the tax was to reclaim for the taxpayer the gains made by those who bought nationalised assets at a discount, it was unable to achieve this fully. For the investors who made ‘windfall gains’ by selling their shares soon after privatisation were long gone by the time the windfall levy was announced. The shareholders hit by the levy were those unlucky enough to be holding utility shares when news of the levy was capitalised into utility share prices.

Retrospective increases in taxation create uncertainty about the future tax environment among firms contemplating investments, and this uncertainty might be expected to deter some investment. Perhaps in recognition of this argument, the government has stuck to its word that this was a one-off levy on the utilities and has resisted the temptation to introduce further ‘windfall taxes’ on banks or North Sea oil producers.

4. Climate change levy

A new tax on business use of energy was announced in the 1999 Budget, following recommendations of the 1998 Marshall Report.9 A modified version of this climate change levy will be introduced from April 2001.

The levy covers energy use in the business, public and agriculture sectors, which jointly account for around a third of CO₂ emissions.10 The levy is part of a wider package of measures aimed at reducing greenhouse gas emissions, to meet government targets including that agreed at the 1997 Kyoto conference on climate change.

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10 DETR, Climate Change: The UK Programme, November 2000 (http://www.environment.detr.gov.uk/climatechange/).
The original blueprint envisaged a levy that would raise £1.75bn per annum, accompanied by a cut in employer National Insurance contributions (NICs) of 0.5 percentage points. The levy introduced will raise around £1bn per annum, with a cut in employer NICs of 0.3 percentage points. Overall, this package is intended to be revenue-neutral, although labour-intensive sectors will benefit more from the reduction in employer NICs than capital-intensive sectors.

The case for the climate change levy depends partly on the extent to which business responds by finding more energy-efficient forms of production, thereby paying less tax and producing lower emissions, or by relocating energy-intensive production processes to countries with lower environmental taxes or standards of regulation, thereby paying less tax with no benefit to global greenhouse gas emissions. Concern over the impact of the levy on the competitiveness of the UK as a location for production led to the reduction in the scale of the levy and to the introduction of Climate Change Levy Agreements in the major energy-using sectors, including chemicals and steel. Under these agreements, firms that meet targets for introducing ‘cost-effective energy efficiency measures’ will receive an 80% discount on the climate change levy.

This illustrates a major problem for individual countries wishing to introduce tough environmental taxes on companies or, for that matter, wishing to introduce tough environmental regulations. Where firms are able to relocate production to countries with lower environmental taxes or lighter regulations, the ability of these measures to achieve their objective of lower global emissions is hampered. In theory, the solution to this conundrum would be greater international co-operation on environmental taxes and regulations aimed at mobile business activities. In practice, this may prove extremely difficult to achieve.