

Labour's Windfall Levy

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Preface

This Commentary forms part of the work of the ESRC Centre for the Microeconomic Analysis of Fiscal Policy at the Institute for Fiscal Studies. The author would like to thank colleagues at IFS for many helpful comments, and in particular Steve Bond, Michael Devereux, Andrew Dilnot, Andrés Gómez-Lobo and John van Reenen. Any remaining errors are her own.

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Introduction

The Labour Party first put forward the idea of a windfall levy on the privatised utilities in a pre-Budget submission to the Treasury in 1992, a proposal that has been included in each of the Labour Party's subsequent Budget submissions. In 1996, this developed into a firm pledge that, should Labour be elected, they would impose 'a one-off windfall levy on the excess profits of the privatised utilities'.¹ However, apart from the fact that the levy will be imposed in the event of the Labour Party forming a government in 1997, and that the money raised will be used to finance a programme of schemes to help the young and long-term unemployed back into work, there are few details about the precise form this levy might take, exactly which companies might be affected by it, or how much money it would raise. The aim of this Commentary is to discuss the background to the policy, to present the economic arguments for and against the levy, and to examine some of the issues about how the levy (or tax) might actually operate in practice.

Background

Three arguments have been presented for the imposition of the tax. These are

1. that the companies were sold off 'too cheaply' at the initial privatisation;
2. that the regulatory regime has been 'too lax' over the period since privatisation; and
3. that the companies have been able to exploit a degree of monopoly power.

It is not necessary for a company to fulfil all three of these criteria for it to fall within the realm of the tax, and the Labour Party's Shadow Chancellor, Gordon Brown, recently stated that all utilities privatised since 1979 and licensed by statute would be liable to the tax. The definition of a public utility is usually that of a service or supply provided for the public, involving a large network, such as gas, electricity, water, transport and telecommunications. This implies that the tax is likely to include the regional electricity companies (RECs), the water and sewerage companies (WASCs), the electricity generators and the National Grid, as well as British Gas (BG), British Telecom (BT) and the British Airports Authority (BAA); although BAA does not control a network, it fits the definition of a company privatised since 1979 and licensed by statute. More recently privatised companies, such as Railtrack and British Energy, might also be included. No definite figures have been given for the amount of revenue that the tax will raise, although the programme of unemployment schemes is estimated to cost £3 billion over the lifetime of the first Labour Parliament. The windfall levy is expected to meet these costs comfortably, and might raise significantly more.

Is there any basis for the three arguments in favour of the tax that have been put forward?

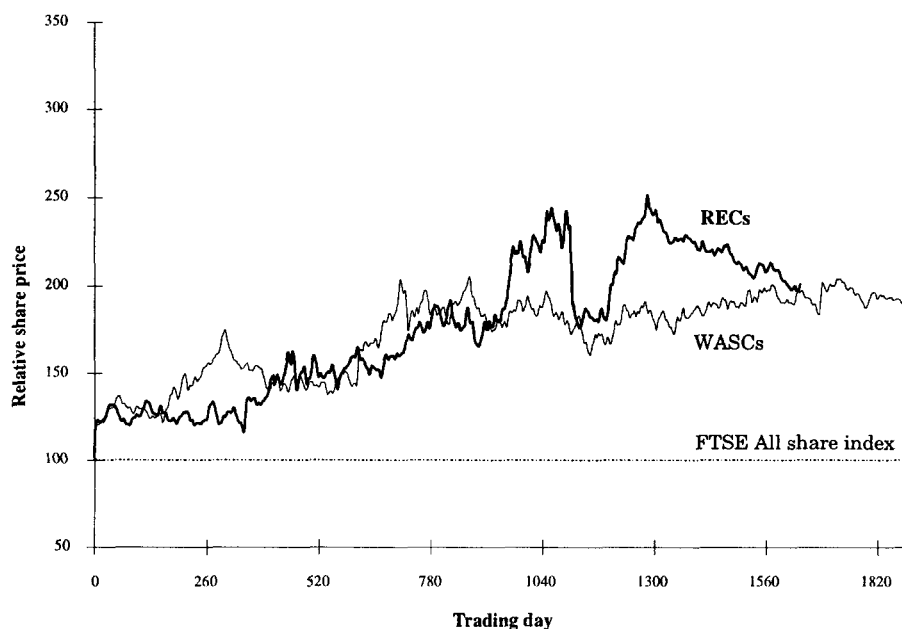
¹ See, for example, Labour Party (1996).

Price

The assertion that the companies were sold off for less than they were worth appears to be true for many of the utilities, with the benefit of hindsight. Shares in the privatised utilities traded at a premium of up to 30 per cent on the flotation price the very next day, and few companies saw their share price jump by less than 10 per cent. The desire to make sure that each flotation was a success, in terms of the take-up of shares, had to be traded off against a desire to receive the maximum revenue possible from each sale. In the absence of accurate information about the level of demand for the shares, the government had to set a price that would equate known supply with an estimate of demand, and the sudden jump in share price indicates that the prediction of demand was too low.

The gains made in the first day of trading do not tell the whole story, since shares in newly floated companies frequently trade at a premium on the first day. Over the longer term, some of the utilities continued to perform well in terms of their share price, while others did not do so well. Figures 1(a) to (c) show the daily share price movements of the

Figure 1: Relative share prices since flotation
(a) RECs and WASCs



Notes:

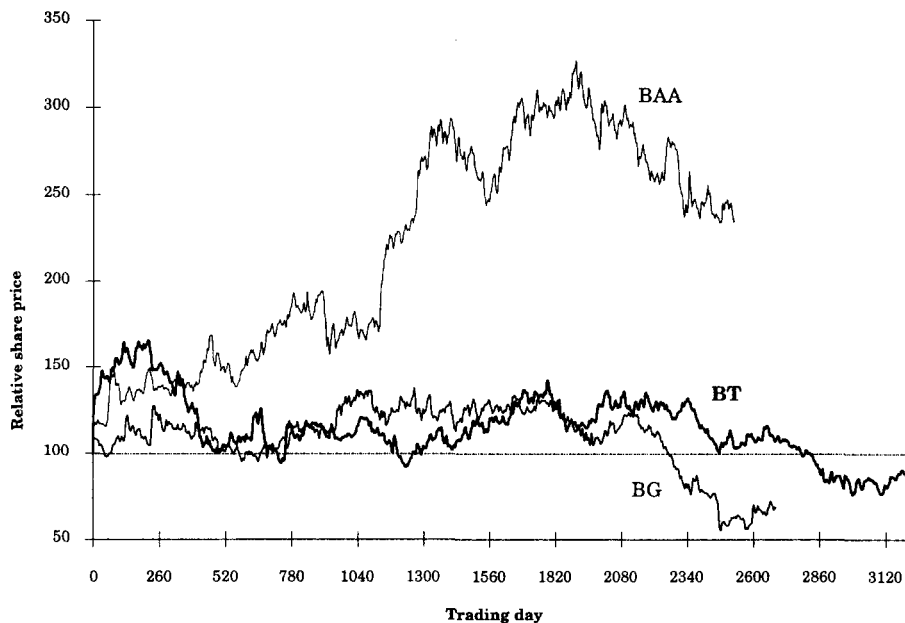
The daily share price data have been rebased to the date of privatisation and scaled by the FTSE All Share index, also rebased to the different privatisation dates.

Where more than one company is included in the series, the individual share prices have been weighted to give an index for the group of companies, where daily market values are used as the relative weights. Companies that have been taken over in the period were kept in the index, at the last price quoted on the Stock Exchange.

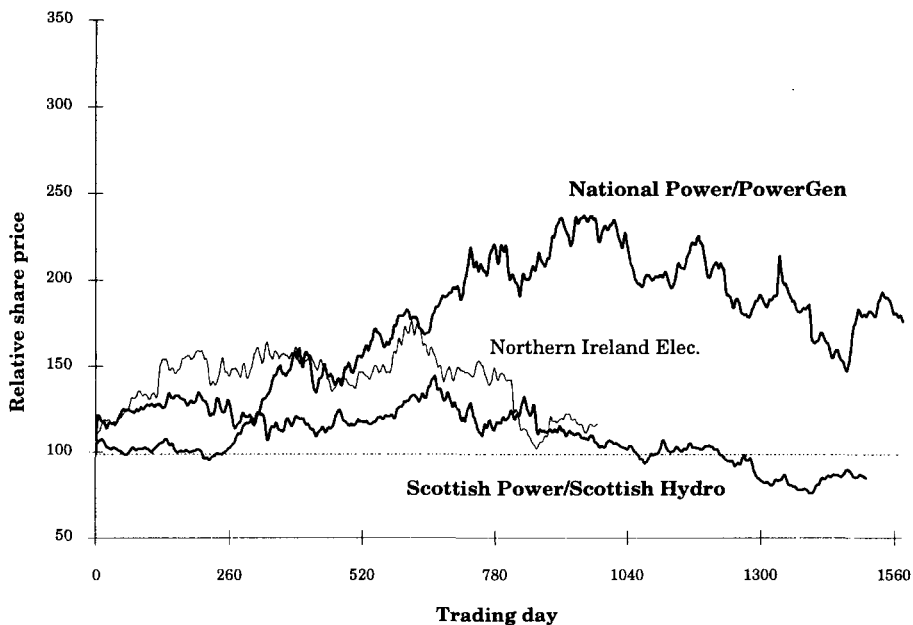
The series have been smoothed to give the moving average over five trading days, to approximate one calendar week. There are approximately 260 trading days in a calendar year.

Source: Datastream International.

Figure 1: Relative share prices since flotation
(b) BAA, BG and BT



(c) Electricity generators



Note: See Notes to Figure 1(a).

Source: Datastream International.

main utility companies, from the date of flotation of the company until late March 1997. The share prices have been rebased to 100 at the date of flotation, and are scaled by the FTSE All Share index (also rebased to the respective privatisation dates), to show how

the different sectors performed in relation to the stock market as a whole. Figure 1(a) shows that both the regional electricity companies and the water and sewerage companies have consistently outperformed the market since privatisation. Figure 1(b) gives the share price movements for British Gas, BAA and BT. Of these three utility companies, only BAA has consistently outperformed the market, and neither BT nor BG has shown long-term price gains. Finally, Figure 1(c) shows the position for several of the other privatised electricity companies, and demonstrates that the share prices of the generators in England and Wales have performed better than those of the other generators.

It is clear from these graphs that the share prices of the utility companies have followed very different paths since flotation, and that not all investors have fared equally well. This highlights the fact that investors, by purchasing shares in the newly privatised companies, were prepared to take a risk in those companies performing well in the private sector, for which some have been rewarded and others have not. Of course, the share price information only accounts for part of the return to shareholders — the capital gain — and part of the return is received in the form of dividend income. Very few of the privatised utilities have generated a dividend yield below that of the FTSE All Share index during their years in the private sector.

Regulation and monopoly power

The arguments that the regulatory regime has been too lax since privatisation, and that companies have been able to exploit a measure of monopoly power, are closely related. If the regulatory regime is very tight, companies governed by the regime will be unable to exploit their monopoly power. If the companies do not have any monopoly power, the relative strength of the regulatory regime becomes less important.

In a competitive market for a product, with many suppliers and many consumers, each individual firm must usually accept the market price for its product (that is, the price at which total demand and total supply for the good or service are equal). If any individual firm tried to charge a price above the market price, its customers would simply buy from another company selling the same good at the cheaper price.² Where the market is not competitive, there might be only one or very few suppliers, and many consumers. In this situation, the supplier will be able to set its own price for the good, since consumers have no alternative but to buy from the only supplier. The price determined by the supplier will generate excess (or supernormal) profits. One possible source of market power is the existence of barriers preventing other companies from entering the market. In the case of the utility industries, the existence of a network of pipes or cables which would be costly and unnecessary to reproduce creates one barrier to entry, while a related barrier is the existence of large, dominant firms already in the market.

When moving these firms into the private sector, the government's response to the threat of monopoly power being exploited was to create a regulatory regime to protect consumers from monopoly pricing, and to promote competition where possible.

² This assumes that there is no qualitative difference between the good or service provided by the different firms, and that the companies charging the market price can produce more output at a similar cost per unit.

Monopoly power

In its strictest sense, a monopolist is the only supplier of a particular good or service. For much of the period since privatisation, several of the utility sectors have operated as effective monopolies, at least in the supply of their services to households and in their control of the distribution networks. The issue is complicated by the fact that in some cases, one part of the industry might be relatively competitive — for example, in the supply of gas or electricity to large, business users — while another part of the industry is not — for example, supplying individual households with the same service. This means that a windfall levy that attempted to take the degree of monopoly power into account would quickly become quite complex.

The 12 regional electricity companies of England and Wales currently operate a local monopoly for distribution of electricity to households in their authorised regions, while competing with each other and other licensed suppliers to provide electricity for large users. The Office of Electricity Regulation (OFFER) intends to extend this competition to households in 1998, so that mainland consumers are expected to have a choice of supplier by September 1998.³ The National Grid Company (NGC), which owns and operates the electricity transmission system, is a natural monopoly, since the high cost of duplicating the transmission infrastructure would render competition inefficient. The distribution of electricity to households and firms by the RECs, as opposed to the supply of the electricity, is also considered a natural monopoly.⁴ Competition is unlikely to be introduced into these aspects of the electricity business.

The market for generating electricity in England and Wales was privatised as a competitive market, in the sense that additional companies could apply for licences to generate, but so far the market has been dominated by the two initial incumbents, National Power and PowerGen. With the sale of some of their generating capacity to Eastern Group in 1996, their influence over the price of electricity has declined, but a recent report from the Trade and Industry Committee expressed concern that competition in the generation market was not yet 'sufficiently robust' to ensure that consumers were obtaining the best possible prices (see Trade and Industry Committee (1997)).

The two Scottish electricity companies — Scottish Power and Scottish Hydro-Electric — are both licensed to generate, transmit and supply electricity, and can compete in England and Wales over supply and generation. Northern Ireland Electricity provides the transmission, distribution and supply of electricity in Northern Ireland, while generation is provided by four companies. Other companies are also licensed to supply electricity in

³ See OFFER Press Release R64/96, 2 December 1996, 'Arrangements for opening the electricity market to full competition in 1998'.

⁴ Transmission of electricity occurs at high voltage along the national grid, while distribution refers to the lower voltage system at the regional and local level usually required for customers to use the electricity. In principle, a distribution company in region A could be contracted to supply electricity to customers in region B, provided it had access to the distribution network. In practice, the distribution and supply of electricity have been carried out by the same company in each region, i.e. the regional electricity company.

the region, and the regulator is planning to develop competition in the wholesale electricity market.

The 10 water and sewerage companies in England and Wales do not face competition to supply water and/or sewerage services in the regions for which they have been granted a licence, and methods for introducing competition into the market are being considered by the water regulator (the Director General of Water Services, Ian Byatt).

British Gas was privatised with a monopoly in the supply of gas below a certain threshold, a threshold that was reduced significantly in 1992 in order to encourage some competition in the market for large users. Since April 1996, about half a million households in the South-West have had a choice of gas supplier, in a pilot scheme that is planned to extend to some parts of the South-East during 1997. In common with the proposals to increase competition in the electricity industry, the goal of the gas regulator is to give all domestic households a choice of gas supplier by 1998.⁵ Again, the transportation of gas is considered to be a natural monopoly, and, following the restructuring of British Gas in 1994, is controlled by TransCo, which was a division of BG until February 1997, when it was floated as a separate company.

British Telecom first faced competition from Mercury Communications while still in the public sector, in 1981. Nevertheless, the domestic market for telephone calls is still dominated by BT, and as a result it is the only company in the telecommunications sector that faces the same type of price regulation as the energy and water utilities.

Finally, the British Airports Authority, which owns three of the four airports in the UK regulated over the price of some of their charges, handles 72 per cent of UK air passenger traffic.⁶

Although it is not the case that all of the utilities operate as monopolies in all of their markets, there is little doubt that the privatised utilities have had, and in some cases continue to have, a degree of monopoly power in the greater part of those markets.

Regulation

Given that monopoly power does exist in these industries, the assertion that the regulatory regime has been too lax in the period since privatisation highlights an extensive debate over the most effective form of regulation for the UK. The debate rests on whether or not the current system of regulation, which is based upon price controls, should be replaced by a more explicit system of profit-sharing. Since the precise nature of the regulatory regime affects the future structure of the utilities and the long-term balance between costs

⁵ See Trade and Industry Committee (1997).

⁶ The four airports large enough to come under *economic* regulation by the Civil Aviation Authority (CAA) are Heathrow, Gatwick, Stansted and Manchester, of which BAA owns the first three. Manchester Airport is owned by the 10 Manchester local authorities. The price cap set by the CAA applies to the landing charge, the aircraft parking charge and the passenger charge, which account for only 35 per cent of BAA's revenue. (See Centre for the Study of Regulated Industries (1996).)

faced by the companies and the prices they can charge, any change in the regulatory regime is likely to have a much greater impact on these companies than a one-off tax.

The precise regulatory regimes governing privatised utilities vary between different sectors, but are based upon a common set of objectives, including the promotion of competition and the protection of consumers. The main mechanism for the latter goal, in the absence of genuine competition, has been the use of price controls. These are designed to prevent companies from exploiting their monopoly power by raising prices, but to leave them with an incentive to reduce costs through efficiency gains, subject to maintaining acceptable levels of service. Price caps were initially set at four- to five-year intervals, which allowed the utilities to hold on to any profits made from additional cost-cutting until the next regulatory review. When the next price review took place, if the regulator believed that benefits from the additional gains in efficiency had accrued more to the shareholders (in the form of higher dividends or higher share prices) than to the consumers (in the form of lower prices), the prices that the companies would be allowed to charge in the future were adjusted.

One criticism of price-cap regulation has been that the price caps have not been tough enough, so that high returns and profits achieved by some companies have in fact accrued more to shareholders than to consumers. A related criticism has been that the regulator has had difficulty in obtaining accurate information from individual companies about their opportunities for efficiency gains in the future, which leads to a tendency for the price caps to be too lax. This was illustrated by the decision of the Director General of Electricity Supply, Professor Stephen Littlechild, to recalculate the electricity distribution price controls announced in August 1994 and to impose new, tighter price caps less than one year later. The adjustments were made as a result of Northern Electric's spirited defence against a take-over bid from Trafalgar House, and the enthusiastic stock market response to his initial proposals, which indicated that the first judgement had been very much in favour of the companies. A third criticism has been that the impact of mistakes in the price-setting process is increased by the gap between regulatory reviews, although these gaps have been shortened through the intervention of individual regulators in the telecommunications, gas and water sectors, and not just the electricity sector.⁷

Although very few people would argue that the regulatory regime has operated perfectly in the UK from the first utility privatisation in 1984 to date, the right response to a problem of imperfect regulation is presumably to improve the system. There seems to be little doubt that investors who bought shares in some of the privatised utilities would have been prepared to pay more for their shares, if they could have foreseen both the level of efficiency gains that were possible in those companies and the difficulties in establishing tight regulatory control over them. These events could not be perfectly foreseen, so that some investors have been rewarded for the risk that they took and some have not.

⁷ A thorough review of the debate over the future of the UK regulatory regime is not possible here, but a presentation of the debate can be found in Trade and Industry Committee (1997). Armstrong, Cowan and Vickers (1994) study the UK experience of price-cap regulation, and an economic critique of profit-sharing can be found in Mayer and Vickers (1996).

Precedents

Are there any UK precedents for a one-off tax on one particular group of companies? In the Budget of 1981, a Special Tax on Bank Deposits was imposed by Geoffrey Howe. The bank tax was levied at a rate of 2.5 per cent on banks' non-interest-bearing current account deposits above a minimum threshold and it largely affected the major clearing banks. It raised £350 million at the time (about £700 million in 1996–97 prices). The justification given for the tax was that the government's tight monetary policy led to unusually high interest rates, which increased banks' interest income from lending but did not increase their costs, since deposits held in current accounts did not earn interest at the time.

The tax on banks appeared to be a response to an external event — the increase in the rate of interest — which led to higher profits through no particular increase in effort by the managers concerned. Managers of the utilities might argue that their companies have been profitable as a result of the discipline imposed on them by the market and the regulators, which has led to efforts to lower costs through increased efficiency. But, just as the high interest rates of the early 1980s were out of the banks' control, the low flotation price and arguably lax regulation have been essentially outside the control of the utilities.⁸ The excess profits earned by the utilities have been generated by a combination of both external and internal events, rather than simply an external event.

The most important difference between the two taxes is that, by virtue of the fact that it was proposed by the party of government, the bank tax was imposed hard on the heels of the high profits that the banks earned. The delay between announcement and likely implementation of the windfall levy is several years, and the delay since the first excess profits were actually earned even greater. This time lag makes it less likely that those who received the excess profits will be those who are actually caught by the tax.

Taxing profits

Finally, the privatised utilities are all liable to corporation tax on their profits already. Collectively, they now account for about £2 billion in corporation tax revenue each year, which is almost 10 per cent of total corporation tax receipts. Hence a one-off windfall levy of £3 billion is equivalent to one-and-a-half times a single year's corporation tax payment from these companies. The one group of privatised utilities that pay relatively little corporation tax are the water companies. This is partly as a result of these firms being granted a high stock of capital allowances (that is, deductions from taxable profits that approximate the wear and tear of capital assets used by firms) when they were privatised, and partly the result of their continuing high levels of investment.

The water companies do pay advance corporation tax (ACT), which is a tax levied when companies pay out dividends and which can usually be deducted from the final corporation tax bill. If the companies have low taxable profits in relation to the size of

⁸ Although this ignores the extent to which companies were able to negotiate more favourable debt and capital asset bases from the government in the run-up to privatisation, and the problem that managers of the companies have more information than the regulators about how their companies operate.

their dividend payments, because of large deductions, then some or all of the ACT payment cannot be offset, and if the situation continues, it becomes in effect a final tax payment.⁹

The arguments thrown up by a discussion of the rationales behind the windfall levy highlight the need to assess the tax in an economic framework, which the next section attempts to do.

What is a 'good' tax?

There are several criteria by which a tax can be judged. The four most commonly used to organise discussion were first suggested by Adam Smith, and are *efficiency*, *equity*, *certainty* and *convenience*. Some of these are closely related, and not all of them are likely to be fulfilled at the same time. How does a windfall levy on the privatised utility companies stand up to scrutiny, using these criteria as a bench-mark?

Efficiency

The goal of efficiency is to raise revenue with as little distortion of economic behaviour as possible, unless there are clear reasons for wanting to interfere in the market for the activity that is being taxed.¹⁰ Most taxes affect economic behaviour because they affect the price of a particular good or service, such as the wage rate (the price of labour) or the price of consumer goods. Individuals are likely to change their decisions about how much labour to supply when there are taxes that change the wage rate, and they are likely to change their decisions about what to buy when there are taxes that increase the cost of consumer goods. Companies are likely to change their decisions about what and how much to produce, how much to invest in future production and how to finance that investment if the method of taxing corporate profits treats these different choices in different ways.

In the case of a windfall tax that is levied only once, the real economic behaviour of the firms taxed should be unaffected. If firms have already set their output, prices and investment at levels that maximise profits, these levels should not change with the imposition of a one-off tax. This is because a one-off lump-sum tax does not change the cost of each additional unit of production, nor the price that can be charged for each unit, nor the expected return on future investment opportunities, and so does not change the profit-maximising levels of output, prices and investment. The windfall levy will act like a lump-sum tax provided that the tax base is related not to future behaviour, but to profits

⁹ The amount of ACT that cannot be offset in the current tax year, or carried back to set against previous taxable profits, is known as surplus ACT. The nominal amount of surplus ACT can be carried forward to set against future taxable profits, but if the company continues to earn low levels of taxable profits in relation to its dividend payments, the ACT might never be offset, and so effectively becomes the final tax payment.

¹⁰ For example, a government wanting to reduce the incidence of lung disease may impose high consumption taxes on tobacco to reduce the consumption of goods that increase the probability of contracting lung disease.

that have been earned in the past and that companies cannot affect by their behaviour today.¹¹

This strong result relies on the credibility of the statement that the tax is 'one-off'. Any perception that the tax could be imposed again implies that the future return on investment in the affected companies is lower than would be earned in the absence of the tax. In order to compensate for that risk, investors would demand a higher pre-tax return on their capital to be persuaded to invest in the utilities (that is, the cost of capital would increase for those firms). Under the current system of price caps, the regulators allow companies to earn a rate of return that will cover the cost of financing their investment (that is, the cost of capital). So if the cost of capital increased for these firms, this would be likely to feed through into higher prices than would otherwise have been the case. If there were no change to the regulatory regime, the tax would be partly paid by customers through higher prices set at the next regulatory review.

In theory, investment projects must earn a return that at least matches the cost of the capital that was used to finance the project, so an increase in the cost of capital is likely to reduce the amount of investment carried out by the firm (assuming that some investment projects were only just profitable before the tax was imposed). A reduction in investment would lead to lower cost reductions in the future, lower levels of employment and lower returns to shareholders than would otherwise have been the case. But if the tax is truly one-off, there is no additional risk of receiving a lower rate of return on future investments, and the cost of capital and hence the level of investment should be unaffected.

A secondary concern relates to how the companies will finance the tax. If the utility companies neither had enough money to finance the tax bill out of reserves, nor were able to raise the finance in the capital markets by increasing their borrowing without facing a higher rate of interest, nor felt able to reduce their next dividend payment to meet the bill, then investment might fall. Although there is evidence that some UK firms are affected by financing constraints (that is, they cannot carry out as much investment as they would like, due to a lack of available finance),¹² it seems unlikely that many of the utility companies are suffering from a shortage of finance.¹³

Equity

The question of whether a tax is equitable or fair can be divided into two parts: whether the tax achieves horizontal equity and whether it achieves vertical equity. Horizontal

¹¹ Strictly speaking, a lump-sum tax has to be completely independent of the actions of the firm for it to have no effect on the profit function (see, *inter alia*, Gravelle and Rees (1992)). The windfall tax will approximate such a tax if it is based on some past measure of excess profits, which the firms can no longer influence.

¹² See, for example, Bond and Meghir (1994).

¹³ This seems particularly unlikely for companies in the electricity and water sectors, since many of these have made large cash payments to their shareholders in the last two years, in the form of special dividends, share buy-backs and capital repurchases.

equity implies that the tax system should impose similar tax burdens on those with similar abilities to pay, while vertical equity implies that those with a greater ability to pay should bear a greater share of the tax, so that the tax system redistributes from the rich to the poor. At first glance, this suggests that, provided utility companies earning a similar amount of excess profits were taxed a similar amount, horizontal equity would be achieved, and that, provided companies earning large amounts of excess profits bore a greater share of the total windfall levy than companies earning small amounts of excess profits, vertical equity would be achieved. Unfortunately, this is not true.

In reality, companies do not pay tax in any meaningful sense; people pay taxes. Although the physical payment of the tax is made by a company, the actual incidence of the tax will fall on individuals: the shareholders, employees and customers of the companies concerned. Exactly how the burden might be shared between these groups — through lower returns on shares held in the company, through lower wages for employees or through higher prices for customers — is a difficult question to answer.

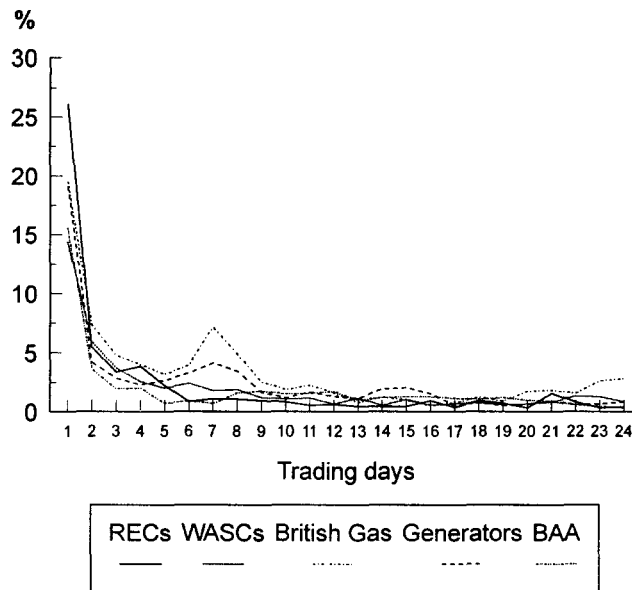
If the cost of capital does not increase for the companies affected by the tax (as it should not if the tax is truly one-off), and if companies can raise the finance to pay for the tax without changing their investment plans, and if the regulator can, if necessary, protect customers from higher prices and reduced levels of service, then much of the burden of the tax is likely to fall on shareholders. It could be argued that taxing shareholders is equitable, since only the relatively wealthy own shares. However, a tax on the windfall profits of privatised utilities is a very blunt instrument for taxing wealth, since it focuses on only one element of wealth — shares — and on one particular group of shareholders — those people owning shares in the utility companies (either directly or through a pension fund or unit trust, for example). If the goal is to tax wealth or high incomes, it would be sensible to do so more directly.

In principle, it would be possible to identify the individuals and institutions that have owned shares in the utility companies over their lifetime in the private sector, and levy a windfall tax on those investors in proportion to the total return received while holding these shares, rather than taxing the utility companies. This would tax the individuals who have benefited from the excess profits, but would make the tax very costly to administer and would not resolve the inequity of only taxing shareholders of the privatised utilities.

Perhaps the most serious criticism of the windfall levy is that it is unlikely to tax all the owners of the firms who have actually received excess profits from the privatisation of these companies, and it does tax many owners who have not benefited at all. The investors affected by the tax are those who hold shares in these firms when the prospect of the windfall levy is discounted into each company's stock market valuation. This is determined by the probability the market placed on the Labour Party forming the next government, the probability that any particular company is likely to be covered by the tax and the probable size of its tax bill. This has already led to fluctuations in the stock market value of the firms concerned, which vary according to the prevailing view over which companies might be liable, rather than concrete knowledge.

Figure 2 shows that the volume of turnover of shares in the privatised utilities was very similar across the different sectors immediately after flotation. In the first day or two of

Figure 2: Volume of turnover in privatised utility shares
(as a percentage of the number of shares issued)



Note: The proportions for the RECs, WASCs and generators have been weighted by the number of shares issued.

Source: Datastream International.

trading, between 15 and 26 per cent of the utilities' shares changed hands, although these figures do not show how many of these trades were the same shares being traded more than once and how many were genuinely different trades. More recently, since the government relinquished its special shares in the WASCs and the RECs, there has been a spate of take-over activity in these sectors, so that some companies are now wholly owned by other corporations (for example, Eastern Electricity was purchased by Hanson plc, Seaboard by Central South Western, a US utility) and some companies have combined (for example, North West Water's agreed take-over of Norweb, to form United Utilities, and Scottish Power's take-over of Manweb). Of the original 12 RECs, only Southern Electric has not either already had or agreed upon a change of ownership. The new owners of the utilities might argue that they have not reaped excess profits, but given that the commitment to impose the tax has been in the public domain for some years, the price these companies had to pay for the utilities will have been partly adjusted to reflect that.¹⁴

¹⁴ An expectation of the amount of the tax to be paid will have been discounted into the share prices of the companies that were likely to be affected by it.

Certainty and convenience

The goals of certainty and convenience are quite closely related. Convenience requires that the tax is relatively easy to administer and collect, while certainty requires that the flow of revenue from a tax is reasonably certain and secure. A tax on 30 (or fewer) companies is more convenient, for example, than an attempt to track down millions of individual shareholders, since it is not as difficult to collect and less costly to administer.

There are two elements to the issue of certainty: certainty for the tax collector and certainty for the taxpayer. Certainty for the tax collector requires that the tax can actually be collected, and there has been some debate over whether or not the windfall levy would be legal. The most recently published legal opinion on the tax, commissioned by the Labour Party from Michael Beloff QC, argues that, although there are potential challenges that could be made against the tax at the European level, any such challenge would be likely to fail.¹⁵

For the taxpayer, certainty involves carrying out economic activity under a predictable tax regime, with the knowledge that the tax system will not be changed arbitrarily. The windfall levy clearly changes the rate at which one group of companies is taxed on profits earned in the past, albeit without causing the kind of uproar that would ensue if a political party were to decide that personal income tax had been too low for one group of employees for the past few years and that the difference would be made up in the first Budget of the next government.¹⁶ The Special Tax on Bank Deposits helped to set the precedent for this, and, in fact, the normal tax on company profits is set retrospectively as a matter of course, although traditionally it does not change often.

To summarise this section, the windfall levy is potentially an efficient tax, in the sense that it should not distort the economic behaviour of firms, provided there is no perceived risk that the tax could reoccur. It is unlikely to be an equitable tax, since even if it does fall largely on the shareholders of the utility companies, it is likely to target investors who have not made excess profits, having purchased their shares more recently, and it is likely to allow some investors who have sold their shares to escape entirely. Since it is a tax on companies rather than on individuals, it will be convenient to collect, but it does increase uncertainty about the tax system for taxpayers, and might be an uncertain source of revenue, if any legal challenge were mounted against it.

Implementing the tax

What sort of a base might be used for the windfall levy? The simplest type of tax base would be a measure of the firm's turnover, such as total sales, while a more sophisticated

¹⁵ See 'In the matter of the Labour Party and the windfall tax', a joint opinion from Michael Beloff QC and Rabinder Singh, 12 February 1997. For an example of one of the concerns relating to European aspects of the case, see 'Brussels warns on Labour's windfall tax plans', *Financial Times*, 3 February 1997.

¹⁶ This demonstrates the perception that a tax on companies affects companies and their well-paid managers, rather than individuals.

measure would try to estimate the actual excess profits that have been made, measured either using the returns to shareholders in the utility companies over and above those made on the stock market as a whole, or using the profits reported by the companies and allowing some deduction for an estimate of 'normal' profits. Exactly which measure of the tax base is finally used, and the time period considered, will have a significant effect on the individual companies concerned. Table 1 shows how the tax burden might be shared between the different utility sectors, according to four different types of tax base, one of which is based on sales, one on excess shareholder returns and two on reported profits. These figures are not intended to predict how the burden of the windfall levy would be shared between different sectors, but to demonstrate how sensitive those shares would be to the actual measure of the tax base used.

Table 1: Estimated distribution of a windfall levy

Sector	Total sales (1995)	Excess shareholder returns (1991–95)	Pre-tax profits (1993–95)	Excess pre-tax profits (1993–95)
WASCs	11%	23%	7%	9%
RECs	28%	34%	17%	30%
Generators	18%	27%	14%	27%
Others	43%	16%	61%	34%

Notes:

The figures show the share of the total windfall levy liability paid by each sector under the alternative tax bases. Figures may not sum exactly to 100 due to rounding. The definitions of the tax bases used are given in the text.

The WASC sector contains the 10 water and sewerage companies privatised in 1989, i.e. Anglian, Northumbrian, North West, Severn Trent, Southern, South West, Thames, Welsh, Wessex and Yorkshire Water. The REC sector contains the 12 regional electricity companies privatised in 1990, i.e. Eastern, East Midlands, London, Manweb, Midlands, Northern, Norweb, Seeboard, Southern, South Wales, South Western and Yorkshire Electricity. During the period, the RECs wholly owned the National Grid. The electricity generators include National Power, PowerGen, Scottish Power, Scottish Hydro-Electric and Northern Ireland Electricity. 'Others' includes British Gas, British Telecom and BAA. British Energy and Railtrack are excluded due to a lack of available accounting data.

Excess shareholder returns are taken from OXERA (1996) and are based on a return index that accounts for both dividend income and capital gain and assumes that these are reinvested in the company. The return from the FTSE All Share index is subtracted, as an approximation of the normal return.

Pre-tax profits and excess pre-tax profits are based on company accounting data, as described in Dilnot and Giles (1996). Excess pre-tax profits allow a deduction for normal profits estimated at 10 per cent of the net book value of total assets employed.

Size-based measure

The first measure in Table 1 is simply based on company size, measured by total sales in 1995. This has the advantage of being easy to calculate, but does not necessarily bear a strong relationship to the company's excess profits. The sectors included are the WASCs, the RECs and the electricity generators, and BT, BG and BAA are grouped into a sector of 'others'. Using 1995 as the relevant year has the advantage of providing information on most of the companies before they were taken over but the disadvantage of excluding other companies that might be liable to the tax (such as British Energy and Railtrack) because they were privatised in the summer of 1996. The group of 'other' utilities accounts for over 40 per cent of a tax based on sales, much of which is in fact borne by BT, which had a turnover of almost £14 billion that year (in 1995 prices). The electricity companies account for another 46 per cent, and the remaining tenth is paid by the water companies.

This means that if the windfall levy were to raise revenue of £3 billion from this particular tax base, for example, the WASCs would face a combined bill of about £300 million, the electricity companies would pay about £1.4 billion, and the group of other companies would pay £1.3 billion between them.

Although the more profitable utility companies argue that using profits or returns penalises the most efficient companies and appears to reward companies that have performed badly, the Labour Party has stated that the aim of the levy is to tax excess profits, so it seems likely that a more sophisticated measure would be used. In addition, any base that relied only on one year of information, as this one does, would be very sensitive to the particular year used.

Shareholder returns

An alternative measure would be to base the tax on the return to shareholders, given that it is clear that some of the privatised utilities have proved to be lucrative investments. This would involve calculating a total shareholder return that combined both increases in share price (the capital gain) with total dividend payments (the income), and comparing this against the total return from a broad index of companies (as an approximation of a normal return).¹⁷ Some work looking at a measure of excess shareholder returns for a group of privatised utilities over the period 1991–95 is summarised in the second column of Table 1 (see OXERA (1996)). Unlike the example based on turnover, the balance shifts away from the group of 'other' utilities, towards the electricity and water companies, as the share price data in Figure 1 suggested. This measure does not take into account some of the additional payments that have been made to the shareholders of the electricity and water companies, in the form of special dividends and share buy-backs, which would shift the burden further towards these companies.

¹⁷ This would be a good approximation of the normal return for these companies only if the risk attached to investing in them is similar to that for the market as a whole.

This type of tax base has the advantage of appearing to be closely related to the rationales suggested for the tax, and might capture elements of excess profits that would not be caught by looking solely at a company's reported profits. It was clear from the market's reaction to the electricity distribution review of 1995 that the regulator, Stephen Littlechild, had not been able to capture fully the market's assessment of the RECs' future profitability, despite a thorough examination of the regulatory accounts provided by the companies. One of the disadvantages of this measure, and of any measure that uses share price as part of the calculation, is that share prices are based on the expected *future* stream of income from the company, and so depend upon expected future profits growth, while the stated aim of the tax is to extract some part of excess profits that have been earned in the *past*. Share prices also tend to be very sensitive to events in the wider economy, such as the level of interest rates and inflation, and not just sensitive to information on the particular company. If these external events affect all firms in a similar way, comparing them against a market index would resolve this problem.

One slight disadvantage of this tax base is that it is affected by the prospect of the tax, which is capitalised into share prices. In other words, when it became probable that a windfall tax would be levied, the share prices of the companies that market analysts believed would be subject to the tax adjusted downwards, to allow for the fact that there was an expectation that these companies would have to face an additional tax bill at some future date. If the tax base is measured using share prices, it clearly shrinks by the amount of the tax. This is not a serious problem, since the same amount of tax revenue can be raised by imposing a higher tax rate (on the now smaller tax base). Finally, the fact that several companies have been taken over, in many cases by foreign firms, means that they are no longer listed on the UK stock exchange, and therefore that no separate share price or dividend information is available after the take-over date. Since separate listings for these firms are unlikely to be available for some time, this suggests that a cut-off point for measuring the base would have to lie at or just before the spate of take-overs in the autumn of 1995, and perhaps should lie before any firm announcement of the policy was made.

Company profits

A third type of tax base that could be used is a measure of company profits, but it is not clear which measure of profits would be most appropriate. The tax base used for corporation tax purposes is unlikely to be used for the windfall levy. As a result of being granted relatively generous capital allowances at privatisation, the water companies have paid relatively little corporation tax (although they have paid advance corporation tax in relation to their dividend payments). If the same measure of taxable profits were used to determine liability to the windfall levy, the water companies would still pay relatively little, which would seem to defeat one of the objectives of the tax.

This leaves a choice between a straightforward accounting measure of profits and a measure of 'excess' profits. A tax based on excess profits, or 'economic rents', would exempt an estimate of 'normal' profits (that is, the required return on capital invested). Accounting measures of profit subtract the required return on capital borrowed (that is, interest payments) but do not subtract any measure of the required return on shareholders'

funds. Normal profits could be estimated in practice as some interest rate multiplied by an estimate of the net value of the firm's assets; and excess profits could be measured by allowing this estimate of normal profits as a deduction in place of interest payments. Estimating the value of capital invested in the case of a network of water or gas pipes is not straightforward, and the use of historic cost values might produce quite different results from those using a current cost measure of the replacement value of these assets. (See Edwards, Kay and Mayer (1987) for a discussion of the difficulty in valuing capital assets.)

Whichever measure of profits were used, the liability of individual firms to the windfall levy would again depend on the time period over which profits are measured. Taking one recent year as the tax base would be very sensitive to the different stages of the economic cycle at which these companies find themselves, and would be vulnerable to any attempts companies have made to disguise profits once the windfall levy was announced. It also would not capture the backward-looking nature of the tax. A cumulative or average measure of profits earned since flotation would affect companies differently because of the variable lengths of time they have been in the private sector, and a cumulative measure would shift the burden of the tax towards the older companies, such as British Telecom and British Gas. Using a common time period would appear to move all companies to a more even footing, regardless of age, but might be a less accurate reflection of the extent of excess profits earned.

The last two columns in Table 1 show the results for two different measures of profits — published pre-tax accounting profits and an estimate of excess profits derived from pre-tax accounting profits in the way described above. The measures have been cumulated over the three financial years 1992–93 to 1994–95.¹⁸ When either measure based on accounting profits is used, the burden falls more heavily on the group of other companies than was the case for excess shareholder returns. In particular, the water companies would pay a much smaller proportion of the tax if either the pre-tax or the excess profits measure were used, and BT would pay substantially more.

This discussion points out some of the difficulties in constructing a measure of excess profits, and that the size of each sector's tax bill (and hence each individual company's bill) varies widely according to the type of measure that is chosen. Given that the rationales for the windfall levy suggest that the initial share price was too low and that the returns since privatisation have been too high, it seems most likely that a measure would be adopted that takes account both of the initial value of the companies on flotation and of the total returns since then (including any special payments of dividends or similar distributions). This would tend to shift the burden of the tax towards the electricity and water sectors.

¹⁸ Except in the case of Northern Ireland Electricity, where the accounting year ending 1995–96 is included in order to have three years of data after privatisation for this company.

Conclusion

The windfall levy on the privatised utilities seems certain to be imposed in some form if the Labour Party wins the 1997 election. The arguments put forward for windfall levy rest upon the assertions that the companies were sold off too cheaply at privatisation and that, as a result of lax regulation, the companies have been able to exploit their monopoly power since privatisation. While it is clear that some of the utility companies have earned a good return, in terms of share price, for their owners in the years since privatisation, others have not done so well. Any windfall levy is likely to attempt to shift the burden of the tax towards those companies that have earned the best returns.

A windfall levy appears to be a method of raising a large one-off amount of revenue which should have little effect on the real economic behaviour of the companies affected, provided that the statement that the tax is 'one-off' is credible. If this is the case, the tax should fall largely on the shareholders of the companies concerned, rather than on its consumers. It is unlikely to be an equitable tax, in the sense that some of those who are intended to be caught by it have already sold their shares in the utilities and some who are not intended to pay the tax will bear some of the burden. Any type of one-off tax, whether it is imposed on banks or utility companies, increases uncertainty about the tax system, but is more feasible than a direct tax on the shareholders.

The exact form the windfall levy takes, and the period of time to which it relates, will significantly affect how the burden of the tax is shared between the different utility companies. In particular, if the tax is levied on a measure of excess returns to shareholders since privatisation, up to some point in the fairly recent past, the majority of the tax would be paid by the water and electricity companies.

Finally, the most troubling aspect of the tax is that it demonstrates the fact that, in order to raise revenue, political parties increasingly seek to conjure up new taxes on targets they believe will be palatable to the electorate, rather than being able to raise revenue from the existing tax structure, which would be more coherent economically and also more transparent.

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