

Statement to accompany the release of the documents

## **BACKGROUND**

### **Payable tax credits**

The documents enclosed all relate to advice provided to inform the decision to abolish payable tax credits on dividends. The purpose of such advice is to provide Ministers with an assessment of all the potential impacts of a particular policy change, both positive and negative.

The specific advice contained in these documents was provided in 1997-98 prior to the July Budget, but this was itself informed by the thinking which had been going on in HM Treasury since at least 1992, which led to the decision in the 1993 Budget to remove the link of the rate of payable tax credits to the basic rate of income tax, reducing the credit from 25% to 20% over two years.

The system of payable tax credits encouraged companies to pay out dividends rather than reinvest their profits. It also encouraged pension schemes to make decisions on investment strategies for tax reasons rather than on their economic merits. This had led to long-standing concerns in HM Treasury that the system of payable tax credits was acting as a disincentive to long-term investment.

In 1993, the then Chancellor Norman Lamont announced his decision to reduce the rate of payable tax credits as follows:

*"In discussions with business organisations over the last few months, one issue has come up again and again: the problem of surplus advance corporation tax, or ACT. Many believe that this feature of our tax system both penalises successful British-owned international companies and distorts investment decisions. This issue has, of course, been with us for many years, and it has so far defied solution. Nonetheless, I made a commitment in my Budget last year to return to this subject, and I am pleased to be able to report to the House that I have now found a way forward".*

On the basis of the advice in the attached documents, and in the context of the wider changes announced in the 1997 Budget to encourage long-term investment, the Chancellor decided that the payable tax credit on dividends should be abolished. He announced his decision as follows:

*"The present system of tax credits encourages companies to pay out dividends rather than reinvest their profits. This cannot be the best way of encouraging investment for the long term as was acknowledged by the last Government. Many pension funds are in substantial surplus*

*and at present many companies are enjoying pension holidays, so this is the right time to undertake a long-needed reform.”*

The documents attached illustrate a number of scenarios presented to Ministers on the implications of the abolition of the payable tax credit, all in the context of the wider reforms being proposed for the 1997 Budget. Experience has shown that many of these scenarios did not materialise. For example, concerns that there might be a fall in the stock market of up to 7.2% were unfounded. By close of the FTSE (all share) index on Budget day 1997, the market had risen by 0.45%, and continued to rise over the following year.

### **Wider 1997 reforms**

The withdrawal of payable tax credits on dividends were part of a package of reforms in 1997 to develop a tax system that encouraged personal savings, favoured higher levels of investment and rewarded long-term investment.

To improve the climate for long-term investment, the 1997 Budget announced:

- A reduction in the main corporation tax rate from 33 per cent to 31 per cent from 1 April 1997; and
- A reduction in the small companies' rate of corporation tax from 23 per cent to 21 per cent from 1 April 1997; and
- The temporary doubling of capital allowances for small and medium enterprises' plant and machinery, allowing expenditure on such items by small and medium sized enterprises for 12 months after the Budget to qualify for a first year allowance at double the previous rate of writing down allowance.

The reduction in the corporation tax rates benefited 450,000 companies and enhanced the UK's position as a major industrialised nation with the lowest main corporation tax rate whilst improving climate for long-term investment in the UK.

In the long term, when looked at in the context of the wider reforms, this package, including the abolition of payable tax credits, has contributed to a stronger investment climate for UK companies.

As a result, business investment has increased almost 50 per cent since 1997.

Alongside the changes to corporation tax, the Government announced in the 1997 Budget that:

- payment of tax credits to pension schemes and UK companies (other than charitable companies) would be abolished for dividends paid on or after Budget day;

- other shareholders would generally not be affected by changes to tax credits until 6 April 1999, when tax credits were no longer payable to other shareholders with no tax liability; and
- the rate of tax credits were halved to 10 per cent from April 1999 to protect individual shareholders from higher income tax bills as a result of the changes.

As part of this package, the Government announced that there would no change for charities or individuals until April 1999.

From April 1999, a transitional compensation scheme was introduced for charities for 5 years up to 2004. At the same time, a wider review of the taxation of charities was announced, which led – inter alia – to the introduction of much more generous and flexible reliefs on charitable giving.

The timing of the changes to the rate of tax credits for individuals was designed to coincide with the introduction of Individual Savings Accounts (ISAs) in 1999 as the successor to TESSAs and PEPs. This ensured that individuals would continue to have favourable tax incentives for investing in equities. ISAs are now held by more than 1 in 3 adults and have been more successful than TESSAs and PEPs, particularly with the young and those on low incomes.

### **The impact on pension funds**

The combined effect of all the 1997 Budget measures on pension schemes, including the beneficial impact of offsetting cuts in the Corporation Tax rates, must be considered alongside wider factors affecting pension schemes in recent years. These factors – both individually and combined – have had a far greater impact on the funding of pension schemes than the specific impact of the 1997 Budget measures, including the removal of payable tax credits.

Specifically:

- the most significant downward effect on the funding of pension schemes resulted from the stock market fall around the turn of the century, which accounted overwhelmingly for a reduction of around £250bn in the market value of occupational pension scheme assets between 1999 and 2002;
- many firms made the decision during the 1980s and 1990s, despite rising liabilities, to take contribution holidays, believing a bullish equity market to be a long-term trend. The Turner Commission on Pensions reported that “the deep dip in contributions seen in the period 1988-91 almost certainly reflects the impact of this policy”; and
- whereas in 1950 a 65 year-old man could expect to live for only another 12 years, this has now risen to 20 years. This rapid rise in life expectancy has

meant that pensions are in payment for more years, thus increasing a fund's liabilities.

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