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Britain *is* booming

Excessive money growth lies behind current upturn

***Business Week* pronounces "Britain's boom",**

Britain is booming. It must be true; *Business Week* says so. With the union jack unfurling into a ten pound note on the magazine's front cover and a confident statement that "Britain's economy is on a roll", the good times have returned. The interesting question is "why?".

which cannot be explained in Keynesian or semi-Keynesian terms

Britain's economic forecasting community has not been completely wrong-footed. The consensus view for some time has been that 1997 would enjoy above-trend growth. However, the strength of the upturn in domestic demand has been a surprise for most commentators. A traditional Keynesian explanation, in terms of the budget position, does not fit at all, because both the actual and the cyclically-adjusted budget deficit have been declining in the last two years. It is also difficult to appeal - in the manner of the pragmatic semi-Keynesians at the National Institute and the London Business School - to a composite measure of monetary conditions based on interest rates and the exchange rate. As base rates have been more or less stable for the last two-and-a-half years and the exchange rate has risen sharply since last August, this measure of monetary conditions has become tighter in the relevant period.

An explanation based on faster money growth looks most convincing

and implies rising inflation

As in many previous cyclical episodes, an explanation based on money supply growth looks the most coherent. The current acceleration in money growth began in early 1995, when Glaxo's bid for Wellcome added over £5b. to both sides of banks' balance sheets. Since then monetary growth (as measured by annualised rates over three-month periods) has run consistently at between 8% and 11%. Although aggregate demand was held back in early 1996 by an unfavourable movement in stocks, the whole of the last two years has seen strengthening balance sheets and buoyant asset prices. These developments - which are standard precursors of improving economic activity - are best interpreted as due to attempts to eliminate excess money balances. The excess liquidity has been most obvious in the financial sector, whose money holdings have been soaring at annualised rates of over 20%. Early 1997, in sharp contrast to a year earlier, has benefited from a favourable phase of the stocks cycle. The combination of wealth effects from the asset price gains and a positive contribution from stocks is now leading to extremely fast growth of domestic demand. While it is early days to be making precise estimates, there seems every likelihood that real domestic demand is growing in early 1997 at annualised rates of between 4% and 5%. This is indeed a boom. Unhappily, the *high rate of change* in output seems certain to push the *level* of output well above its trend level next year, implying intensifying shortages of labour and strains on capacity. The current monetary acceleration, and the associated boom in economic activity, will lead - like all previous monetary accelerations and booms - to higher inflation.

Professor Tim Congdon

14th April, 1997

Summary of paper on

Raiding the pension nest egg

Purpose of the paper

The Labour Party is expected to win the general election on 1st May. As its leadership has denied any intention to raise personal tax rates, the presumption has to be that any significant increase in the tax burden will fall on companies. This *Review* examines the background to possible changes in the taxation of pension funds. (They are widely regarded as a "soft target", as they are said to have benefited unduly in the last 20 years from rapid dividend growth.)

Main points

* **The cost of pension funds' tax reliefs to the Exchequer has risen less than GDP since the late 1980s, as cuts in the standard rate of income tax and the move to a 20% rate of ACT relief in the 1993 Budget have already lowered the value of ACT credits. (See p. 5.)**

  [N.b. Under the UK's imputation system of taxing dividends, companies pay "advance corporation tax" on dividend distributions. Shareholders receive ACT "credits" in respect of the tax paid. If they are tax-exempt investors, like pension funds, they can recover tax by claiming the credits from the Inland Revenue.]

* **The ratio of dividends to GDP soared from about 1 1/2% in the mid-1970s to 6% last year. The ratio of dividends to GDP is much higher in the UK than in other countries, including the USA. (See p. 6.)**

* **Much of the rise in the dividend/GDP ratio reflects the behaviour of unquoted companies. The increase in the dividend/earnings ratio in the quoted sector is far less than for all UK companies. (See pp. 8-9.)**

* **The ratio of gross trading profits to GDP is not particularly high at present. (See p. 11.) The ratio of company earnings to GDP is a post-war record, but this is due to low corporate interest payments and, more particularly, to very buoyant income from abroad. (See p. 10.)**

* **One common justification for changing dividend taxation - that the current system encourages the distribution of profits, taking funds away from retentions and investment - is not entirely convincing. Since the late 1980s changes in corporate investment and retentions have often moved inversely. (See p. 7.)**

This paper was prepared by Professor Tim Congdon and Stewart Robertson.

Raiding the pension nest egg

Will Mr. Brown's first Budget attack the pension funds' tax exemptions?

Mr. Brown's first Budget in late June or early July

The result of the next general election looks certain, that Labour will win with a comfortable overall majority. Whether they like it or not, the UK's financial markets will have to start adjusting to the new political reality. So far the price action in gilts and equities has implied widespread complacency about possible tax changes under Labour, while the pound has been remarkably strong on the foreign exchanges. Assuming Labour is elected, the first Budget from Mr. Gordon Brown, now the Shadow Chancellor, is likely to be in late June or early July, and will give him an opportunity to spell out his macro-economic intentions. One line of argument is that he will pursue a tight fiscal policy, in order to keep interest rates (and so the exchange rate) as low as possible.

cannot raise much revenue from the personal sector

As Labour has said that it will not change the public expenditure limits laid down for the next two years by the present Government, the only way to tighten fiscal policy will be to raise taxes. Mr. Blair, the Leader of the Opposition, has made commitments not to raise the rates of personal tax. Admittedly, that would leave Labour free to lower the value of certain reliefs and perhaps eliminate them altogether. But the scope for boosting the tax take by this means is limited, partly because the present Government has already curbed reliefs to help pay for large cuts in the standard rate of income tax. For example, back in 1989/90 and 1990/91 the cost to the Exchequer of tax relief on mortgage interest (in 1995/6 prices) was roughly £9b. In 1995/6 it was down to under £3b.

and must therefore focus on companies,

including pension funds

Logically, Labour has to attack the corporate sector. A frontal assault on company profits might nevertheless be unwise, as profits are needed to finance capital expenditure. (New Labour is very like Old Labour in its enthusiasm for "investment", "technology", "growth" and such like.) So the more likely strategy is a complex flank movement against parts of corporate Britain which can be politically demonized, notably the privatised utilities and "the City". A £5b. windfall tax on the utilities seems inevitable, but also probable is a reduction in the so-called "tax privileges" of the pension funds. As discussed in the July 1995 issue of this *Monthly Economic Review*, one possibility is the abolition of advance corporation tax and the associated ACT credits. Even if ACT remains, a halving in the rate of relief (from 20% to 10%) might do nasty things to post-tax profits and share valuations.

Abolition of ACT very easy to present in political terms

The Lex column in the *Financial Times* (9th April) noted these consequences, but protested that none of them were likely "if British business gets its act together and ensures that Labour understands". This is naive. Every tax rise has unpleasant results, but - as tax increases go - scrapping ACT must be the most presentable, and the least politically painful, that can be imagined. In fact, when Mr. Lamont reduced the rate of ACT relief from 25% to 20% in the first Budget of 1993, his phrasing gave the impression that he was cutting taxes!

and Labour has made statements, implying change is being considered

To replace the current "imputation system" of taxing company dividends, whereby distributed profits are taxed only once, by the "classical system", where they are effectively taxed twice, would be in line with practice in many other industrial countries. In any case, the Labour Party's manifesto includes the sentence, "We will review the corporate and capital gains tax regimes to see how the tax system can promote greater long-term investment." This does not say that the arrangements for taxing dividends will be changed, but it contains rather more than a veiled threat. People have forgotten that the Labour Party consists of socialists who believe that high profits are excellent, as long as they are never received by the shareholders.

Cost of all pension fund reliefs £12b. and of ACT relief alone about £6b.

The current *Monthly Economic Review* examines the background to the coming review of corporate taxation. In its annual statistics publication the Inland Revenue provides an estimate of the cost (to the Exchequer) of tax reliefs granted to pension funds. The cost rose from £9.1b. in 1986/87 to £12.0b. in 1995/6, much less than the increase in gross domestic product. This may seem surprising, since pension fund assets have been growing more rapidly than GDP. The apparent anomaly has two explanations. First, the need for employers' contributions has been reduced by pension fund surpluses. Secondly, because the rate of ACT relief has been cut from 30% in the mid-1980s to 20% today, the cost of ACT relief has not gone up in step with higher dividends. In 1986/87 the cost of tax relief on funds' investment income was £3.5b.; in 1995/6, it was £6.1b. But - if ACT relief had still been available at 30% - the cost would probably have been £9.1b.

Scrapping ACT relief would cut corporation tax receipts, but overall effect on tax revenues would be positive over medium term

The withdrawal of relief on contributions is not being contemplated. (A small exception is relief for contributions by the higher-rate taxpayers, which Labour would limit to the standard rate.) The message would seem to be that the maximum Mr. Brown could extract from the pension funds would be somewhat more than £6b., through scrapping ACT relief entirely. But, a number of actuaries have protested that the net revenue gain would be considerably less. (Also see Mr. Alastair Ross Goobey's letter in *Financial Times*, 4th April, which claimed "The net effect on corporate tax revenues may be negligible.") The reason is that, because the abolition of ACT would leave many schemes actuarially deficient, companies would have to bump up contributions to restore solvency. The extra contributions would bite into corporate profits and so into mainstream corporation tax, reducing the Exchequer's gain from the ending of ACT. The size of this adjustment would be significant for a year or two, to compensate for the once-for-all change in solvency. But over the medium term it would surely be outweighed by the gains from eliminating the ACT credits. It is difficult to believe that Labour would be deterred from an attack on ACT relief by considerations of this kind.

The cost of pension tax reliefs

How much is there to be raided?

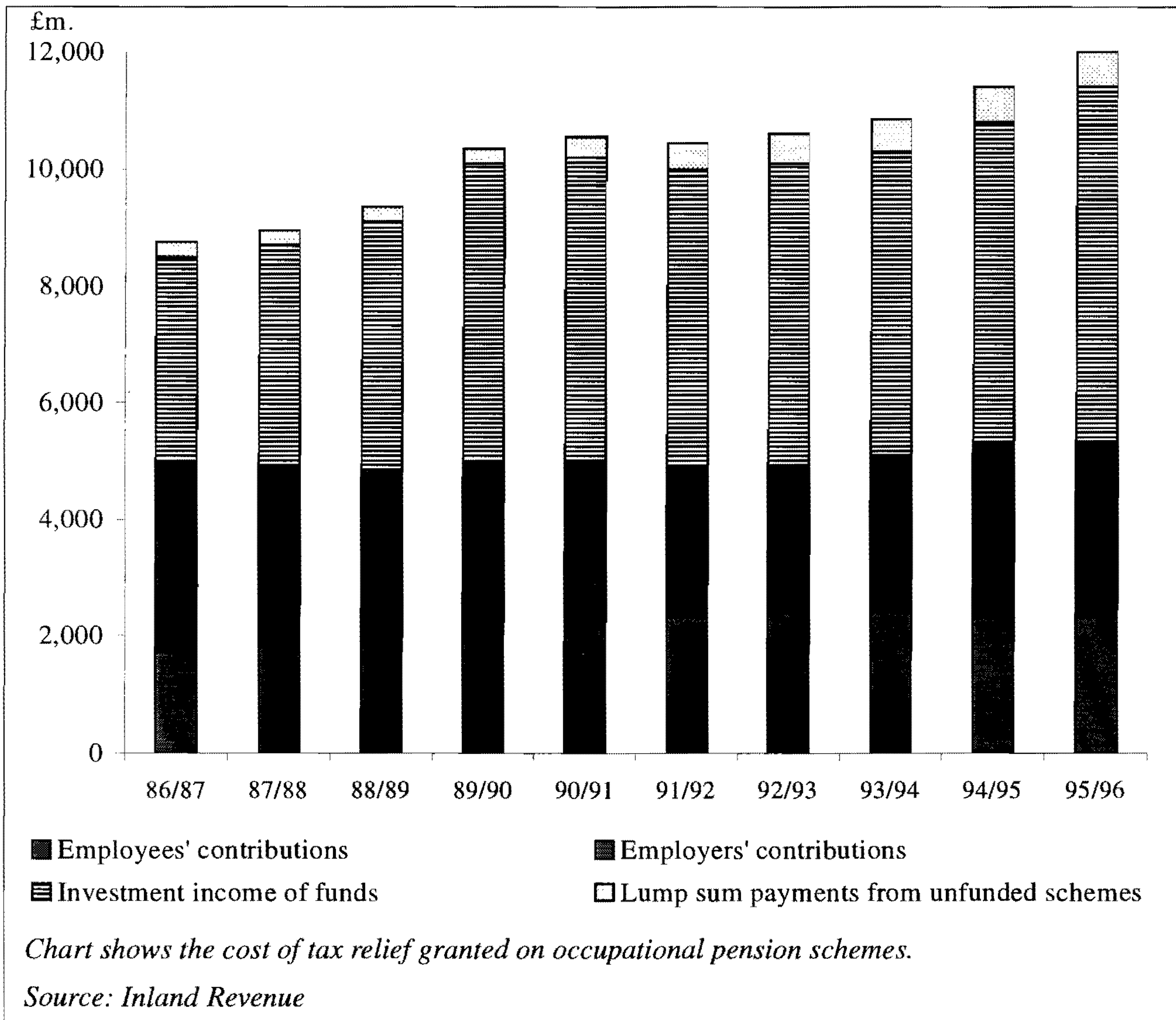


Chart shows the cost of tax relief granted on occupational pension schemes.

Source: Inland Revenue

Mr. Gordon Brown, presumably the new Chancellor from 1st May, may attempt to plug the "black hole" in a new Labour Government's public finances by increasing the tax burden on pension funds. The chart above illustrates the attraction of this source of revenue. The cost (to the Exchequer) of tax relief on the investment income of funds rose from £3.5b. in 1986/7 to £6.1b. in 1995/6. The increase would have been much greater if relief were granted at 30%, as it was in 1986/7, rather than the current figure of 20%. It is estimated that restricting the ACT credit to 10% could raise over £3b. in revenue. The contrast with tax relief on mortgage interest, the value of which has already been reduced dramatically, is interesting. The total cost of mortgage interest tax relief was just £2.7b. in 1995/6.

Dividends in the UK and USA

Ratio of dividends to GDP soaring in the UK, rising in the USA

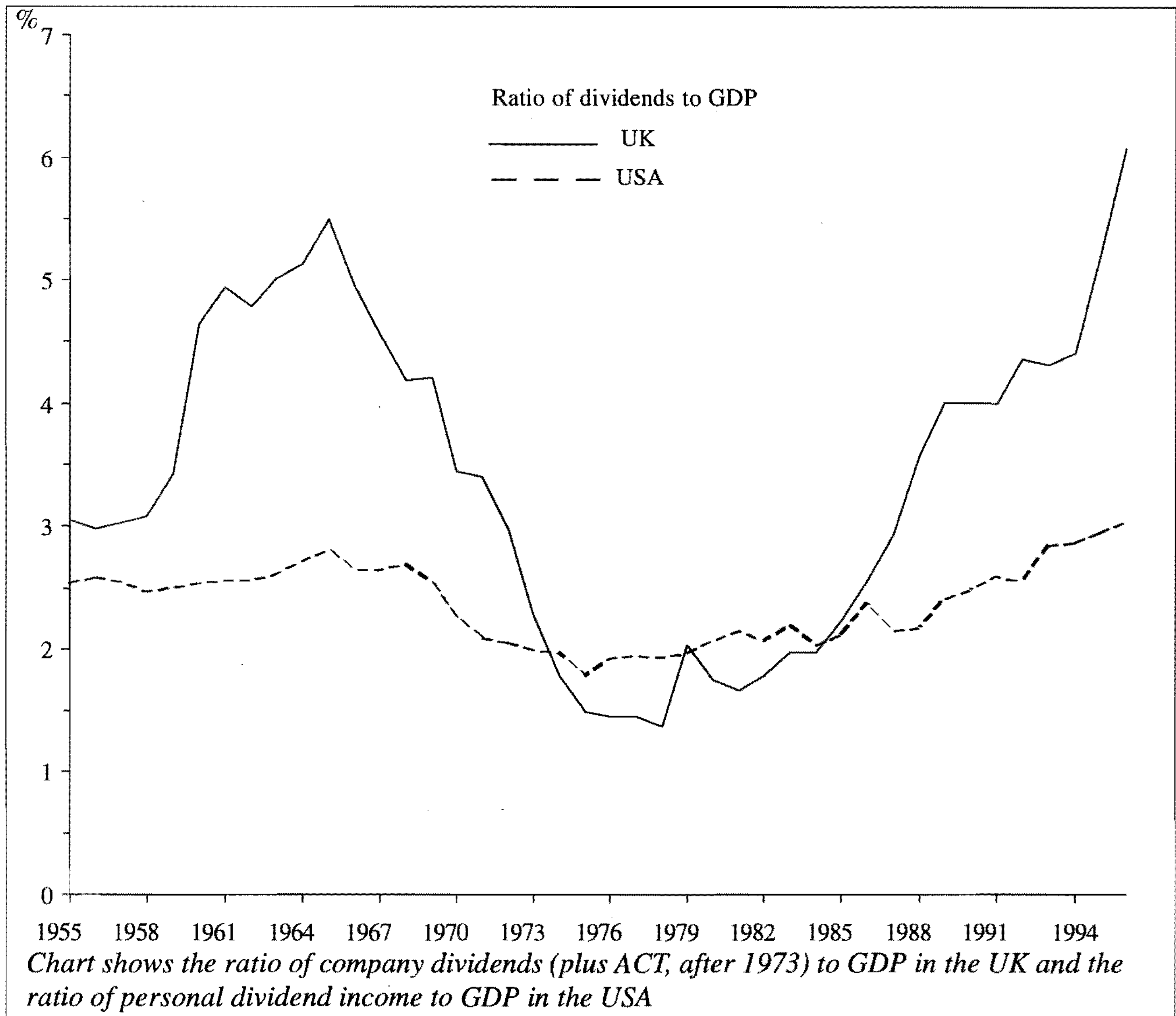
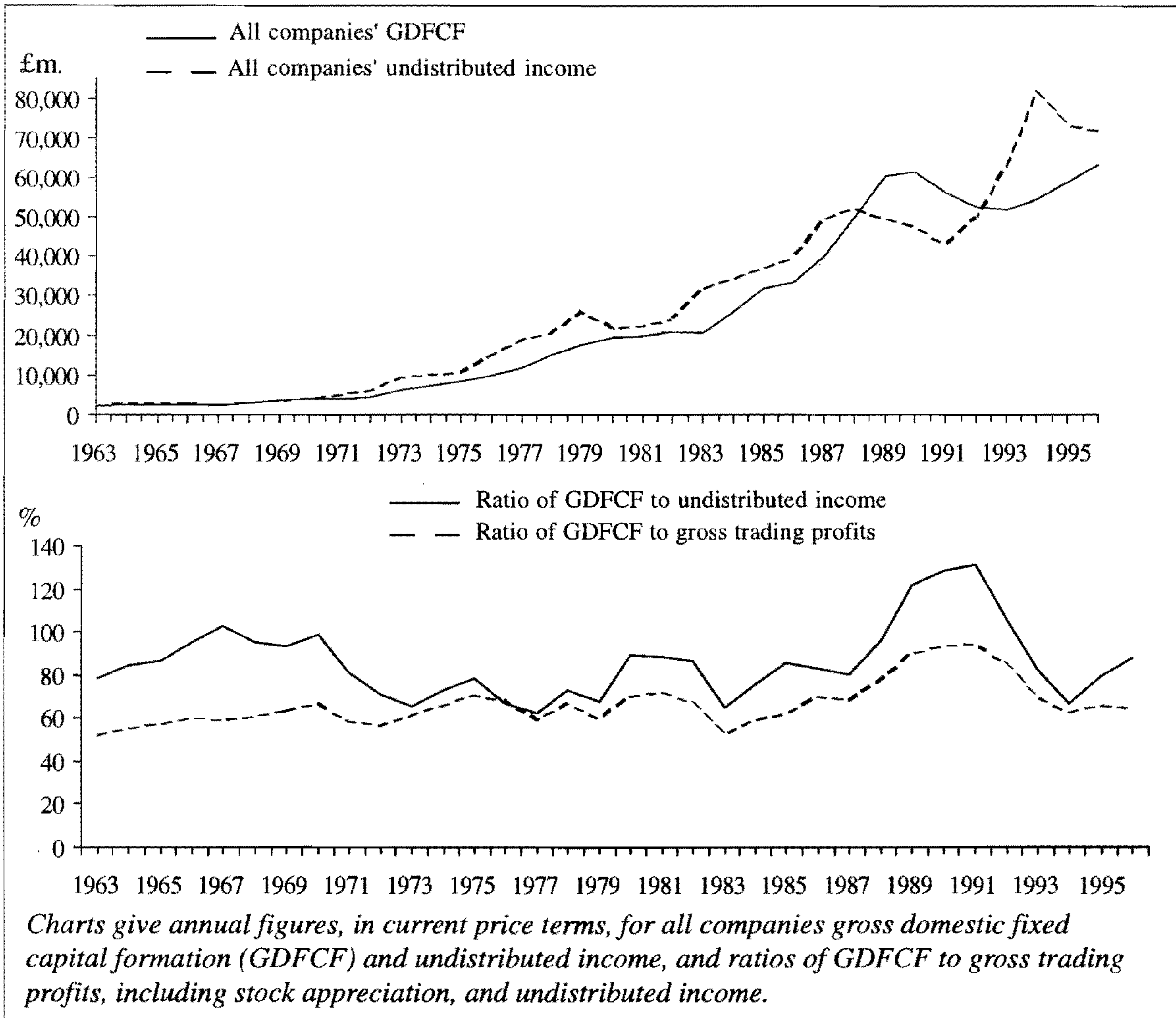


Chart shows the ratio of company dividends (plus ACT, after 1973) to GDP in the UK and the ratio of personal dividend income to GDP in the USA

Part of the surge in the ratio of dividends to GDP in the UK over the last two years is explained by the sharp increase in special dividends. This trend, which may itself be partly due to anticipation of a less favourable tax regime under a Labour Government, has probably exaggerated the underlying growth of dividend payouts. Nevertheless, the current value of over 6% of GDP is undeniably high and is starkly different from the figure of 2% or less when Labour was last in power. Another reason for the recent increase has been the enormous rise in distributions by unquoted companies (see pp. 8-9). International comparisons are complex because of variations in tax systems and corporate capital structures. In addition there are definitional differences. But dividends as a proportion of GDP have also been on a rising trend in the US.

The pay-out ratio and investment

Retentions and investment have moved inversely in recent years



Charts give annual figures, in current price terms, for all companies gross domestic fixed capital formation (GDFCF) and undistributed income, and ratios of GDFCF to gross trading profits, including stock appreciation, and undistributed income.

Critics of the high dividend payouts seen in the UK argue that industry is starved of funds for investment, with adverse effects on the long-run growth rate of the British economy. The problem has, allegedly, been particularly acute since Lawson's 1984 Budget. The evidence for this contention is mixed at best. It is not sufficient to point to the apparent close relationship between retentions and investment over time. Similar correlations can be found in any series which have a dominant time trend. More relevant is the relation between changes in the two series. In theory, a rise in retentions should lead to a increase in investment. But in the past 18 years, retentions and investment have moved in opposite directions on eight occasions, i.e., almost half of the time. Since 1988 they have only moved together twice.

Different measures of the pay-out ratio

Using national accounts data, relative to trading profits

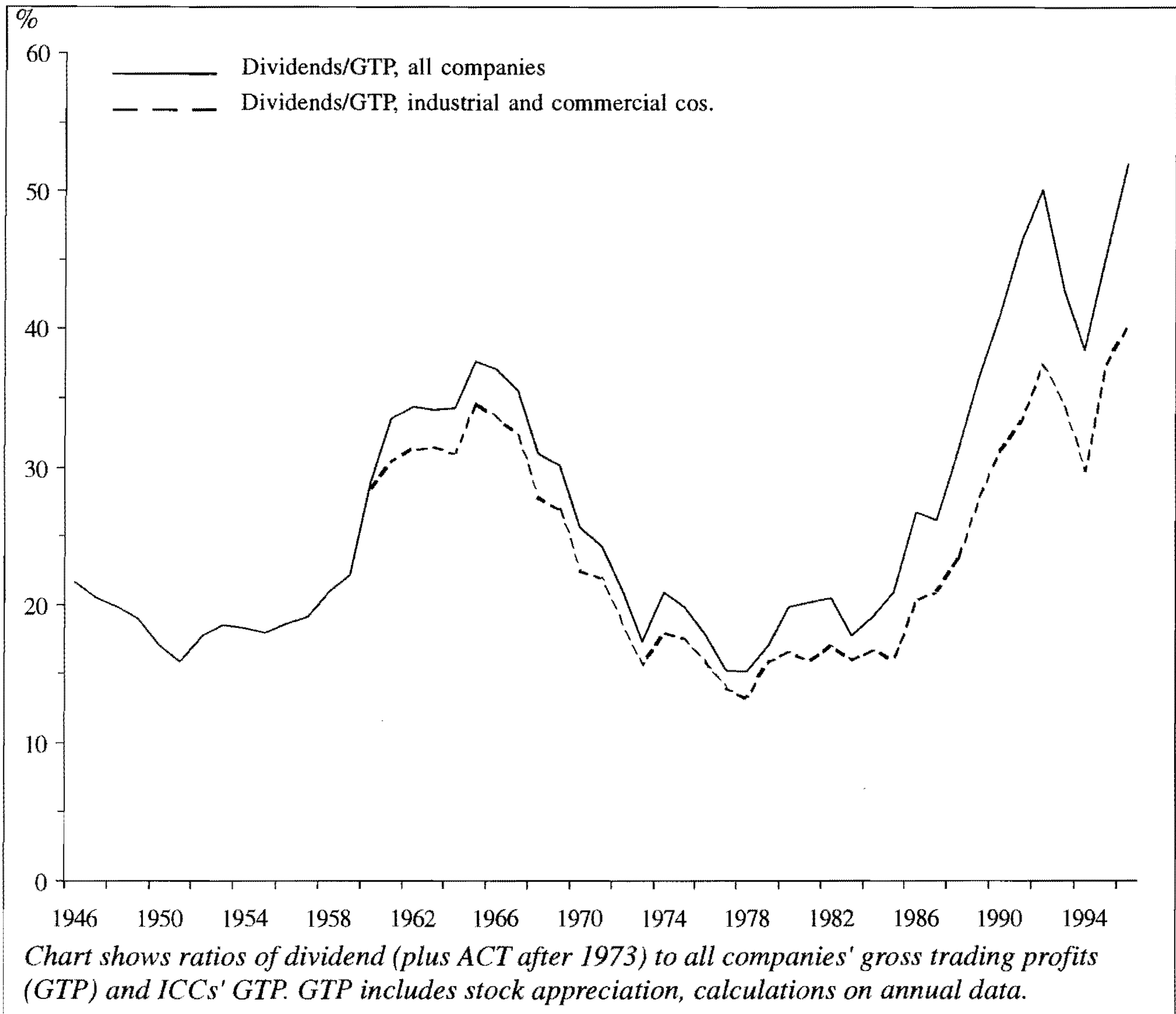
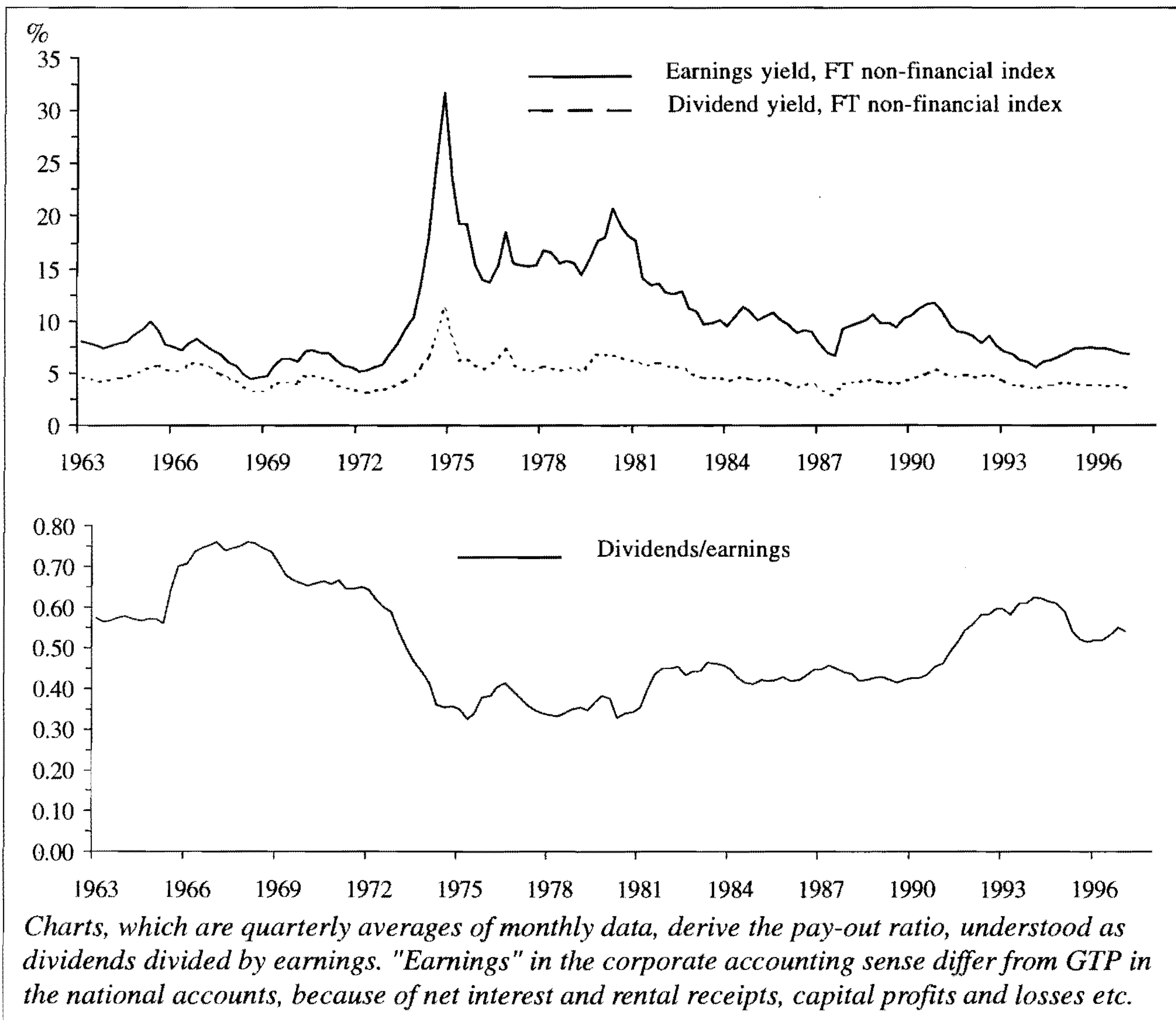


Chart shows ratios of dividend (plus ACT after 1973) to all companies' gross trading profits (GTP) and ICCs' GTP. GTP includes stock appreciation, calculations on annual data.

The payout ratio is generally understood as the ratio of dividends to profits, but several different definitions are possible. The chart on this page relates to National Accounts data for two concepts of "the company sector" and shows the sharp rise in distributions as a proportion of trading profits in the 1980s. After a short reversal, the upward trend has resumed. The National Accounts totals include the thousands of unquoted companies as well as figures for the quoted sector. Unquoted companies' dividends have risen much faster than quoted companies' since the mid-1970s. The chart on p.9 illustrates a somewhat different definition of the payout ratio for quoted companies only. Although the broad pattern is similar, there has been no significant recovery in dividend payments after the dip in 1993/94.

Using data in *Financial Times* share price indices, relative to earnings

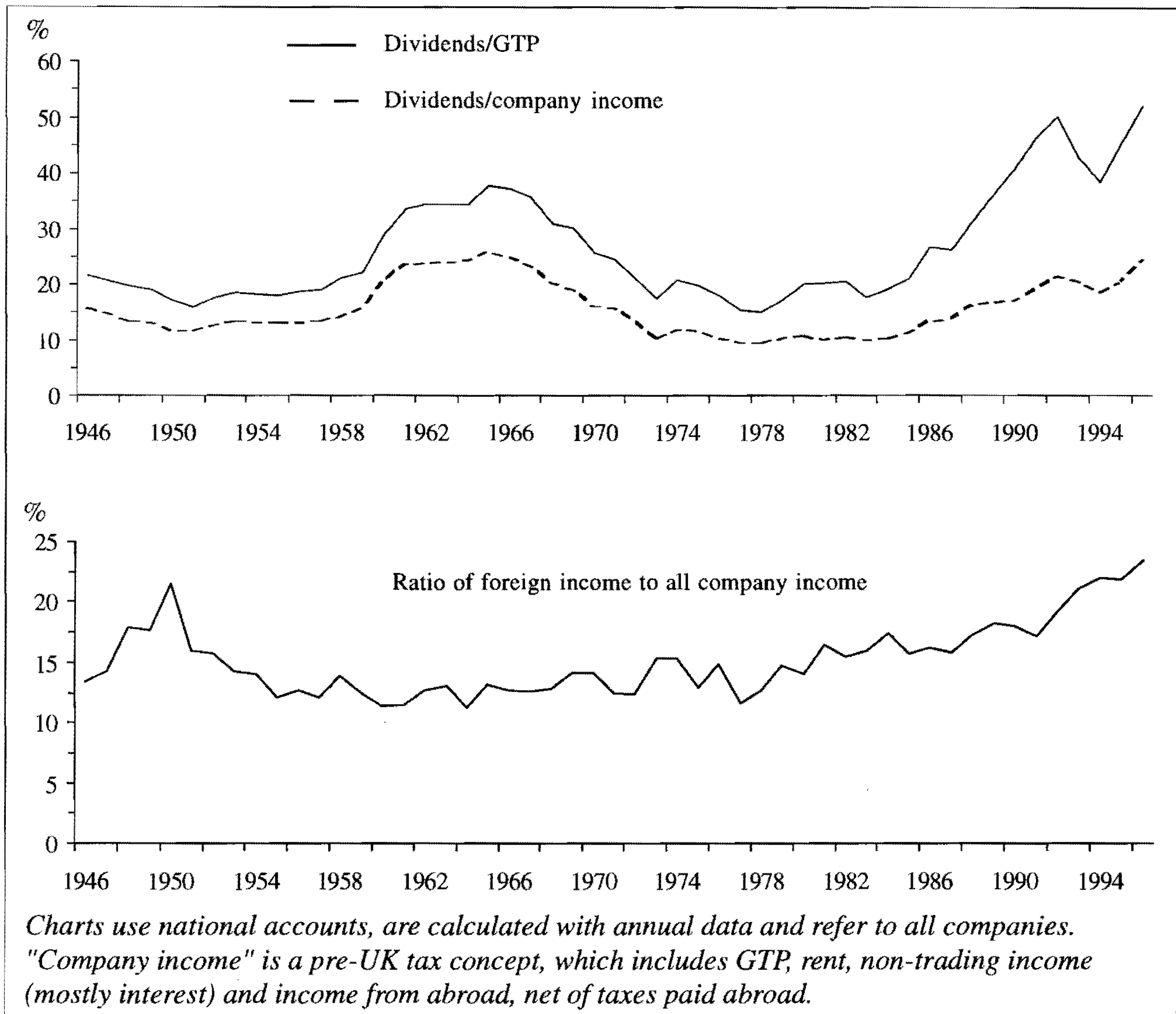


Charts, which are quarterly averages of monthly data, derive the pay-out ratio, understood as dividends divided by earnings. "Earnings" in the corporate accounting sense differ from GTP in the national accounts, because of net interest and rental receipts, capital profits and losses etc.

The implication of the argument on the p.8 is that the payout ratio for small, unquoted companies (although much less in absolute terms) has surged even more dramatically in the second half of the 1980s and, especially, in the 1990s. Part of the explanation for this trend is that the managements of small companies have chosen to take their rewards for successful entrepreneurial activity as dividend payouts rather than in alternative forms. One of the reasons that this practice has become more widespread is that it has clear tax advantages. The Labour Party has claimed in their manifesto that small businesses are "vital to Britain's economy because of the wealth they create", but any change to the system of corporate and dividend taxation would have significant implications in this area. If dividends are discouraged, the proprietors of unquoted companies, as well as large pension funds, will need to reconsider their strategies.

The pay-out ratio and foreign income

Buoyant foreign income explains much of increase in dividends relative to GDP

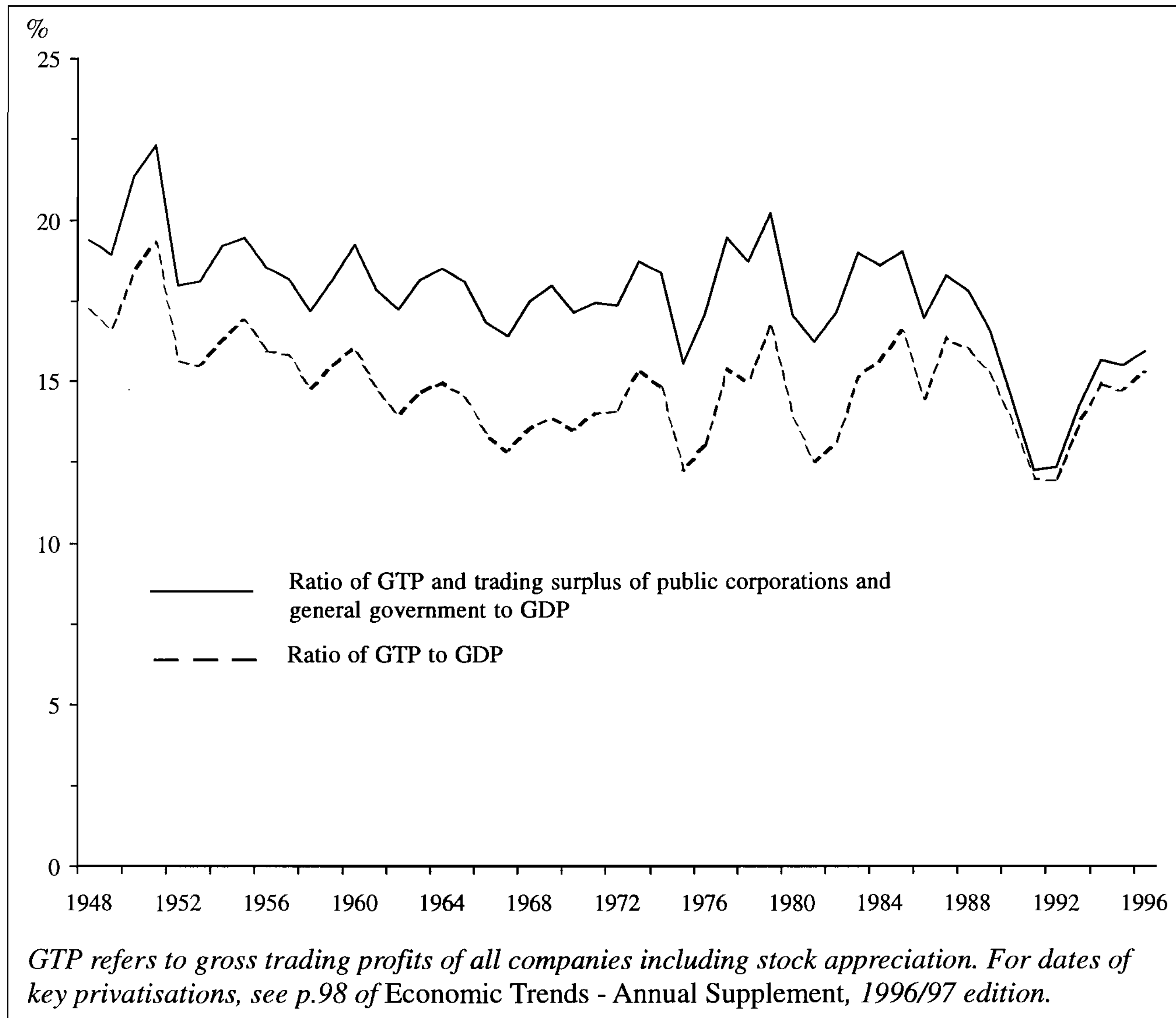


Charts use national accounts, are calculated with annual data and refer to all companies. "Company income" is a pre-UK tax concept, which includes GTP, rent, non-trading income (mostly interest) and income from abroad, net of taxes paid abroad.

A further explanation for the high payout ratio in the 1990s is that a company's ability to pay dividends depends on its total income and not just on profits. Income includes income from abroad, net interest and rental receipts as well as trading profits. Some of the buoyancy of dividends in recent years reflects not that companies have used profits to pay shareholders (supposedly at the expense of investment), but rather that total income has been boosted substantially by foreign income. Net income from abroad now accounts for almost a quarter of total company income, nearly double the figure in 1979. Much of the explanation for the rise, especially in the last four years, has been the relative weakness of sterling. But that trend has reversed significantly in the last six months, implying that foreign income will be more subdued in 1997.

Profits in relation to GDP

Profits still not high relative to GDP, despite cyclical recovery



GTP refers to gross trading profits of all companies including stock appreciation. For dates of key privatisations, see p.98 of Economic Trends - Annual Supplement, *1996/97 edition.*

Privatisation has also had an important influence on the payout ratio in the last fifteen years. Critics have suggested that the relative reliability of the revenues of newly-privatised industries (gas, electricity, water) has resulted in higher distributions to shareholders. The evidence gives little support to this thesis. Although the ratio of trading profits to GDP in 1996, at 15.3%, was above the average since 1970 of 14.4%, the difference was marginal. But when public sector trading surpuses are included in the comparison (to allow for the effects of privatisation), profits do not seem high relative to GDP. The ratio of the combined total to GDP was 15.9% in 1996 compared with an average since 1970 of 17%, suggesting that profits are not excessive by historical standards. Total profits as a proportion of GDP rose sharply after the 1992 devaluation, but have stabilised in the last two years.

Influences on the pay-out ratio

Nominal GDP growth dominant, but worries about Labour have a precedent

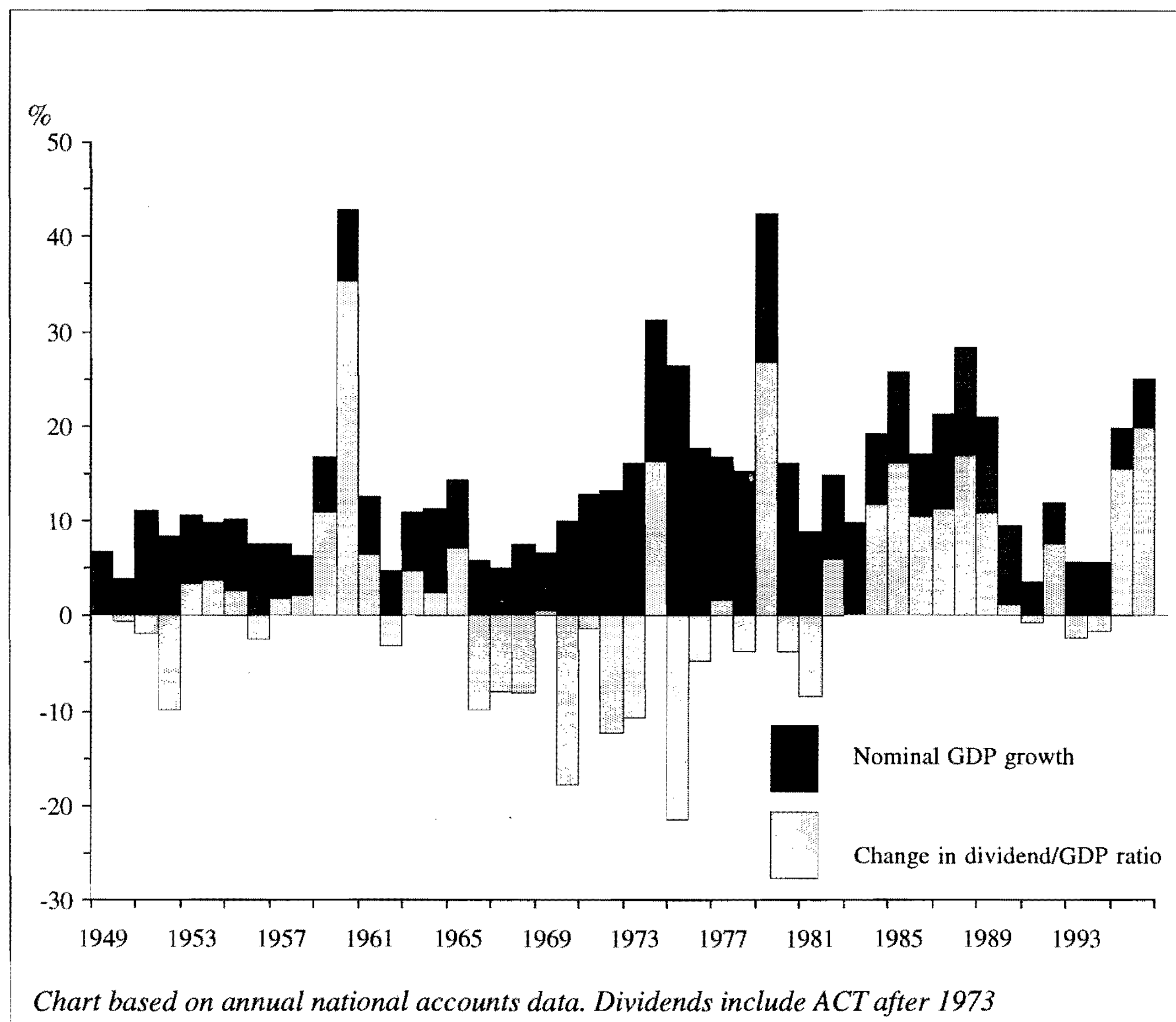


Chart based on annual national accounts data. Dividends include ACT after 1973

Splitting the growth of dividends into two components - the increase in nominal GDP and the change in the ratio of dividends to GDP - is instructive and suggests that nervousness over the prospects under a Labour Government is warranted. Between 1965 and 1979, a period dominated by Labour administrations, the dividend/GDP ratio rose in only three out of fourteen years. Increases in dividend payments were explained entirely by increases in nominal GDP. But between 1979 and 1996, the dividend ratio has fallen on just five occasions. Only the drops in 1980 and 1981 were significant. Even so, for the majority of the period of Conservative Government, dividends have grown as much in response to changes in national income as because of a rise in the dividend/GDP ratio.

Pay-out ratio fell between 1992 and 1994, but has recovered since

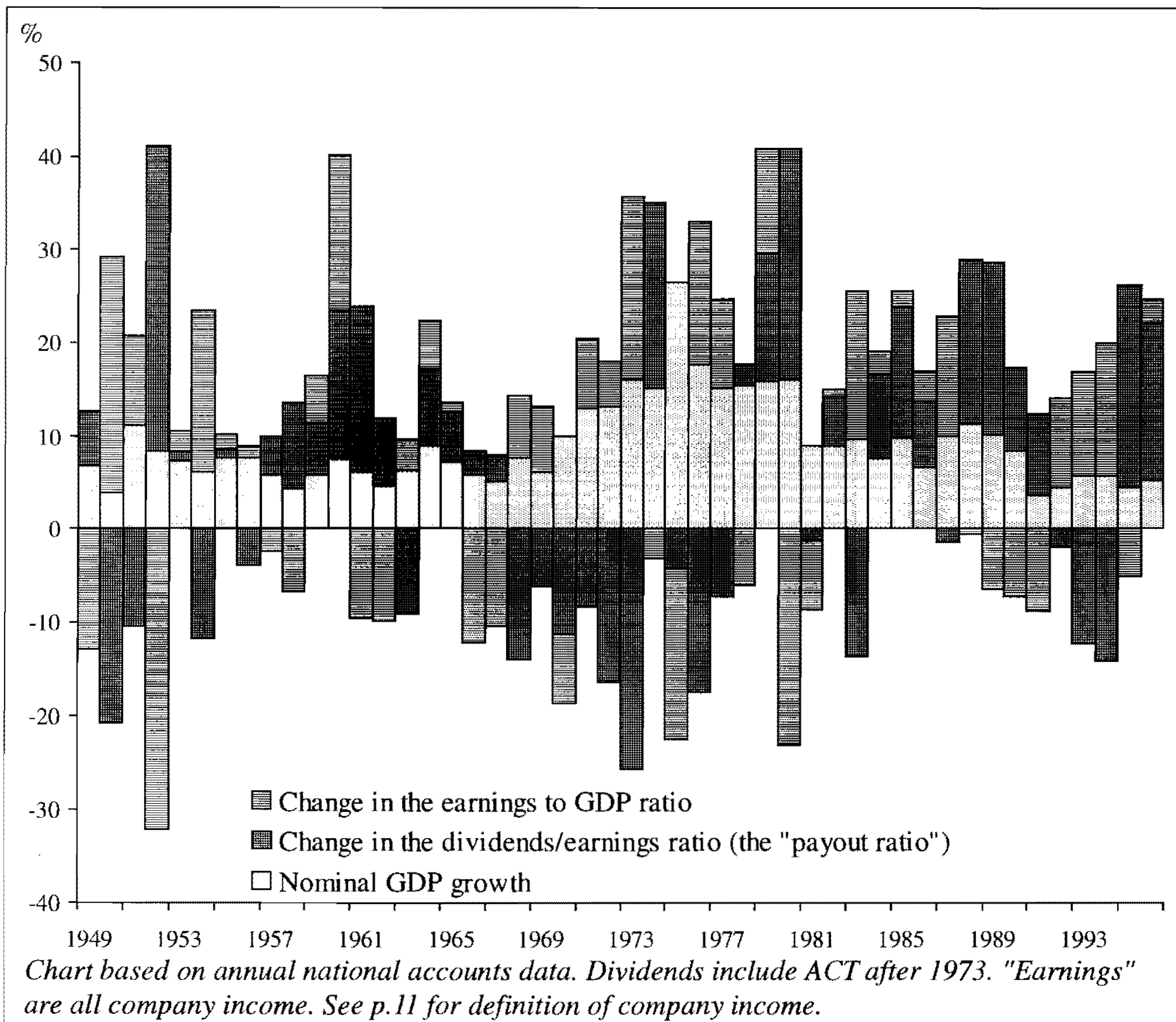
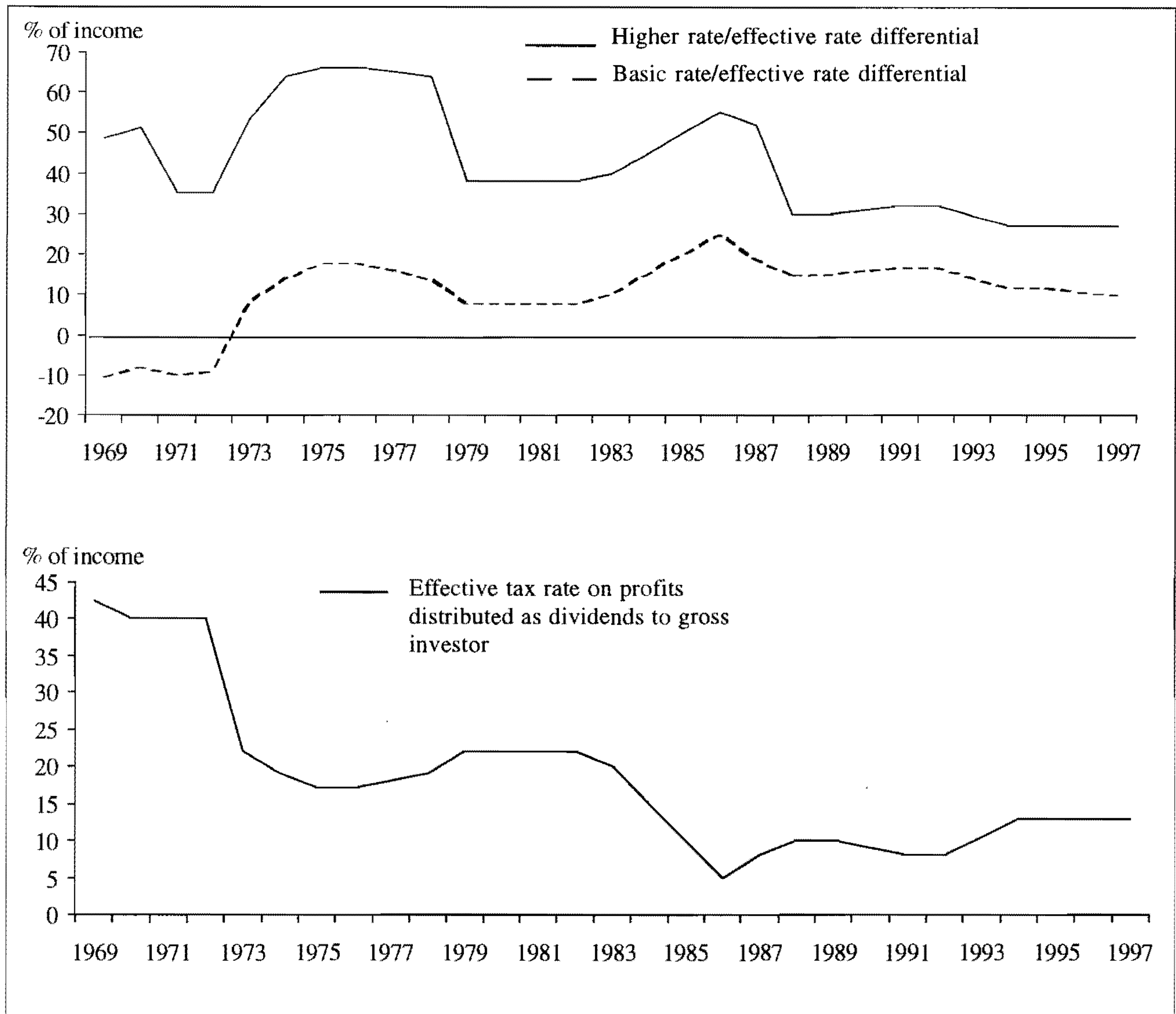


Chart based on annual national accounts data. Dividends include ACT after 1973. "Earnings" are all company income. See p.11 for definition of company income.

Alternatively, dividend growth can be seen as the sum of three components, the increase in nominal GDP, the change in the ratio of company earnings to GDP and the change in the ratio of dividends to earnings (i.e., the payout ratio, on one of its measures).The ratio of earnings to GDP is highly cyclical and was a strongly positive influence between 1992 and 1994. By contrast, the ratio of dividends to earnings had a significantly negative impact over this period. The pattern has changed in the last two years with earnings to GDP contributing very little, but the payout ratio rising substantially. But changes in the payout ratio have not been purely cyclical. Indeed, in the past, changes in the tax regime have been a very important influence. Hence, for example, the large boosts following the removal of direct restriction on dividend distributions in 1979 and 1980, and Lawson's 1984 Budget.

The tax system and savings

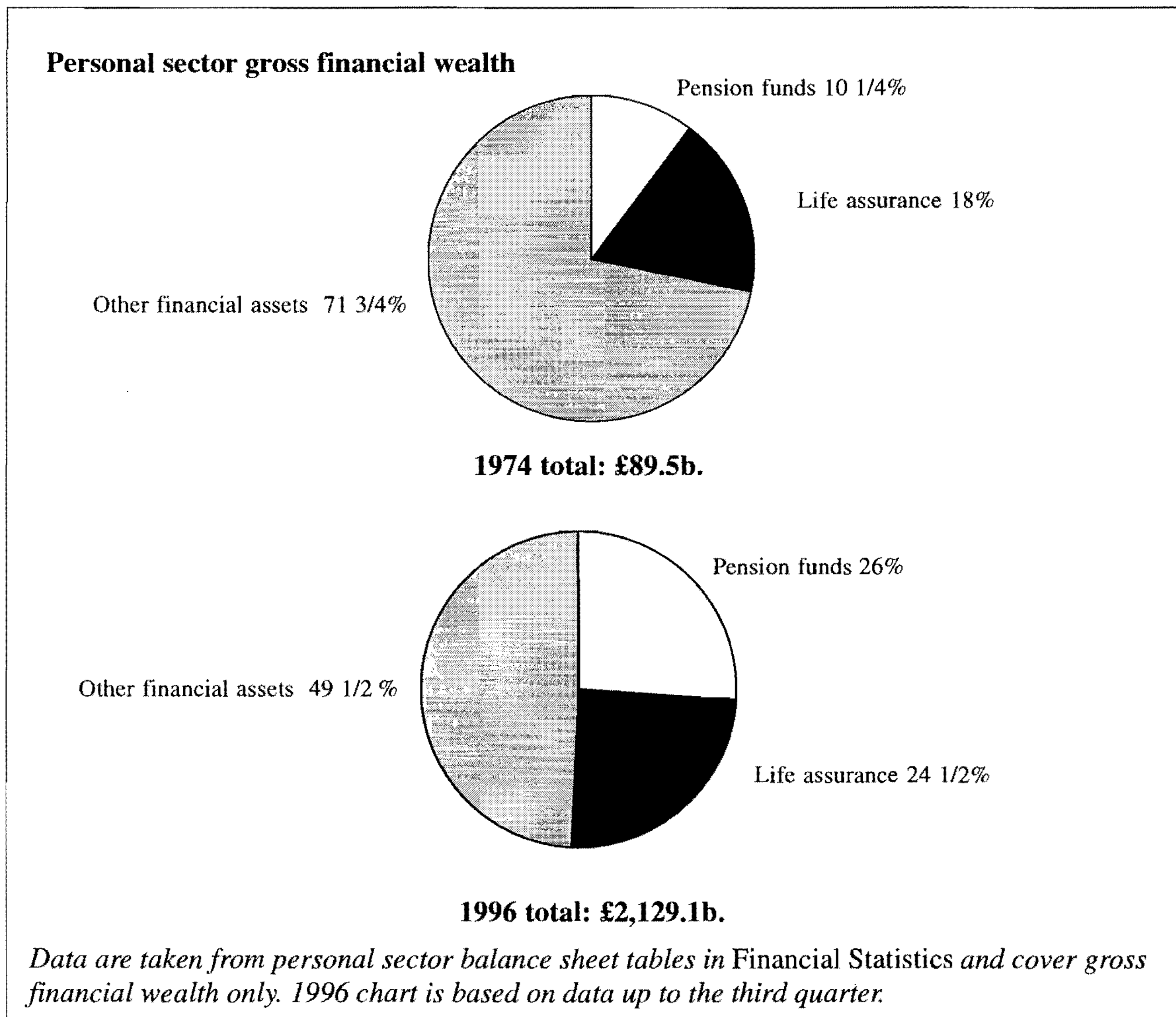
Strong tax incentives to save via pension funds



Under the present "imputation system" the effective rate of tax on profits distributed as dividends is the difference between the standard rate of corporation tax and the rate of the ACT credit. The bottom chart shows how this effective tax rate tumbled from 40% in the early 1970s to under 10% in the mid- and late 1980s. It remains low by international standards, but could more than double under plausible Labour reforms. The top chart measures the gap between the tax rate on dividends for gross funds and both the standard and higher rates of personal tax. The gap indicates the tax incentive to individuals to hold their savings in the form of pension funds rather than in direct holdings of shares. Plainly, the incentive was much stronger in the 1970s than today. But it should be remembered that there is no "free lunch" since tax will eventually be paid on pension income.

The role of pension funds in personal sector saving

Pension fund assets grow faster than personal wealth as a whole

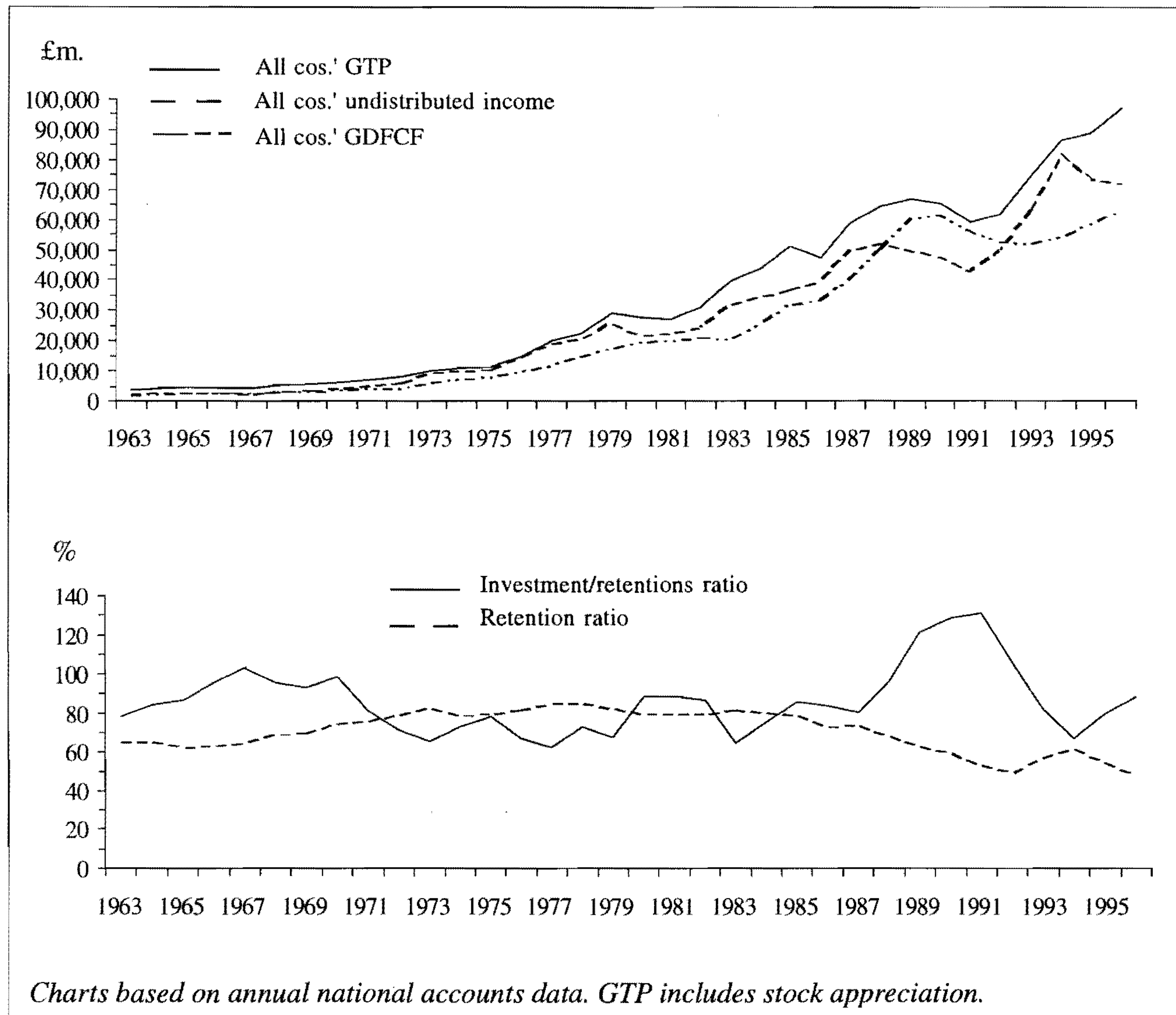


Data are taken from personal sector balance sheet tables in Financial Statistics *and cover gross financial wealth only. 1996 chart is based on data up to the third quarter.*

Institutional forms of saving (primarily pension funds and life insurance) have almost doubled in importance in the last 20 years. The average growth rate of personal sector wealth held in the form of pension funds has been over 20% a year since 1974 (or more than 12% a year in real terms). Over the same period, total gross financial wealth has risen at an average annual rate of around 15½% (7½% in real terms). Partly because of the disputes which have arisen regarding the mis-selling of personal pensions in the last decade, the trend remains firmly towards "defined contribution" and away from "defined benefit" schemes. The increased personalisation of pensions is almost certain to continue for the foreseeable future, ensuring that this trend continues. The latest example of the change in thinking has been the announcement by the Conservative Party of the "Basic Pension-plus".

Profits, retentions and investment

No relationship between retentions and investment since 1988



Charts based on annual national accounts data. GTP includes stock appreciation.

The analysis put forward in the previous pages does not aim to prove that there is no relationship at all between dividend policy and investment. Instead the aim has been to show that blind faith in the belief that biasing the incentives towards retentions rather than distributions would be misguided. There is no guarantee that investment would rise much, if at all, as a result. Since the late 1980s, the exact period over which critics of high payout ratios claim that industry has been starved of internally-generated investment funds, there has been little or no correspondence between retentions and investment. In the recessions of 1974/5 and 1980/1, investment amounted to about 80% to 90% of retentions. But the ratio averaged over 120% between 1989 and 1992. It seems unlikely that high levels of distributions have been at the expense of investment.