Is £5 billion being taken every year from pension funds?

Almost immediately after Labour came to power in 1997, Chancellor Gordon Brown announced a package of tax reforms that are frequently described as a "£5 billion stealth tax" on pension funds.

The reforms had a rationale to try to stimulate growth in the economy. This makes the actual cost of the reforms difficult to determine, as it is impossible to tell whether the reform helped the economy or not, and to what extent.

This Briefing Note shows that although the cost is uncertain, it is likely to be significantly less than £5 billion per year.

Dividends paid to pension schemes are no longer tax free
Companies pay dividends from their profits after they have paid corporation tax. This means that profits have already been taxed by the time they are passed on to the companies' shareholders.

A basic rate taxpayer does not have to pay income tax on his dividends because it is deemed to have been offset by the corporation tax the company pays. Before 1997, non-taxpayers, including pension schemes, could go further and reclaim tax on the company's profits at the rate of 20%. This relief was called Advance Corporation Tax (ACT) relief.

Chart 1: An example of how the removal of ACT relief reduced investment income for pension schemes

		Before 1997	After 1997
Company A	Profit	1,000	1,000
	Corporation tax	330	310
	After tax profit	670	690
	Dividends paid	300	300
	Retained Profit	370	390
Pension scheme investing in Company A	Dividends received	80	80
	Tax reclaimed	20	-
	Net income	**100**	**80**
Treasury	Total tax revenue from Company A net of relief to the pension scheme	**310**	**310**

In 1997, ACT relief was abolished, so that the tax system for dividends is not more advantageous for pension schemes than for basic rate taxpayers.

At the same time as abolishing ACT relief in 1997, the government cut rates of corporation tax by 2%, from 33% to 31%.

A similar reform had been made by Conservative Chancellor Norman Lamont in 1993, who reduced the rate of ACT relief from 25% to 20%, at the same time as reducing corporation tax from 35% to 33%.

The 1997 reform reduces a pension scheme's income from dividend payments by 20% (Chart 1)[1]. Dividend payments form on average about 20% of a pension scheme's income[2].

The rationale was to stimulate growth in the economy
The government claimed that ACT relief was encouraging companies to distribute more of their profits as dividends and reinvest less in their own businesses. It argued that reversing the trend would stimulate growth in the economy[3].

By removing ACT relief, pension schemes would value dividends less. They would instead prefer to see share prices increase, so they can sell their shares at capital gains, which are not taxable. This would in turn put pressure on companies to reinvest their profits to try and increase their share price.

If companies can use their profits more productively than their shareholders, this change in behaviour could result in economic growth.

Chart 2: The annual cost of removing ACT relief for pension schemes

		£ billion
Theoretical cost	Cost to all non-taxpayers	5.4
	Cost to pension schemes	3.5
	Increased contributions resulting from lower corporation tax rates	0 – 1.0
	Net cost to pension schemes	2.5 – 3.5
In practice	If companies reinvested more of their profits in their own businesses	Could reduce cost further in the long-term
	If pension schemes invested more in bonds and less in shares	Could reduce cost further

The £5 billion cost does not fall only on pension schemes
It was estimated that scrapping ACT relief would bring in an extra £5.4 billion in taxes per year in the short-term[4].

This figure included savings from not granting tax relief to other investors, such as some individuals and charities. The cost to pension funds was lower, at £3.5 billion per year.

The actual cost could be even lower than £3.5 billion because the lower corporation tax rates give companies who make profits more scope to increase their pension contributions, without being worse off. A recent estimate is that the offsetting gain to pension schemes could be as much as £1 billion per year[5]. This means the cost could be as low as £2.5 billion (Chart 2).

The true cost is uncertain as it depends on behaviour
If the reform were successful so that companies reinvest more of their profits and share prices grow, the long-term cost could be still lower than £2.5 billion.

Pension funds would begin to see more of their income coming in through capital gains rather than dividends and so would be less affected by how dividends are taxed.

However, this change in behaviour might mean that the cost is greater than £2.5 billion per year in the short-term because not only would pension schemes not be able to reclaim ACT but the amount of dividends they receive would also fall. It might take time before extra reinvestment by companies feeds through into a higher share price.

It is difficult to assess whether the reforms have been successful and whether companies distribute less of their profits as dividends than they would have done if the reforms had not taken place.

The overall impact on pension funds depends on their chosen asset mix. The cost could be less if pension schemes invested less in UK shares and more in other types of assets, such as bonds, which remain tax free.

These uncertainties mean that it is difficult to determine the cost to pension funds today of removing ACT relief. But it is clear that when the reforms were introduced in 1997 they cost pension funds significantly less than £5 billion per year. It also seems likely that this cost will have reduced over time.

For more information on this topic, please contact
Adam Steventon
020 7848 3675 adam@pensionspolicyinstitute.org.uk
www.pensionspolicyinstitute.org.uk

[1]Assumes that the reforms do not affect Company A's profit and the amount of dividends it pays
[2]Office for National Statistics (2004) *MQ5 Self-administered Pension funds*. Income from capital gains and exchange rate gains and losses are excluded from this estimate.
[3]Gordon Brown 2 July 1997 House of Commons *Hansard* Column 306
[4]Inland Revenue (1997) *Companies and their shareholders: tax changes to promote investment by companies*
[5]Institute for Fiscal Studies (2005) *Pension and Saving Policy*