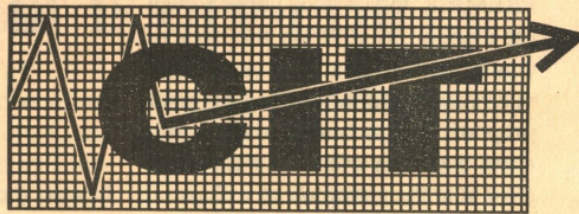


ECONOMIC INTELLIGENCE

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CENTRE FOR INCENTIVE TAXATION

GOVERNMENT ABANDONS DIVIDEND PROBE

BRITISH chancellor Kenneth Clarke insisted in his budget speech on November 29 that he was creating the conditions for a culture of enterprise. But he did not tell the House of Commons that the government had abandoned its investigation into the payment of dividends by companies, to see if these were contributing to the short-termism that afflicts the UK economy.

A year ago, Treasury financial secretary Stephen Dorrell launched an inquiry into whether the tax system induced companies to pay too great a proportion of profits as dividends to shareholders.

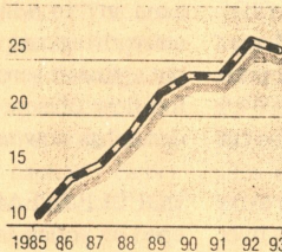
One of the long-standing criticisms of British industry is that high pay-outs compromised the investment needed to improve competitiveness and ensure sustainable growth. Investors, so critics claimed, were more interested in short-term profits than long-run productivity.

This appeared to be a legitimate concern for a government that claims to want to "manage" the economy - at least, in terms of helping to improve private sector entrepreneurship. But the dividends enquiry has been shelved after criticism from a captain of industry. And yet, evidence from a Leeds University enquiry has revealed that companies are under pressure to be over-generous with dividend payments - more so than their German and Japanese competitors. Two reasons are offered:

- Pension funds own about half of all UK shares. These investors are not risk-takers: they structure portfolios to suit the psychology of old age. The tax-exempt status of pension funds also provides an incentive for higher dividends. For companies pay tax on behalf of pension funds, which then receive a tax credit: for every £1 received in dividends, a fund receives an extra 25p from the taxman. The company participates in this rigmorole because its pre-payment -

Dividend payout

UK industrial and commercial companies
Dividends as a proportion of profits
30%



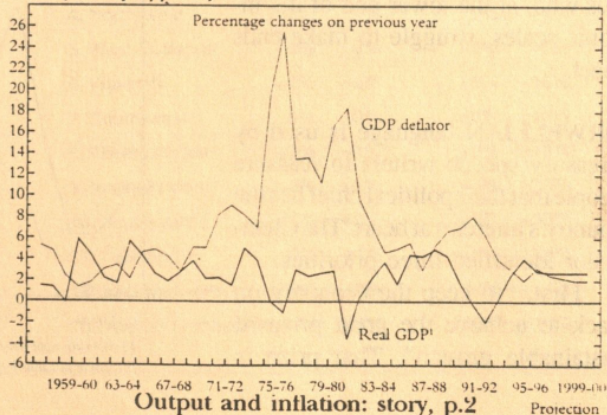
Source: Institute for Fiscal Studies

Advanced Corporation Tax - can be set against its tax bill, which is an encouragement to higher dividends.

- The second encouragement is a bureaucratic one not unrelated to the motives of pension funds. Corporate managers pay high dividends - which raise stock market prices - as a defence against hostile takeovers, and thereby ensure a peaceful managerial lifestyle.

The overall result, then, is a sclerotic entrepreneurship in which the principles of safety-first reign supreme over the risk-taking hustlers who innovate and compete.

The impact of this business psychology is particularly damaging in the trough of a recession. For example, although profits rose by 6% in October, according to the Central Statistical Office there was a fall in investment in plant and machinery. This does nothing to suggest that Chancellor Clarke will achieve his aspiration: the re-creation of a thriving industrial base for Britain (see page 2).



Output and inflation: story, p.2

Projection