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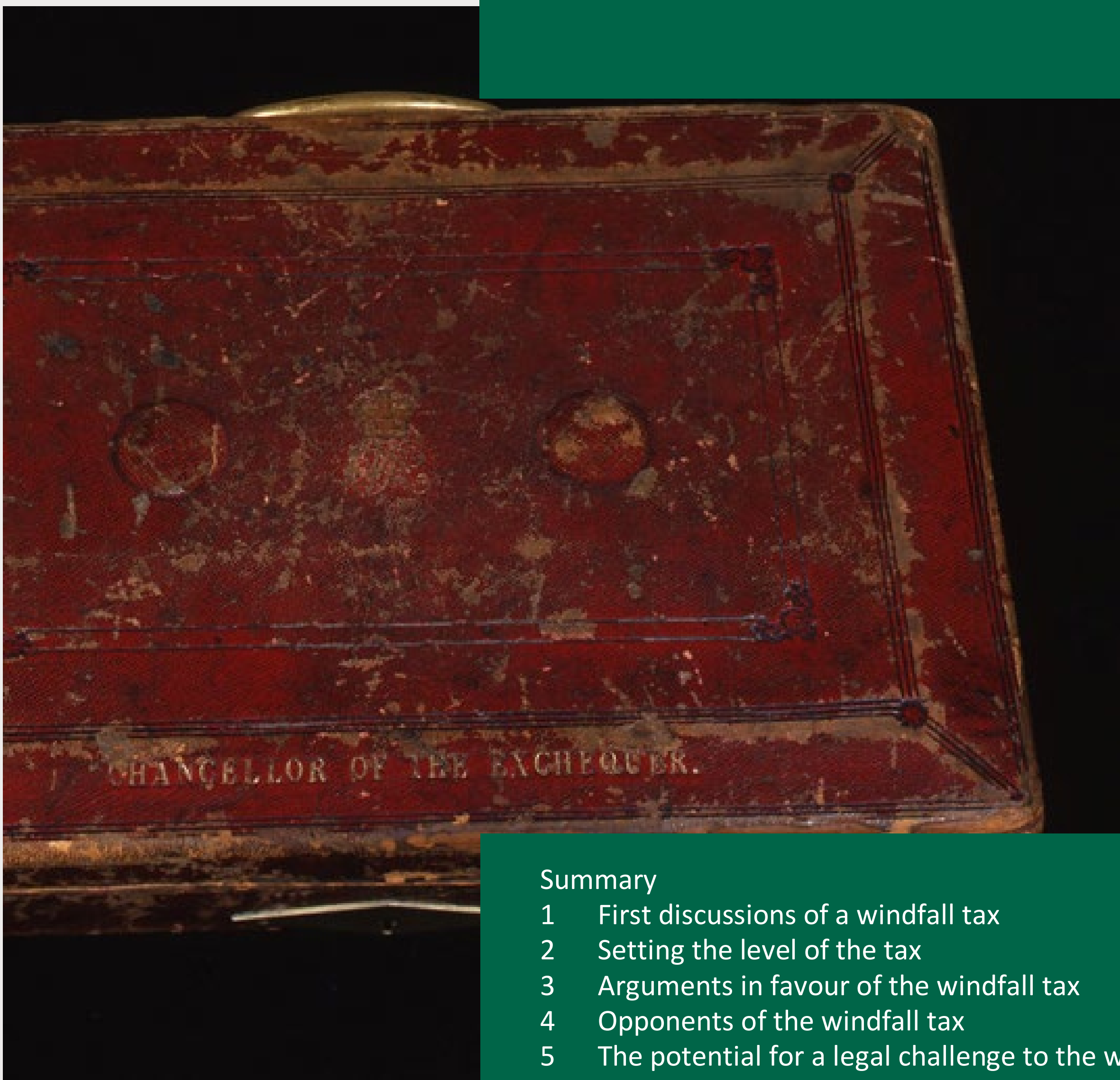
By Antony Seely

The Windfall Tax



Summary

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Summary

In his Budget speech on 2 July the Chancellor Gordon Brown announced the introduction of a one-off windfall tax on the privatised utilities: BAA, British Energy, British Gas (now BG plc and Centrica), British Telecom, National Power, Northern Ireland Electricity, Powergen, Scottish Hydro, Scottish Power and Railtrack, the regional electricity companies and the privatised water and sewerage companies (including such companies now forming part of Hyder, United Utilities and Scottish Power).[1]

Legislation to this effect was introduced under ss 1-5 of the Finance (No.2) Act 1997. The expected yield from the windfall tax was estimated to be £5.2 billion, payable in two equal instalments on or before 1 December 1997 and 1 December 1998. It was estimated that of this figure, the water companies would pay about £1.65bn, the electricity companies about £2.1bn, while the others would share a £1.45bn bill. Details of each company's contribution have not been published for reasons of taxpayer confidentiality.[2] In the event the tax raised exactly this amount.[3]

This Commons Library briefing gives a history of the windfall tax, and the arguments that were raised for and against its introduction. The tax was often compared to the one-off levy on the banking sector introduced by the Conservative Government in 1981; a short appendix gives some details of this second one-off tax.

1 HC Deb 2 July 1997 cc 313-314

2 HC Deb 31 January 2002 c 516W (In this case the PQ asked about the charge to Railtrack only.)

3 HC Deb 11 July 2001 c 580W. Receipts were £2,610m in December 1997 and £2,614m in December 1998 (HC Deb 19 June 2000 c 107W).

1 First discussions of a windfall tax

The proposal for a windfall tax to be levied on the privatised utilities was made first by the Labour Party in January 1993, when it was suggested that the tax cover gas, water and electricity companies, and could raise at least £1 billion. On 19 January 1993 Gordon Brown gave a speech at the Institute of Chartered Engineers as Labour's Shadow Chancellor. In it he proposed that the 'privatised utilities' should be charged a one off public dividend on their 'excess recession profits':

> We will ask the utilities to pay a public dividend as a result of their excess profits during the recession. By the end of the year the utilities profits will exceed £35 billion. They have risen by 70 per cent in the middle of a recession, enabled to do so by the generosity of the terms of privatisation. Having paid for the excess profits, the country deserves something back. [4]

The following day, the Times reported on this new policy proposal:

> Gordon Brown, the shadow chancellor, … outlined a programme to ensure that anyone who had been unemployed for more than a year would be automatically given a job or a training place. Jobs for about 900,000 long-term unemployed would be concentrated in infrastructure projects such as hospitals and schools. This pledge, achievable within two years, would be funded by retaining the stamp duty on share transactions, closing tax loopholes on corporate financial transactions and asking public utilities to pay a public dividend on excess profits made during the recession ... Mr Brown said …. [that] the amount raised by the windfall tax would be negotiated with the regulators and the utility companies, but would be expected to raise at least £1 billion.[5]

Following this announcement, the windfall tax on the privatised utilities became one of the party's key tax policies. In June 1995 the party published its economic strategy - A New Economic Future for Britain - in which it stated, "it would be irresponsible for Labour to make commitments on the precise level of tax rates and allowances, so far away from the election, before we know the state of the economy"; nonetheless, the paper went on to state a Labour government would "take action" in tackling tax abuse, by introducing, among other things, "a windfall dividend on monopolistic profits of privatised utilities, on the same principle as that applied under the Tories in their 1981 windfall levy on the banks."[6]

[4] Labour Party press notice, Statement by Gordon Brown MP speaking at the Institute of Chartered Engineers at the Launch of Labour's Budget for Jobs, 19 January 1993

[5] "Labour's new budget seeks to create jobs", Times, 20 January 1993

[6] Labour Party, A New Economic Future for Britain, June 1995 p 66, 70

In September of that year, the tax was given further publicity, when estimates that Labour's proposals would raise about £2.5 to £3 billion were left uncontested by the party. Apparently, City analysts had expected something closer to £4 billion. Share prices in the electricity and water sector fell only slightly, suggesting that investors considered the tax a viable proposition.[7] In October 1996 it was announced that the windfall tax was one of two "cast-iron taxation commitments" to be included in the party's election manifesto (the other being a cut in VAT on domestic supplies of fuel & power, from 8% to 5%), though the rate, scope and expected receipts of the tax remained unspecified until the July 1997 Budget.[8] On this question the party's 1997 election manifesto said, "We will introduce a Budget within 2 months after the election to begin the task of equipping the British economy and reforming the welfare state to get young people and the long-term unemployed back to work. This welfare-to-work programme will be funded by a windfall levy on the excess profits of the privatised utilities, introduced in this Budget after we have consulted the regulators."[9]

7 "City breathes a sign of relief", Financial Times, 26 September 1995

8 "Labour makes two tax pledges", Financial Times, 31 October 1996

9 Labour Party, New Labour: because Britain deserves better, April 1997 p 13

2 Setting the level of the tax

Following the 1997 General Election, the Chancellor Gordon Brown set out his proposals for a windfall tax on the privatised utilities during his first Budget speech, on 2 July 1997:

> Our reform of the welfare state - with the programme to move the unemployed from welfare to work - is funded by a new and one-off windfall tax on the excess profits of the privatised utilities. The tax will apply to companies privatised by flotation and subject to economic regulation under specified Acts of Parliament.
>
> In determining the details of the tax, I believe that I have struck a fair balance between recognising the position of the utilities today and their undervaluation and under-regulation at the time of privatisation. The windfall tax will be related to the excessively high profits made under the initial regime. A company's tax bill will be based on the difference between the value that was placed on it at privatisation and a more realistic market valuation based on its after-tax profits for up to the first four full accounting years following privatisation.
>
> In preparing the windfall tax, we looked more broadly at the position of the affected companies. As a result of my earlier announcement, justified on its own merits, to reduce the gas levy to zero, I am satisfied that no company faces an unduly heavy tax burden. The windfall tax will raise some £2.1 billion from the electricity sector, around £1.65 billion from the water sector, and some £1.45 billion from the remaining companies. After taking the reduction in the gas levy into account, which will cost the Government £400 million over the next three years, the net effect of the gas levy and the windfall tax together will raise £4.8 billion.
>
> After consulting the regulators, it is my judgement that the tax can be paid without any impact on prices, investment, or the quality of service to customers; or, in my view, on employment. In recent weeks, many companies have asked to pay the tax in instalments. I have now agreed that that shall be the case. It will be a one-off tax payable in two instalments. The first instalment will be paid on 1 December 1997, the second a year later. [10]

It was proposed that the tax would be charged at a rate of 23 per cent on the difference between company value, calculated by reference to profits over a period of up to four years following privatisation, and the value placed on the company at the time of flotation. Each company liable to windfall tax would be required to make a return to the Inland Revenue, including a computation of its liability, by 1 December 1997 (the date when the first

[10] HC Deb 2 July 1997 cc 313-314

instalment of the tax was due). Further details of how the tax would be calculated were given in an Inland Revenue press notice:

> The taxable amount will be the difference between company value, calculated by reference to average annual profits over a period of up to four years following privatisation, and the value placed on the company at the time of flotation. Company value will be calculated by multiplying average annual profits after tax over the period by a price/earnings ratio of 9.[11] The value placed on the company at the time of flotation will be calculated by multiplying the ordinary share capital of the company at flotation by the price at which shares were offered to the financial institutions at flotation.
>
> Profits after tax figures will be derived from accounts drawn up under the rules set out in the Companies Act 1985. Where consolidated accounts are drawn up figures from those accounts will be used. The price/earnings ratio of 9 approximates to the lowest average price/earnings ratio of the taxpaying companies during the relevant periods, grouped by sector. The period will be the first four financial years of the company beginning after flotation and ending before 1 April 1997. Where flotation took place too recently for four financial years to be completed, the period will cover financial years ending after flotation and before 1 April 1997. Where a financial year straddles flotation only the profits of the part of the year following flotation will be taken into account, on a time apportioned basis.
>
> The charge to tax will arise on Budget day and the rate will be 23 per cent. Where 85 per cent or less of the ordinary share capital of a company was offered for sale at the flotation of the company only the appropriate proportion of both - company value by reference to the average profits after tax, - and the value placed on the company at the time of flotation, will be taken into account in calculating the taxable amount. The appropriate proportion will be that which the shares offered for sale at flotation bear to the ordinary share capital of the company at that time.
>
> There will also be rules to allocate the tax liability between companies which have demerged under statutory schemes. The allocation will be on the basis of the respective market capitalisations of the companies at the time of the demerger. The tax will not be deductible in computing a company's liability to corporation tax and it will not be possible for a company to set advance corporation tax against liability to windfall tax.[12]

When the legislation to introduce the tax was debated, there was some criticism of the use of the PE ratio to calculate the size of the taxable windfall accrued to each company, and that the choice of a PE ratio set at 9 was arbitrary; in Standing Committee, the then Paymaster General, Geoffrey Robinson, gave the following explanation:

> The figure of nine is not arbitrary; it is meant to be as fair as possible to the companies involved. We analysed the relevant PEs for the companies in the

11 [The P/E ratio is "the current market price of a company share divided by the earnings per share of the company … loosely it can be thought of as the number of years it would take the company to earn an amount equal to its market share. High multiples, usually associated with low yields, indicate that the company is growing rapidly, while a low multiple is associated with dull no-growth stocks" Oxford Dictionary of Finance & Banking, 1997 p 277]

12 Inland Revenue Budget press notice REV1, Windfall tax, 2 July 1997

> relevant period in which windfall profits will be taxed, and the lowest we could find was--if my memory serves me right--9.2 for water companies. Therefore, it seemed fair to take a figure below that to show that we were not seeking to introduce a tax that would penalise them. We are trying to be fair and reasonable in the circumstances.[13]

Inevitably in the days before the Budget there was considerable speculation as to the basis on which the levy would be based, and how this would affect individual companies. Several weeks before the Chancellor's speech the Lex Column in the Financial Times suggested that shareholders should consider the wider picture when evaluating the impact of the tax:

> There are endless arcane debates about calculating the tax, with each utility arguing passionately for the method which conveniently hurts its shareholders least. But for investors generally, three considerations will count rather more. One, clearly, is that the size of the overall windfall tax burden should not be too great. Another is that the money should be well spent. If the Government's promised assault on long-term unemployment is successful, business and therefore investors have plenty to gain. Most crucial of all, however, is that Mr Brown's speech must include a cast iron commitment that the windfall tax is to be genuinely one-off. He must not equivocate on this point: if he does, utilities' customers will end up paying a heavy price for the residual risk.[14]

Indeed, Geoffrey Robinson underlined this point in Standing Committee: "We have made it clear that this is a one-off tax on clearly described companies for a clearly limited period on a clearly defined basis. It is a one off, and will remain a one off."[15]

Following the Budget itself, estimates for the amounts to be paid by each of the privatised utility companies were given in the Financial Times;[16] these are reproduced overleaf:

[13] Standing Committee A 17 July 1997 c 26
[14] "Lex column: taxing times", Financial Times, 16 June 1997
[15] Standing Committee A 17 July 1997 c 67
[16] "Electricity and gas bear brunt of levy", Financial Times, 3 July 1997

Estimated cost of the windfall tax to utilities

£ million

	Initial value	Implied value	Estimated tax
Regional Electricity Companies			
East Midlands	523	941	96
London	523	1,133	140
Manweb	285	707	97
Midlands	503	1,086	134
Northern	295	810	118
Norweb	414	1,090	155
Seeboard	306	783	110
South Wales	244	634	90
South Western	295	717	97
Southern	648	1,367	165
The Energy Group	648	1,133	112
Yorkshire	498	1,082	134
Generators			
National Power	2,231	4,122	261
PowerGen	1,367	2,835	203
British Energy	na	na	0
Others			
Scottish Power Core	1,956	2,357	92
Hydro-Electric	920	1,114	44
Northern Ireland	362	553	44
Water Companies			
Anglian	707	1,281	132
North West	854	1,982	259
Northumbrian	157	502	79
Severn Trent	849	2,218	315
South West	293	746	104
Southern	393	943	127
Thames	922	1,925	231
Welsh	348	1,183	192
Wessex	246	677	99
Yorkshire	472	1,081	140
Multi-Utilities			
United Utilities	na	na	415
Hyder	na	na	282
Scottish Power	na	na	316
Others			
BT	7,800	12,242	513
BAA	1,225	1,494	62
Railtrack	1,950	2,628	156
British Gas	na	na	515
Centrica	na	na	190

As the windfall tax had formed such an important part of the Labour Party's election campaign, there was no surprise at the Chancellor's announcement on Budget day; as the Financial Times noted "most of the privatised utilities reacted with resignation to the details of the [levy]."[17] Some days later the paper commented that it had been the uncertainty over the scope and size of the tax that the stock market had found hardest to deal with:

The surge in utility share prices over the last week demonstrates once again that there is nothing stock markets hate more than uncertainty … The relief that the uncertainty is over has driven the utilities index up by about 7 per cent since Monday [1 July]. The ending of uncertainty was such a powerful influence that even companies that were hit harder than expected saw the benefit. Shares in the water companies, which were particularly harshly treated, shot up the day after the Budget.[18]

The formula for calculating the tax relates an 'implied' valuation of each utility company, based on the post tax profits made by the companies in the first four years after privatisation, to the market capitalisation on flotation. The bigger the difference, the higher the company's tax bill. The theoretical valuation is calculated by multiplying profits by a price-earnings multiple of nine. Using a standard multiple across all sectors favours those companies given higher multiples (such as the power generators and BT, rather than the water and regional electricity companies).

For some this met a concern that the tax should recognise the fact that some companies were sold off in stages (BT, National Power and PowerGen). In a submission to the Treasury in May 1997 PowerGen argued that by selling shares in tranches in these cases, returns were more equally shared between taxpayers and shareholders.[19]

However, other commentators criticised the use of a profit figure related to just the first four years after privatisation; for example, in the Lex Column the day following the Budget:

> The government is calculating the tax in an arbitrary way. Instead of using total shareholder returns, it is basing it, much more crudely, on profits. And the focus on profits in the first four years after privatisation ignores the effects of later regulatory tightening. In addition, the formula - a price/earnings ratio of nine and a tax rate of 23 per cent - appears to have been chosen with particular victims in mind, rather than being dictated by logic.[20]

[17] "Electricity and gas bear brunt of levy", Financial Times, 3 July 1997
[18] "End of the uncertainty", Financial Times, 5-6 July 1997
[19] "Utilities claim fair share of windfall tax", Financial Times, 19 May 1997
[20] "Lex column: windfall tax", Financial Times, 3 July 1997

3 Arguments in favour of the windfall tax

At the time many commentators noted that the 'political' case for a windfall levy was strong. Investors who bought shares in the privatised gas, water and electricity companies during the 1980s and early 1990s have made considerable gains from sharply rising share prices and strong dividend growth. An image of corporate profligacy has been strengthened by the well-publicised use of generous salary and share option packages for senior executives in all these sectors.

There are a number of factors which have encouraged some to see these gains as fortuitous, or windfall in character, and well-deserving of being charged a retrospective levy. First, the utilities were sold at prices which - at least with the benefit of hindsight - look cheap. Some evidence for this assertion is given in the table overleaf, which shows some of the major privatisations that have been sold by means of a stock market flotation.[21]

The gross equity proceeds have been used as an indicator of the perceived value of the company at the time of the sale. These values have been compared with the current market valuations of the companies. In order to provide a more meaningful basis for comparison, sale proceeds have been converted to 1997 prices. In real terms, all but one of the companies shown now have a greater market valuation than when they were sold, and in many cases the current value is well over double the sale proceeds.

This approach has some limitations. Firstly, the longer the time period since privatisation, the less meaningful such comparisons become. This is because many of the companies will have acquired other companies; the functions of the companies may have changed; and the share price will be influenced by external factors, such as the general state of the economy and specific factors affecting the markets within which the companies operate. To give an example, at the end of December 1989, the month in which the water companies were privatised, the FTSE All-share index stood at 1204.7. By 14 July 1997, the index had risen by almost 90 per cent. Set against this general increase in the value of shares, the increases in the market capitalisation of the water companies, although still significant, are not so extreme.

Another factor that limits the usefulness of this approach comes from the fact that many of the privatised companies have been taken over (for example, several of the water companies and all but one of the electricity

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21 Table and commentary provided by Nicola Chedgey, Economic Policy & Statistics, 15 July 1997.

companies). These companies are excluded from the table because comparable market valuations are no longer available.

Market valuations of privatised industries
£ million

	Gross equity proceeds Cash prices	Gross equity proceeds 1997 prices (a)	Market capitalisation at 14 July 97	% change Cash prices	% change 1997 prices
Amersham International	63	122	996	1481%	718%
Associated British Ports	74	132	1,003	1248%	657%
BAA	919	1,408	6,113	565%	334%
British Aerospace	700	1,226	5,771	724%	371%
British Airways	900	1,379	7,115	691%	416%
British Gas (b)	5,603	9,020	13,639	143%	51%
British Steel	2,500	3,612	3,087	23%	-15%
BT	14,329	18,826	29,202	104%	55%
Cable & Wireless	1,432	2,522	13,156	819%	422%
Southern Electricity	648	822	2,252	248%	174%
National Power/PowerGen	5,780	6,403	11,565	100%	81%
Water & sewerage companies:					
Anglian	707	954	2,074	193%	117%
Severn Trent	849	1,146	3,057	260%	167%
South West	293	395	1,027	251%	160%
Thames	922	1,244	2,882	213%	132%
Wessex	246	332	999	306%	201%
Yorkshire	472	637	1,631	246%	156%
Scottish Hydro/Scottish Power	2,855	3,400	7,018	146%	106%
Northern Ireland Electricity (c)	348	502	605	74%	20%
Railtrack	1,930	1,984	3,620	88%	82%
British Energy	1,220	1,254	1,792	47%	43%
Total of above	42,789	57,320	118,604	177%	107%

(a) adjusted using GDP deflator, assuming 2.8% increase in 1997
(b) current figure includes Centrica
(c) excludes proceeds from trade sale

Sources Vickers & Yarrow 'Privatisation: An Economic Analysis', table 7.1
NAO reports on privatisations (various)
Price Waterhouse 'Privatisation: The Facts'
Financial Times 15 July 1997
HC Deb 16 October 1996 c951w
HC Deb 27 November 1996 c273w
ONS Database (series DJDT)

In addition, to ensure their successful privatisation, these companies were packaged with strong balance sheets containing small amounts of debt which could be paid off within a few years. Second, the boost in productivity that many companies have enjoyed has been associated with substantial reductions in manpower, and significant numbers of employees being made redundant. Third, the system of price regulation has been controversial and has, in some people's view, failed to distribute the benefits of privatisation fairly between investors and customers. When challenged on this question during Treasury Questions on 12 June 1997, the Chancellor cited the report of the Public Accounts Committee in March 1997, which referred to the price at which the water and regional electricity companies were sold for, and the profits made by both of them subsequent to privatisation.[22] The Committee's comments on both matters are reproduced below:

> We note that in calculating the level of price caps the Directors General aim to allow for the cost of the capital employed in each business, and they do this by multiplying a capital value for the business by a percentage rate of return. We note that the replacement values of the assets of the water and sewerage companies are now estimated to be £138 billion, and those of the regional electricity companies £20 billion. When these two industries were sold in 1989 and 1990, the sale proceeds were only £3.6 billion and £7.7 billion respectively and we and our predecessors expressed concern that the shares in the companies had been under-priced.
>
> We consider that there should now be no question of the shareholders benefiting through prices being based on asset values for which they have not paid in full. We therefore welcome the decision by the Directors General of Electricity Supply and of Water Services to base the capital values used for price regulation on what the shareholders have actually paid for these assets …
>
> We recognise that the Directors General were not responsible for the initial regulatory regimes, including the price controls, which applied in the industries they regulate in the period immediately following privatisation. We note that in the five years after privatisation the water companies made profits totalling £7.4 billion, and the regional electricity companies profits of £8.7 billion, and that in both cases the profits were in excess of the level that the respective Directors General have judged it reasonable to allow for in the future. To avoid the risk that profits might again rise above a reasonable level we recommend that the Directors General set price controls which will ensure that profits should be no more than is sufficient to provide the return required to attract the necessary funds for investment in future periods. [23]

The then Paymaster General, Geoffrey Robinson, summarised the Labour Government's case in a written answer when he explained, the windfall tax "is a one-off tax which puts right the bad deal which customers and taxpayers got from the privatisation of the utilities."[24]

The feasibility of a levy received support in a report by the merchant bankers S.G.Warburg leaked to the press in November 1996, which implied the balance sheets of the privatised utilities were strong enough to withstand a

[22] HC Deb 12 June 1997 cc 1269-1270

[23] Committee of Public Accounts, The work of the Directors General of telecommunications, gas supply, water services and electricity supply, 5 March 1997 HC 89 1996-97 paras 73, 69

[24] HC Deb 10 July 1997 c 603W

one-off levy of this type.[25] Indeed in his Budget speech the Chancellor was at pains to stress that in his view neither consumers nor employees would not be affected by the imposition of the tax: "After consulting the regulators, it is my judgement that the tax can be paid without any impact on prices, investment, or the quality of service to customers; or, in my view, on employment."[26]

Comment following the Budget tended to concur that most of the utilities would be able to pay the tax without very significant implications for customers and future investment. The Financial Times quoted an analyst at Credit Lyonnais Laing who stated that even the water companies - those hardest hit by the tax - would not be faced by too heavy a burden: "These companies can bear it. There's a lot of cost cutting to come out and their balance sheets are generally under-stretched."[27] Clearly the utilities' ability to pay the levy could not be taken as sufficient argument that the imposition of the levy was justified (some of the major criticisms of the tax are considered below). Even so, prior to the 1997 Budget the idea of a windfall levy found qualified support in the press; for example in September 1995 a Times editorial was supportive of the idea:

> By privatising the electricity and water industries with too much cash and too little debt, the Treasury gave away too cheaply the assets which taxpayers had financed over many decades. A windfall tax would allow taxpayers to recoup some of this value without being unfair on shareholders or customers. Even after paying the tax, utility companies could afford to go on raising dividends and cutting prices in line with the projections made at the time of privatisation. [28]

In a second piece at this time the Independent argued that the proposal made "political sense", and, as a consequence, its practical flaws were most likely to be ignored:

> The Labour plan faces two important difficulties. Under fear of takeover, companies have been jacking up dividends in an effort to sustain shareholder loyalty. They could well offload the cash so fast that there will be none left by the time the election arrives … The second danger is the spectre of Labour wilfully penalising profits and business success … Many would view the tax as a breach of contract ... Mr Brown knows full well that he must be trusted in the markets, on everything from the conduct of monetary policy to the search for joint public-private sector projects. His windfall profits tax risks disturbing the considerable progress he has made on this front. Fortunately for Labour, the utility fat cats could save the party's fiscal reputation. Animosity towards the pay rises of the utility bosses has reached such heights that everyone, even industrialists and financiers, senses that they deserve their knuckles rapping. No matter how suspect the economics of windfall taxation, the politics are strongly in Labour's favour. [29]

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[25] "Government adviser boosts Labour's windfall tax plan", Guardian, 8 November 1996

[26] HC Deb 2 July c 314

[27] "Lion's share falls on water sector", Financial Times, 3 July 1997

[28] "Editorial: windfall for taxpayers ", Times, 18 September 1995

[29] "Leading Article: A popular tax on the fat cats", Independent, 26 September 1995

4 Opponents of the windfall tax

Prior to the introduction of the windfall tax, the one time in recent years that a similar one off levy was introduced was in 1981, when the Conservative Government introduced a special tax on bank deposits. The analogy between the two taxes has often been made, as the financial journalist Robert Chote did in the Independent on Sunday in 1994:

> The similarities are indeed striking. In 1981, the Government was in desperate need of revenue and the banks were unpopular. By paying no interest on current accounts they made a fortune as the Government pushed base rates as high as 17 per cent to choke off inflation. So the Treasury imposed a one-off levy raising £400m, a tax that Nigel Lawson had to concede in his autobiography was 'somewhat in conflict with our non-interventionist philosophy'. But Labour will hardly be troubled by philosophical reservations. The party will need revenue to fund its spending plans, and the utilities are just as unpopular now as the banks were then. Sold off at knock-down prices to well-off investors, they are making enormous profits and paying fat salaries.[30]

Nevertheless the Conservative Party has consistently opposed charging a windfall tax on the utilities. In January 1993, when Labour first made this suggestion, the then Prime Minister John Major argued the idea was "a product of the 'anti-business thinking of the 1960s and 1970s." At the time, the Financial Times noted that, "Mr Major stressed that the regulatory authorities could curb 'excess' profits by forcing lower prices."[31] The unpopularity of the gas, water and electricity companies has encouraged some to be cautiously supportive of the idea.[32] Although the then Chancellor, Kenneth Clarke, invited speculation before the November 1995 Budget that he was considering the introduction of a windfall levy,[33] he ruled out the introduction of such a tax in his Budget speech that year:

> I turn now to the utilities. My right hon. Friend the President of the Board of Trade will speak about the regulatory regime that protects consumer interests in his speech in the Budget debate on Thursday. I have been looking at the case for a windfall tax on the utilities. I have been told that it has many splendid qualities. It is a one-off tax, often described as if it hurts nobody. It is claimed that it has no impact on the economy and apparently can be used to pay for up to 10 public spending proposals which cost far in excess of the

30 "There is no airtight case for a windfall tax", Independent on Sunday, 13 November 1994. Further details on the special tax on bank deposits are given in an appendix to this note.

31 "PM scorns utilities' windfall tax", Financial Times, 20 January 1993

32 In September 1995 Sir Marcus Fox MP was quoted saying he would not oppose a windfall tax if the Chancellor introduced one ("Tory backbench leader calls for windfall tax on utilities", Times, 26 September 1995).

33 "Clarke hints at windfall levy on utilities", Financial Times, 27 September 1995

> amount of tax that it actually raises. What a potential pot of gold; an elixir to cure all the ills of some people.
>
> Of course, a windfall tax is nothing of the kind. It would damage investment and threaten the quality of customer service. It is an illusion that a windfall tax is paid by the company. It is paid by its shareholders, including many small shareholders and pension funds, and it would mean higher future prices for customers. The whole point of privatisation is to benefit consumers, not simply the Exchequer. I have no intention of introducing such a tax. [Interruption.] If that decision is meant to be a help to the Labour party, heaven help it. I do not think that it can make much of that.[34]

At the time the Liberal Democrats were also critical of the proposed levy, as Malcolm Bruce MP, argued in a letter to the Guardian in September 1996:

> The windfall tax can only be justified by the claim that the utility companies have been ripping off the consumer. This must mean either that they have invested too little, or that they have charged the consumer too much. Giving the money to the Treasury will not put this right. The windfall tax must be paid for either in excessive charges to the consumer, or in continuing pollution in the drinking water and continuing sewage on the beaches. There is no such thing as a free tax. Moreover, Labour proposes to use the windfall tax to meet continuing spending commitments. Rising tax yields from growth would take some time to come on stream. So utility companies, in setting the level of charges to the consumer, would be effectively setting the level of taxation. This means that the tax is a proposal to privatise control of taxation. The constitutional implications of that proposal need some thought. [35]

Some critics argued that by focusing on the ‘excess profits’ made by the utilities after their privatisation, proponents of the tax ignored three important problems: the retrospective nature of a windfall tax; the incidence of the tax (ie, who would actually pay it); and, the implications the tax may have for capital investment in the utilities, and for tax policy generally. All three issues were raised in a strongly worded editorial in the *Financial Times* in September 1995, which argued the proposal for a windfall tax was both “misguided and damaging”:

> It is now clear that the utilities were enormously overcapitalised at privatisation, particularly water and electricity ... Despite subsequent price regulation, some of that over-capitalisation remains; in most cases, the utilities’ net interest payments, as a proportion of operating profits, are well within tolerable levels. Mr Brown maintains that taxpayers - as opposed to the utilities’ customers - are now entitled to some of this lucre. This is a dangerous argument. For a start, it offends all principles of contract. If the state sold assets too cheaply, tough luck: the government cannot go back nearly a decade later and say that it wants to change the terms of sale to its advantage.
>
> It is also unfair to treat companies’ profits as an unearned bonanza. Those profits have largely been earned by efficiency gains since privatisation. These have been unexpectedly large, partly because the companies were grotesquely inefficient while in state ownership, and partly because the

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34 HC Deb 28 November 1995 cc 1065-1066

35 “Letter: Helping the poor but not the rich”, Guardian, 7 September 1996

> companies have responded to regulation regularly tightening the cap on annual price rises to encourage efficiency. Moreover, it is disingenuous of Mr Brown to direct his attack at the headline figures of profit, rather than cashflow. In the water companies' case, their debt levels are increasing to fund £29bn of capital expenditure, to compensate for underinvestment when in state hands. This infrastructure spending also accounts for their recently low levels of corporation tax, another of Mr Brown's targets. Under the present tax regime, capital spending is deductible from taxable profits precisely because such investment is considered desirable.
>
> The proposed taxes would also hurt utilities' customers. First, the present regulatory framework is designed to return most of the companies' efficiency gains to customers through tighter price controls set at regular price reviews. If present profits are skimmed off, long-term prices will be higher than otherwise. Second, a windfall tax that is not credibly one-off - and Mr Brown's proposed tax would not be - would raise the utilities' cost of capital, and push up prices further. In general, Labour's intervention would impede the ability of the regulatory framework to secure its long-term goals: giving customers the best service at the lowest price. Finally, it is absurd of Labour to suggest that it can fund long-run employment programmes out of one-off taxes. It is deceptive to use that ploy to duck unsolved questions of funding…
>
> The most disturbing element of the plans is what they reveal about Labour's view of the role of government. It would, of course, not be the first government to resort to windfall taxes. However, the state is party to many kinds of contract, with businesses and with individuals. Most windfall taxes introduce uncertainty into that relationship, in a manner which abuses the power of the state.[36]

This final point was echoed in a commentary published by the Institute for Fiscal Studies (IFS) in April 1997, in which it was argued, "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."[37] The IFS proved a trenchant critic of the tax, arguing that the tax "is in effect an arbitrary capital levy that falls on a group of shareholders in the utility companies, whether or not those individuals have earned high returns";[38] a long extract from the IFS 1996 Green Budget, setting out their objections, is given below:

> **A Tax in Search of a Rationale**
>
> The principal arguments used to justify a windfall levy are that lax regulation has allowed these firms to earn excessive profits and/or that these firms were sold off too cheaply when they were privatised. These arguments are closely related, since the market value of regulated companies depends crucially on how tough the regulatory regime is expected to be. It may be that they now appear to have been sold 'too cheaply' principally because price regulation was expected to be tougher than it has so far proved to be. On the other

36 "Leading Article: Windfall tax deception", Financial Times, 26 September 1995

37 Lucy Chennells, Labour's Windfall Levy, IFS April 1997 p 18

38 IFS, The IFS Green Budget: Summer 1997, May 1997 p 54

hand, it is possible to believe they were sold for too little, even if one does not subscribe to the view that regulation has been flawed.

With the benefit of hindsight, it is hard to dispute that many of these assets could have been sold for a higher price. Again with the benefit of hindsight, there is little doubt that the initial subscribers to many of the flotations would have been willing to pay the government rather more than they were asked to - they could have paid substantially more and still enjoyed a decent return on their investment.

Attractive as it may seem to use the benefit of hindsight to rectify past mistakes, retrospective taxation raises many difficulties. In particular, in this case, it would set an awkward precedent that might make it harder for future governments to sell assets to the private sector, or, perhaps more worryingly, to convince private investors that today's rules of the game would not be changed retrospectively in areas such as the Private Finance Initiative. However, a major problem with the windfall levy is that it fails to tax the same investors who actually benefited from the earlier 'windfall' gains.

It would in principle be possible to identify the individuals and institutions who subscribed to the flotation of any particular set of utilities, and charge a windfall levy on those investors in proportion to their initial shareholdings or capital gains.[39] This would not be achieved by Labour's proposal for a windfall levy on the utility companies. The investors affected by this tax would be today's shareholders, or, more accurately, the investors who are (or were) holding shares in these firms at the time when the prospect of the windfall levy is discounted into their stock market valuations. Given the high level of turnover in company shares, and the short holding periods of many stock market investors, this group of shareholders may be quite different from the individuals and institutions who enjoyed the earlier windfall gains.

Given that there is no close connection between the investors who benefited from windfall gains and the shareholders who would bear (or who have borne) the burden of the windfall levy, this supposed rationale for the windfall levy offers little guidance as to the form this levy should take. This contrasts with the case of the 1981 special tax on bank deposits, which is sometimes suggested as a precedent for Labour's proposed windfall levy. In 1981, the government's tight monetary policy was reflected in unusually high interest rates. Deposits held in current accounts with banks did not pay any interest at that time, so high interest rates resulted in high income on lending for the banks, but were not fully reflected in higher interest payments on bank deposits. This policy therefore contributed to unusually high profits in the banking sector, and this link was used as a reason for subjecting the banks to a levy of 2.5 per cent of their non-interest-bearing sterling deposits.

The special tax on bank deposits had the merits of being applied to a well-defined set of firms and of being charged on a tax base that was coherently related to the reasons given for introducing the tax. It also had the advantage of being introduced at around the same time as the banks were earning these windfall profits, and not several years later.[40]

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[39] Alternatively, if the case for the windfall levy is linked with weak regulation, those individuals and institutions holding shares in these companies at the time of the regulatory reviews could be identified.

[40] Institute for Fiscal Studies, Options for 1997- the Green Budget, October 1996 pp 103-108

5 The potential for a legal challenge to the windfall tax

Prior to the July 1997 Budget, the legal status of a windfall tax was questioned in two ways: first, the possibility that legislation might be "hybrid", and second, that it might be contrary to European law. Although no legal challenge was made at the time, it may be of interest to explain why at one time it appeared to be a real possibility.

First, hybridity. During the debate on the windfall tax held in November 1996 Sir John Cope MP made the point that a successful definition to cover those companies the Labour Party might wish to tax might be difficult to achieve:

> The more important definitions, rather than just the name of the tax, are those concerning "excess profits" and "privatised utilities" ... whatever the definition [of excess profits] is ... the same definition must apply right across the companies on which the levy, tax, or whatever one likes to call it, will fall. Apart from any other consideration, the Bill would be hybrid if that were not the case. A single definition must cover all the different companies to which the measure will apply. [41]

In a piece on the windfall tax in December 1996, the Economist made a similar point: "Opponents claim that, if the tax singles out named firms for adverse treatment, the legislation to introduce it would be hybrid. If true, this would mean a long-drawn-out parliamentary procedure, including MPs taking evidence from firms adversely affected."[42]

There does not, in theory, appear any reason why a Finance Bill could not contain hybrid legislation. However, the consultation between the Parliamentary Draftsmen and the Clerk of Public Bills in advance of legislation being printed is considerable. Should it be ruled that legislation is hybrid **once** it has been introduced, it would become impossible to proceed with. Great efforts are made to avoid any possibility of this occurring (indeed, one assumes this was the case when the Finance Bill was drafted prior to the July 1997 Budget). Erskine May gives the definition of a hybrid bill as "a public bill which affects a particular private interest in a manner different from the private interest of other persons or bodies of the same category or class". The commentary on hybrid bills in Erskine May goes on to make two interesting points:

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41 HC Deb 21 November 1996 cc 1139-1140

42 "A rotten windfall", Economist, 7 December 1996

> It is not uncommon for objection to be taken that [public bills] ought to have been treated as hybrid bills ... As such objections of their nature arise from particular cases it is not easy to describe generally the ground on which such objections have been sustained or over-ruled. A bill has not been regarded as hybrid if all the persons or bodies affected by it, and no others, belong to a category or class germane to the subject matter of the bill and it is not the practice to treat as hybrid, bills dealing with matters of public policy whereby private rights over large areas or of a whole class are affected. [43]

Erskine May cites a number of examples, including certain classes in the Finance Bill 1966.[44] At the time Graham Page MP argued that the proposed changes to be made in the tax treatment of friendly societies - set out in clause 27 of the Bill - constituted hybrid legislation. The Speaker ruled that this was not the case:

> In the present instance, the Bill has not been referred to the Examiners and the hon. Member is fully entitled to ask why. The answer to his submission depends on the definition contained in Clause 27(1,a), the Clause to which he is referring. This Clause - as the Chancellor explained in his Budget statement, reported in HANSARD of 3rd May, cols 1435 and 1436 deals with the tax exemption which friendly societies enjoy under Section 440(1) of the Income Tax Act 1952. Broadly speaking, the effect of the Clause is to take away this exemption from new societies - as defined in subsection (1,b) - and also from those old societies which did any single premium business in the three months ending 3rd May 1966, as defined in paragraph (a). Old societies, with the exception of those defined in paragraph (a), will continue to draw their tax exemption so long as they do not enter into single premium business.
>
> The hon. Member for Crosby submits paragraph (a) makes the Bill prima facie hybrid, because its effect is to penalise only six out of more than a thousand old friendly societies and that the date has no particular significance in society law or finance law. After considering the definition contained in subsection (1,a) of Clause 27, however, I am satisfied that it comprises a certain class of friendly society which are to be treated in a uniform manner and, therefore, this must be treated as a public and not a Hybrid Bill.[45]

Turning to the question of European law, some commentators argued in the months running up to the July 1997 Budget that a windfall levy might be challenged, either at the European Court of Human Rights (as an arbitrary confiscation of property), or at the European Court of Justice (as contrary to the Treaty of Rome's provisions on state aid). In January 1997 the Conservative think tank, Aims of Industry, published an opinion by Gerald Barling QC which argued that 'serious legal issues' would arise in the event

43 Erskine May (21st Edition), 1989 p 519. The definition of hybridity which is cited here is given at: HC Deb (1962-63) 669 c 45.

44 The legislation is now contained in section 29 of the Finance Act 1966.

45 HC Deb 24 May 1966 c 301

of the adoption of the tax (though it is notable that this opinion did not suggest any such challenge would succeed).[46]

At the time the general prohibition against state aid in the Treaty Article 92 (at present it is Article 87). This states, "save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market."[47] State aid may be permissible to assist deprived areas, to facilitate the development of certain economic activities (if it does not distort trading conditions), and in "exceptional circumstances" (if the Council of Ministers agrees unanimously). Since outlawed aid is defined broadly ("in any form whatsoever"), it is quite possible that a State's corporate tax system might be interpreted as illegal state aid.

Arguments over how this part of the Treaty relates to the tax structure in Member States are complex, and its practical application appears to have been quite limited. One example that was cited at this time[48] was a judgement in March 1994 where the Court ruled that tax concessions did qualify, in terms of EC law, as State aid.[49] The Court found that the definition of State aid provided in Article 92 included not only outright subsidies but all measures which, in various forms, "mitigate the charges which are normally included in the budget of an undertaking and which, without therefore being subsidies in the strict meaning of the word, are similar in character and have the same effect." It concluded that this covered the practice by the Spanish authorities in granting a particular tax exemption for public credit institutions.[50]

Nonetheless, some commentators argued that a successful challenge on these grounds was never very likely. In February 1997 the Labour Party published the opinion of Michael Beloff QC which stated a windfall tax "could not even attract a challenge under domestic law; should not attract a challenge under EC law, but if it did, such a challenge would fail; and would withstand any challenge which may be made under the European Convention of Human Rights."[51]

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46 "Claim and counter claim", Press Association, 12 January 1997 This was fuelled in May that year when British Telecom announced it would consider legal action if included in the scope of the levy; most likely on the grounds that the tax contravened EC rules on competition law ("BT and BAA vow windfall tax challenges", Financial Times, 16 May 1997).

47 Following the ratification of the Treaty of Amsterdam on 1 May 1999, Articles 92-94 of the Treaty were renumbered as Articles 87-89 (Treaty of Amsterdam Cm 4434, August 1999).

48 For example, Timothy Lyons, "Discrimination against individuals and enterprises on the grounds of nationality: direct taxation and the ECJ", The EC Tax Journal, vol.1 issue 1 1995/96 p 51

49 Case C-387/92, Banco de Crédito Industrial SA, now Banco Exterior de España SA v. Ayuntamiento de Valencia [Simon's Tax Intelligence, 16 June 1994 p 709]

50 In the event, as the Commission had not found this aid was incompatible with the common market, the Court ruled this exemption could continue to operate.

51 "Labour windfall tax is legally watertight, QC tells Brown", Guardian, 13 February 1997

On the matter of state aids, Mr Beloff argued that a levy would be classified as part of the general system of taxation - not as a specific measure - since it would apply to every privatise utility of a particular kind, cutting across sectors of the economy. To construe the law on state aids to cover general measures rather than the grant of specific state aids "would be to extend the scope of Articles 92-94 beyond what was every intended by the Member States and would result in a serious and unforeseen derogation from their autonomy. We consider that, for those reasons, neither the Commission nor the ECJ would accede to the argument that the windfall tax was a state aid …"[52]

This reasoning appears to have held sway with the utilities themselves. Just after the July 1997 Budget it was reported that it was "unlikely that any companies will challenge [the tax]"[53] – and so it proved. The issues of both hybridity, and a legal challenge to the tax, were both raised at the Committee stage of the 1997 Finance Bill; Quentin Davies MP opened this exchange with the then Paymaster General, Geoffrey Robinson, by asking why the legislation to introduce the tax did not list the companies to be charged the tax:

> **Mr. Quentin Davies**: Why do [the Government] not simply list the companies on which they wish arbitrarily to levy the tax? …
>
> **Mr. Robinson**: We consulted on the matter. It was ruled that, had the Bill contained such provisions, it would have been hybrid. That is why it contains a precise definition, which has stood up to all aspects of scrutiny--not by the Committee, which has got nowhere on it, but previously.
>
> **Mr. Boswell**: Will the hon. Gentleman confirm my understanding that it is open to any individual aggrieved party to take this matter into the courts, and that it would be for the courts finally to determine whether the Bill, if enacted as worded, would give rise to any partiality between individual shareholders? ...
>
> **Mr. Robinson**: … as far as we are aware, no legal challenges are being mounted by any of the companies. There is general acceptance of the rightness and balance of the tax among those companies, and we look forward to receiving the cheques on 1 December, if not before.
>
> We are confident, as the hon. Gentleman knows, of the proposal's legality. In Opposition we went to great lengths to consult on the matter at great cost with the most eminent counsels we could find. We are convinced--that there is no legal challenge on the matter bears this out--that the proposal is robust against any challenge under the British legal system or under European jurisdiction.[54]

[52] M.J.Beloff & R.Singh, In the matter of the Labour Party and the windfall tax : joint opinion, Wedlake Bell 12 February 1997

[53] "Industry not expected to challenge tax", Financial Times, 3 July 1997

[54] Standing Committee A 17 July 1997 cc 17-18

6 Subsequent developments

Since the introduction of the windfall tax, the Government have not changed their original assessment that the tax would not have a significant impact on prices, investment or service standards across the utility companies:

> **Mr. Laurence Robertson**: To ask the Chancellor of the Exchequer what assessment his Department has made of the impact on employment levels in the utility industries of the windfall tax.
>
> **Mr. Geoffrey Robinson**: The Chancellor's judgement at the time of the July Budget was that, after consulting the regulators, the tax could be paid without any impact on prices, investment or the quality of service to customers or, in his view, on employment. Nothing has changed since then to alter that view.[55]

This assessment was supported, with one caveat, in an article published on the tax in Fiscal Studies in 1997:

> Since the tax is based on past profits which the companies could not affect by their behaviour once the details were announced, it should have a limited effect on prices and investment in the utility sectors, provided that the statement that the tax is one-off is credible. This cannot be proved ex ante, and the very fact that the tax was imposed seems likely to have long-term effects on the perception of the government's preferences over tax policy.[56]

It had always been the Labour Party's intention to use the proceeds of the tax to fund the New Deal programme of employment and training policies, to help move people from welfare benefits into paid employment (otherwise known as the 'welfare to work' programme). The programme was one of the '5 Election Pledges' contained in the Labour Party's election manifesto.[57] This issue is not examined in any detail here, although a written answer on the effectiveness of the windfall tax – given in July 2003 – is reproduced below:

> **Linda Gilroy**: To ask the Chancellor of the Exchequer what assessment he has made of the effectiveness of the use of the windfall tax on privatised utilities to fund the New Deal.
>
> **Mr. Boateng**: The New Deal for Young People and the New Deal for 25+ have both contributed significantly to cutting long-term youth and long-term unemployment by more than three-quarters since 1997.

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55 HC Deb 26 February 1998 c 356W

56 Lucy Chennells, "The Windfall Tax" in Fiscal Studies vol 18, no.3 1997 pp 279-291

57 New Labour: because Britain deserves better, April 1997 p 19. The genesis of the New Deal is discussed in Welfare to Work: The New Deal, Library Research Paper 97/118, 12 November 1997.

> Almost 430,000 long-term unemployed 18 to 24-year- olds have found jobs through NDYP, while ND25+ had helped more than 145,000 older people back into work and over 193,000 people have found employment through the New Deal for Lone Parents. The Government have established a comprehensive program of independent and in-house evaluation for all the New Deals, and is fully committed to ensuring that the lessons learned contribute to continuous improvements in the performance of the New Deals in helping people into work. This evaluation program has demonstrated the success of the New Deal. In 2000, the National Institute of Economic and Social Research (NIESR) found that, without NDYP, the level of long-term youth unemployment would have been twice as high as it actually was. Independent evaluation evidence also confirms the overwhelmingly positive impact of NDLP in helping lone parents into work and suggests that the programme more than doubles the employment chances of participants.[58]

The allocation of the receipts from the windfall tax to the welfare to work programme is shown in table 4.1 to the Budget 2004 report.[59] It is anticipated that most of the £5.2 billion raised by the tax will be exhausted by the end of the 2003-04 year, with only £230 million left to be spent over the next two years – although other funds for the welfare to work programme were allocated in the 2002 Spending Review. Full details of the total expenditure on these measures are given in the Department for Work and Pensions' most recent Departmental Report.[60]

58 HC Deb 10 July 2001 c 929-30W

59 HC 301 March 2004 p 98

60 "Chapter 6: Tables", Department for Work and Pensions Departmental Report 2003, Cm 5921, May 2003 (see, Table 7: Expenditure on the New Deals and Action Teams, p 132)

7 Appendix: The 1981 Bank Levy

In 1981 the Conservative Government introduced a one-off levy on the banking sector which raised about £350 million for the Exchequer. Many have drawn comparisons between this tax on bank deposits and the Labour Government's current proposals for a windfall tax. For example, when the Labour Party published its economic strategy in June 1995, it stated that once in government a Labour administration would bring in "a windfall dividend on monopolistic profits of privatised utilities, on the same principle as that applied by the Tories in their 1981 windfall levy on the banks."[61] Indeed the 1981 bank levy represents the only time in recent years that a one-off tax has been imposed on a single sector of the economy.

In some respects the analogies between the two taxes are striking. In 1981 the banks were highly unpopular, being the one major sector in the economy that was doing well during the recession apart from North Sea oil. Many felt that a significant proportion of their profits were a windfall, arising through no effort on the banks' part, but simply from the high interest rates imposed as part of the Government's monetary policy. The Government of the day believed existing Exchequer revenues fell far short of their spending priorities, threatening an unsustainable growth in government debt.

Nigel Lawson was then Financial Secretary, and in his 1992 memoirs he recalls "other avenues had to be explored in the desperate circumstances in which we found ourselves ... somewhat in conflict with our non-interventionist philosophy, we decided to ask the banks to [assume] ... a financial liability they could well afford."[62] This appendix gives a short history of the 1981 bank levy before examining the parallels between it and the windfall tax.

In one respect the Conservative Government's decision to impose a bank levy was facilitated by a matter of timing. The clearing banks' reporting season has always been an important and visible fixture in the financial market's year. As the banks' financial years coincide with the calendar year, and their annual results are announced about two months after the year end, this reporting season coincided with the run-up to the Budget. (At this time the Budget took place in March, as it does now, rather than November, as it did between 1993 and 1996).

In his 1980 Budget speech the then Chancellor, Geoffrey Howe, commented on the level of bank profitability revealed by the 1980 results, and warned

61 Labour Party, A new economic future for Britain, June 1995 p 70

62 Nigel Lawson, The view from No.11, 1992 pp 92-93

that he was considering the case for a "special tax related to the windfall element in these profits":

> In recent weeks there has been a good deal of comment about the profits declared by the clearing banks. Some represent a "windfall" to the banks, which arises from the combination of high interest rates and the fact that interest is not paid on current accounts. The windfall element is not a sign of enterprise or efficiency, as the banks themselves recognise. But it is equally irrational to attribute these profits to some wickedness on the part of the banks. They need the major part to strengthen their capital base, which would otherwise have been eroded by inflation.
>
> There could, of course, be a case in principle for a special tax related to the windfall element in these profits, and I shall be considering that further. However, it has not yet been established that such a tax is either practical or entirely desirable in today's conditions. [63]

By the following year the economy was in deep recession. In sharp contrast profits enjoyed in the banking sector were considerable. Interest rates - and bank lending rates - had been relatively high since 1979, though the banks' funding costs had not risen in line with interest rates, since these costs were mostly the servicing of deposit accounts on which the banks paid no interest. In addition, the provision of generous allowances on banks' leasing assets meant that the sector as a whole paid relatively little in the way of corporation tax. Unsurprisingly the proposal to tax these "extraordinary" profits was politically popular.[64] Indeed a few days before the Budget, on 6 March, the Guardian took the opportunity of the announcement of Barclay's results to predict, quite accurately as it turned out, that a levy would be introduced, based on each bank's current account balances.

The Government's principal argument for a levy - beyond its popularity - was that the profits made by the banks were "windfall" in character, based not on any initiative by the banks themselves but on the fact interest rates were relatively high. For their part the banks argued that the public perception of their profits was inflated and did not provide an equitable basis for a new tax. To some extent this argument was undermined by a second argument, that the tax was unfair, as it "penalised success", and, as such, ran counter to the then Government's industrial policy. In addition the banks suggested that the tax was unfair, being retrospective, and that it set a bad precedent for future governments, who might well ignore the claims made by the Chancellor that the levy was a "once and for all" charge.[65]

Notably the banks do not appear to have claimed that the imposition of the tax would result in a serious deterioration in their service to their customers. In the summary of the banks' case - published by the Banking Information Service in April 1981 - the point is only referred to once: "Obviously the banks will do their utmost to carry on providing industry with the finance it

63 HC Deb 26 March 1980 c 1466

64 "In 1981 it was the banks' turn", Financial Times, 26 September 1995

65 Banking Information Service, The Case Against the Banking Levy, April 1981

needs to survive and expand. But the measure will inevitably cause banks to look less favourably in future at marginal lending positions."[66]

Nevertheless Geoffrey Howe announced the introduction of a windfall tax on the banks in his 1981 Budget speech:

> Apart from oil, one other business sector has largely been protected from the effects of the recession, and that is banking. Indeed, bank profits in recent years have increased sharply, both absolutely and by contrast with the experience of most other businesses. A substantial part of these profits is the direct consequence of high interest rates in recent years: this applies in particular to the "endowment profit" on current accounts on which no interest is paid.
>
> Recent levels of bank profits are partly, of course, a cyclical recovery from the low level to which they fell in the mid-1970s. Also, the banks have needed to make provision against the effects of inflation and to rebuild the reserves needed to underpin the valuable support that they give to businesses in difficult times. That is why I took no action last year. However, I undertook to keep developments under review. The past year has seen further high banking profits, probably at a level not very different from the record profits of 1979. Certainly the contrast with the sharply reduced profits of industrial companies is, if anything, more striking. In present difficult circumstances, I cannot avoid the conclusion that I should require the banks to make a special fiscal contribution.
>
> This will take the form of a special once-for-all tax on deposits of banking businesses that are in operation today. The tax will be charged by reference to non-interest bearing sterling deposits in excess of £10 million, averaged over the three months of 1980. The rate of tax will be 2½ per cent. It will not be deductible against corporation tax. I estimate that the clearing banks will be the source of about 90 per cent. of the revenue but the tax will apply to banking businesses generally. Altogether an estimated £400 million will be raised in three instalments over the second half of 1981-82. This revenue will make it possible for me to give some help to the rest of industry this year which otherwise I could not afford.[67]

At the time most commentators seem to have welcomed the new levy. The *Times* reported the banks' anger at the new tax, but in its City Editor's column, it judged the effect of the tax would be severe but not catastrophic.[68] The following day the Times reported that the banks would be lobbying MPs to ensure that the tax was never repeated.[69] The strongest reaction in the press seems to have come from the City Editor of the Sunday Times, who warned, "the Chancellor's £400m tax on banks is an appalling precedent for his successors who may now grab with impunity at any sector of industry or commerce whose profits are not, for whatever reason, falling as fast as the others."[70]

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66 op.cit. p 4

67 HC Deb 10 March 1981 c 772

68 "Bankers angered by £400m tax", Times, 11 March 1981

69 "Banks to lobby MPs against windfall tax", Times, 12 March 1981

70 "Howe's bank raid - could you be next?", Sunday Times, 15 March 1981

The tax was levied on about 50 banking businesses: those holding more than £10 million in non-interest bearing sterling deposits in the UK (these deposits consisted mainly of credit balances on current accounts). The tax was charged at 2½% on deposits over the £10m limit and paid in three instalments over 1981-82.[71] Initially it was thought the tax would raise about £400 million, though in practice it raised £355 million, then equivalent to ½% of total Government tax revenues.[72]

The legislation introducing the special tax on bank deposits was included in the Finance Bill of that year,[73] and discussed on the floor of the House in May,[74] when the then Chief Secretary to the Treasury, Leon Brittan, set out the Government's position:

> The Government as a whole gave the matter a great deal of thought and it was only with a considerable degree of reluctance that we concluded that the financial circumstances this year and, in particular, the fiscal requirement to achieve the public sector borrowing requirement that we judged necessary for the maintenance of our anti-inflationary policy meant that the introduction of a tax of this kind was unavoidable. Let me remind the Committee that the tax is a single tax on a single occasion and is not put forward as a general introduction to the system.
>
> I start by explaining the position last year. Reference has already been made to it by a number of speakers. Last year Ministers accepted - and we have had some of the quotations - there could be a case in principle for special taxation of banks in certain circumstances on the grounds that high interest rates for which the banks were not themselves responsible enabled them to make particularly high profits. I will not use the word "excess" profits because that has a derogatory connotation and I do not accept for one moment the strictures of the British banks that fell from the lips of the hon. Member for Blackburn. I am not in any way criticising the banks for making profits of that kind on that basis in circumstances in which they were enabled to do so, but what Ministers last year said was that the existence of those high interest rates did, as a matter of fact, enable banks to make profits which were of an endowment or windfall character in the sense that they had not done anything which led to those profits.
>
> That is not a criticism of them. It is a fact. But the Government felt that last year that to introduce a discriminatory tax of this kind on banks was something which required a very strong case to be made, and they were not persuaded last year that this was so. I think that different considerations apply this year. First, interest rates have continued at an exceptionally high level throughout 1980. The average base rate in 1980 of 16.3 per cent. was two and a half percentage points higher than that in 1979, when it was 13.7 per cent ...
>
> The banks have continued to benefit from exceptionally high interest rates for an unprecedented period and for much longer than could have been expected in the first quarter of 1980, when the Chancellor was putting

[71] Inland Revenue press notice, Special tax on banking deposits, 10 March 1981

[72] Inland Revenue Statistics 1996, p 10

[73] It is now contained in section 134 of the Finance Act 1981.

[74] HC Deb 12 May 1981 cc 683-740

together his 1980 Budget. The effect of these high interest rates has been to increase the endowment element in bank profits. The endowment factor arises because banks can attract and hold deposits from the public at a cost, after allowing for services provided, substantially less than the yield at which they can invest the funds when interest rates are high. That windfall arises because the level of interest rates is the result of economic circumstances or action by the banks. It is generally thought that it now costs the clearing banks about 9 per cent. to provide current accounts with the associated facilities. Over the past two years, they have been able to invest funds deposited on current account in advances or other ways at much higher rates of interest. Given the present levels of current account balances, every one percentage point rise in the general interest rate level increases the potential return from investing current account funds, on which this tax is to be levied, by about £170 million for the banks as a whole. The special tax has the effect of securing the benefit of two and a half percentage points of these higher rates for the Exchequer.

Secondly, as the results of the big four clearing banks indicate, banks have generally enjoyed, overall, another successful year, with their profits being far different from those achieved in 1979. As has been mentioned, however, there has been - I am trying to present a balanced picture - a switch in emphasis, with the overseas profits generally moving ahead and domestic profits declining. The reason for that are twofold. First, there is the provision for bad debts, to which the hon. Member for Blackburn referred. But there have also been increased staff costs, arising in part from pay increases - an average increase of 30 per cent. in 1980 over 1979 levels. The net result, however, has been good. Three of the four banks have been able to increase their dividends by 20 per cent.

Thirdly, the banks' experience with profits contrasts sharply with the reduced profits of industrial companies. Fourthly, as the sharp increase in indirect taxation and the failure to index personal allowances clearly show, the Government have needed substantial additional revenue in 1981-82 to contain the public sector borrowing requirement, and, above all, to set a financial framework - as so many of us have said from this Dispatch Box - in which it would be possible for interest rates to come down and for industry to begin the advance from the trough of the recession.

In a very broad sense, therefore, this tax can be seen as a measure to recycle back to industry some part of the substantial bank profits which have been provided by industry through its payment of high interest rates. Reference was made by the hon. Gentleman to the retiring chairman of Barclays. I would like to quote at only slightly greater length what Sir Anthony Tuke said: "In the past ... where a country has suffered a major recession its bankers have suffered also but this recession is different, with high interest rates ensuring that the tribulations of industry are not shared by the banks. Indeed, it would not be altogether unreasonable for our borrowing customers to go further and observe that some of their profits are being absorbed by high interest rates which find their way into the profit and loss accounts of the banks; but these high interest rates are not of our making as they are part of the Government's policy". Those were not the words of a politician. They were the words of a chairman of one of our major clearing banks.[75]

[75] op.cit. cc 699-700

A database search of the Financial Times in the following three years does not provide any evidence that the tax had a significant impact on the sector's profitability in long term. A survey of world banking in May 1983 found that "banking in the UK remains a highly profitable business." Indeed, the possibility of a **second** windfall tax was discussed, though the biggest influence on the future of the banking sector was felt to be competition from the building societies:

> The interest margins are still better than in many other countries and despite a reduction in the amount of funds which banks utilise from their zero-interest bearing current accounts, they still have access to a sizeable amount of 'free money' from customers. Bankers will dispute this immediately, claiming the cost of cheque processing and other services prevents them from anything like 'free money' deposits, but there is nonetheless little doubt that UK banks are among the most profitable in the world ...
>
> In practice, there are three main areas of concern for Britain's major banks; these can be summed up as the threat of more bad debt provisions, the possible wrath of the Thatcher Government in the form of another windfall profits tax and finally, perhaps most alarming, the threat of genuine competition for customer deposits from Britain's increasingly innovative building societies ... The issue of a special tax on bank deposits, the so-called windfall profits tax, is every UK bank chairman's private nightmare. Such a tax has only been levelled once, but it is a continuing fear for bankers nevertheless. ... Bankers fear the prospect of a special tax from the Thatcher Government almost as much as they do the prospect of a Labour Government coming to power. As the latter appears less likely they are devoting most of their political lobbying efforts to a campaign against any repeat of a windfall tax.
>
> Perhaps the most serious concern for the UK banking oligarchy, however, is the competitive push from Britain's building societies. The past year has seen a major increase in competition for deposits, and the building societies are making progress. ... The growth of competition for High Street deposits is almost certain to develop further this year and for the customer at least, this is not a bad thing. Greater competition in a freer market can only mean a greater variety of financial products and services. The one major coup which banks could score - offering a genuine interest bearing current account rather than the string-attached hybrids now on offer - seems too painful for the Big Four to consider seriously.[76]

Three years on a second levy on the banks was still being discussed, in this case by the Times, in the light of the sector's continued strong profits performance, though not on the same basis as the 1981 levy:

> In banking parlours, insurance offices and other financial intermediaries, there is a nagging fear. Is the Chancellor, strapped for Budget cash because of tumbling oil prices, about to introduce a new tax on financial services? ... The strong profits performance of the banks and the fact that politicians, perhaps rightly, see the banks as unpopular enough for a new tax on them to pose no presentational difficulties, recalls the situation in 1981. In the March 1981

[76] "Survey: World Banking: Britain - Ranked high in the profit ratings", Financial Times, 9 May 1983

> Budget, the then Chancellor, Sir Geoffrey Howe, introduced a special tax on bank deposits, widely regarded as a windfall profits tax on the banks. The tax raised pounds 355 million in the 1981-82 financial year.
>
> There are, however, good reasons for thinking that, if a new tax is introduced, it will not be in this form. In 1981 it could be argued that the banks had benefited at the expense of other sectors, notably manufacturing, from the Government's high interest rate strategy. Although rates of interest have been high since the January 1985 sterling crisis, and real rates even higher than in 1981, it is more difficult to make the case that the banks have benefited while other sectors have suffered. In addition, in 1981, ministers, including the present Chancellor, committed themselves to not reintroducing such a tax. Mr Nigel Lawson, as Financial Secretary to the Treasury, said in the Commons in July 1981: 'This is a once-for-all tax. As such it follows that it will not be repeated.[77]

Though there are striking similarities between the 1981 bank levy and the windfall tax, some have argued that these are of a superficial nature. The Institute for Fiscal Studies, a strong critic of the windfall levy, addressed this point in their 1997 Green Budget:

> Given that there is no close connection between the investors who benefited from windfall gains and the shareholders who would bear (or who have borne) the burden of the windfall levy, this supposed rationale for the windfall levy offers little guidance as to the form this levy should take. This contrasts with the case of the 1981 special tax on bank deposits, which is sometimes suggested as a precedent for Labour's proposed windfall levy.
>
> In 1981, the government's tight monetary policy was reflected in unusually high interest rates. Deposits held in current accounts with banks did not pay any interest at that time, so high interest rates resulted in high income on lending for the banks, but were not fully reflected in higher interest payments on bank deposits.
>
> This policy therefore contributed to unusually high profits in the banking sector, and this link was used as a reason for subjecting the banks to a levy of 2.5 per cent of their non-interest-bearing sterling deposits. The special tax on bank deposits had the merits of being applied to a well-defined set of firms and of being charged on a tax base that was coherently related to the reasons given for introducing the tax. It also had the advantage of being introduced at around the same time as the banks were earning these windfall profits, and not several years later.[78]

David Willetts MP gave a forthright summary of these arguments during the Second Reading debate on the Finance Bill 1996 in January 1997:

> The 1981 bank tax is very different from the Labour party's proposals for a windfall tax. The first difference is that we were clear on the basis on which a tax should be levied. It was a tax on the non-interest-bearing sterling deposits held by all banks in the United Kingdom, and there was no attempt to discriminate between banks on the basis of their status - whether they were foreign or domestic - their circumstances, or their history. The measure was

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[77] "Fears of financial services tax", Times, 7 March 1986

[78] Institute for Fiscal Studies, Options for 1997- the Green Budget, October 1996 p 104

based on agreed and published banking statistics showing the non-interest-bearing deposits held by the banks.

There was a genuine windfall element in that tax because interest rates had risen so high - at one point, they reached 17 per cent. Banks were taking in deposits on which they were paying no interest and were earning interest, sometimes of more than 20 per cent., on the loans that those deposits financed. We formulated a clear, simple measure specifying that the tax on banks should collect 2.5 per cent. of the value of those sterling deposits. The measure was clear and precise, it was introduced at the same time as the banks were making excess profits, and it was based on agreed statistics that had long been prepared and published before by the Bank of England.

I can do no better than quote from the Institute for Fiscal Studies, which has examined the possible analogies between our bank tax and Labour's proposed windfall tax. It states:

"The special tax on bank deposits bad the merits of being applied to a well-defined set of firms and of being charged on a tax base that was coherently related to the reasons given for introducing the tax. It also had the advantage of being introduced at around the same time as the banks were earning these windfall profits, and not several years later. In contrast, it is not at all clear which privatised firm will be liable to the windfall levy, or what basis would be used to decide how much each firm would be charged."

There is a clear difference between the approach in our 1981 Budget, although many Conservative Members regretted the element of retrospection, and Labour's extraordinary proposals, many years after the event, for a windfall tax on the utilities.[79]

[79] HC Deb 14 January 1997 c 180

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