Tax devolution & Wales: a primer

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Coming up

- Some taxation basics, facts and figures
- Devolution of taxes to Wales
  - Stamp duty land tax, landfill tax and (possibly) part of income tax
  - Opportunity for new taxes
- The need for a new Fiscal Framework for Wales
  - Calculating block grant adjustments (BGAs)
  - Is approach being used in Scotland right for Wales?
- Some thoughts on where scrutiny may be most important

Taxation basics, facts and figures

Main objectives of taxation

1. Raise revenue to finance public spending
2. Redistribute from the better-off to the needy
3. Encourage beneficial behavioural change
   - Correct ‘market failures’ which mean behaviour otherwise not optimal
   - Need to consider whether tax policy is most appropriate way of incentivising said behavioural change

- What matters is how well the system as a whole delivers objectives
  - Not individual taxes

Characteristics of a good tax system

For a given revenue yield and distributional outcome, what matters are:

- Economic efficiency
- Operational efficiency
  - Minimise admin and compliance costs
- Transparency
- Fairness
  - Due process, non-discrimination, respect legitimate expectations, etc

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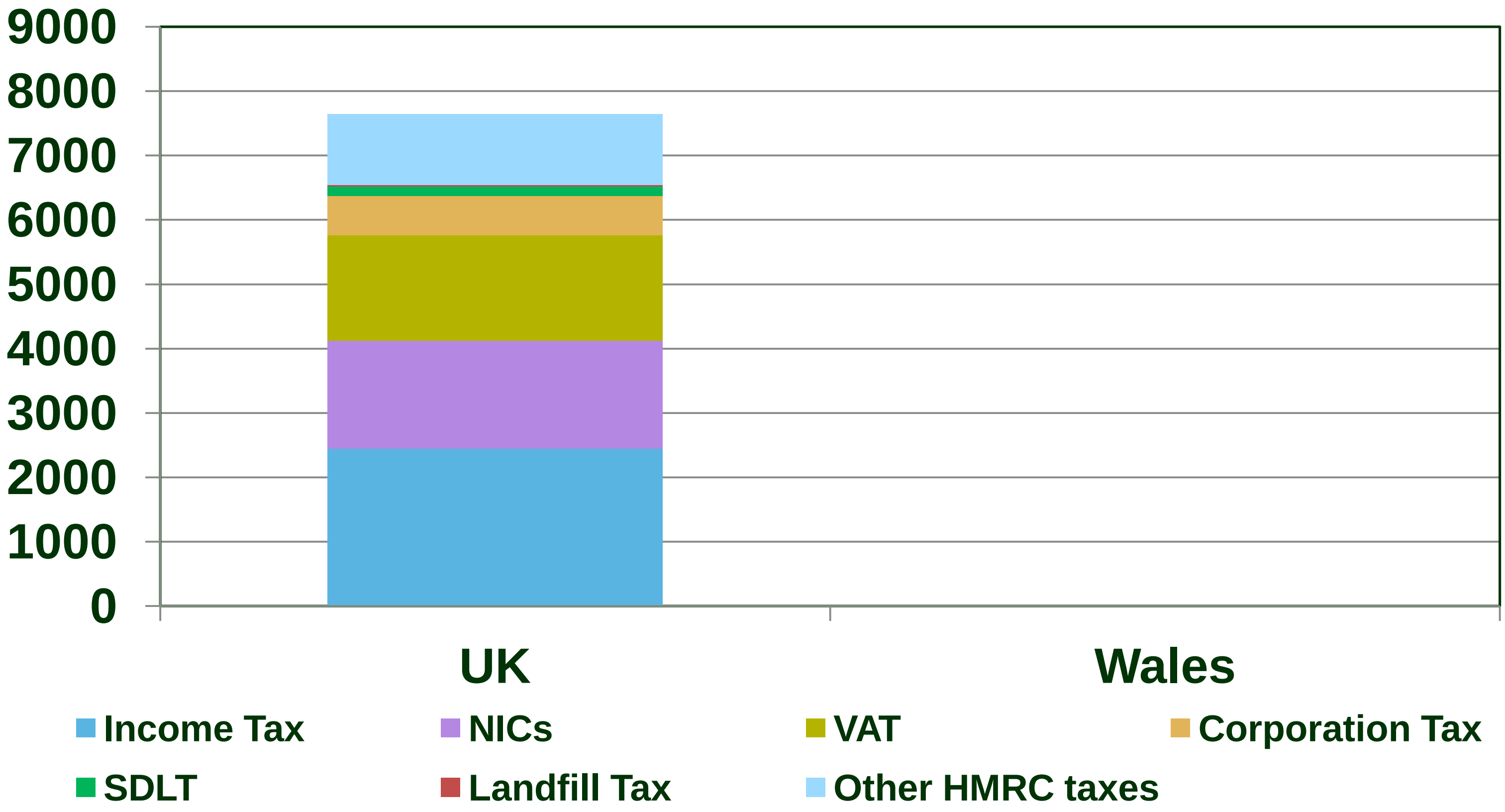
Simplicity

UK Tax Revenues per person

- HMRC raised £490 billion of taxes across whole UK in 2013-14
  - £7640 per person



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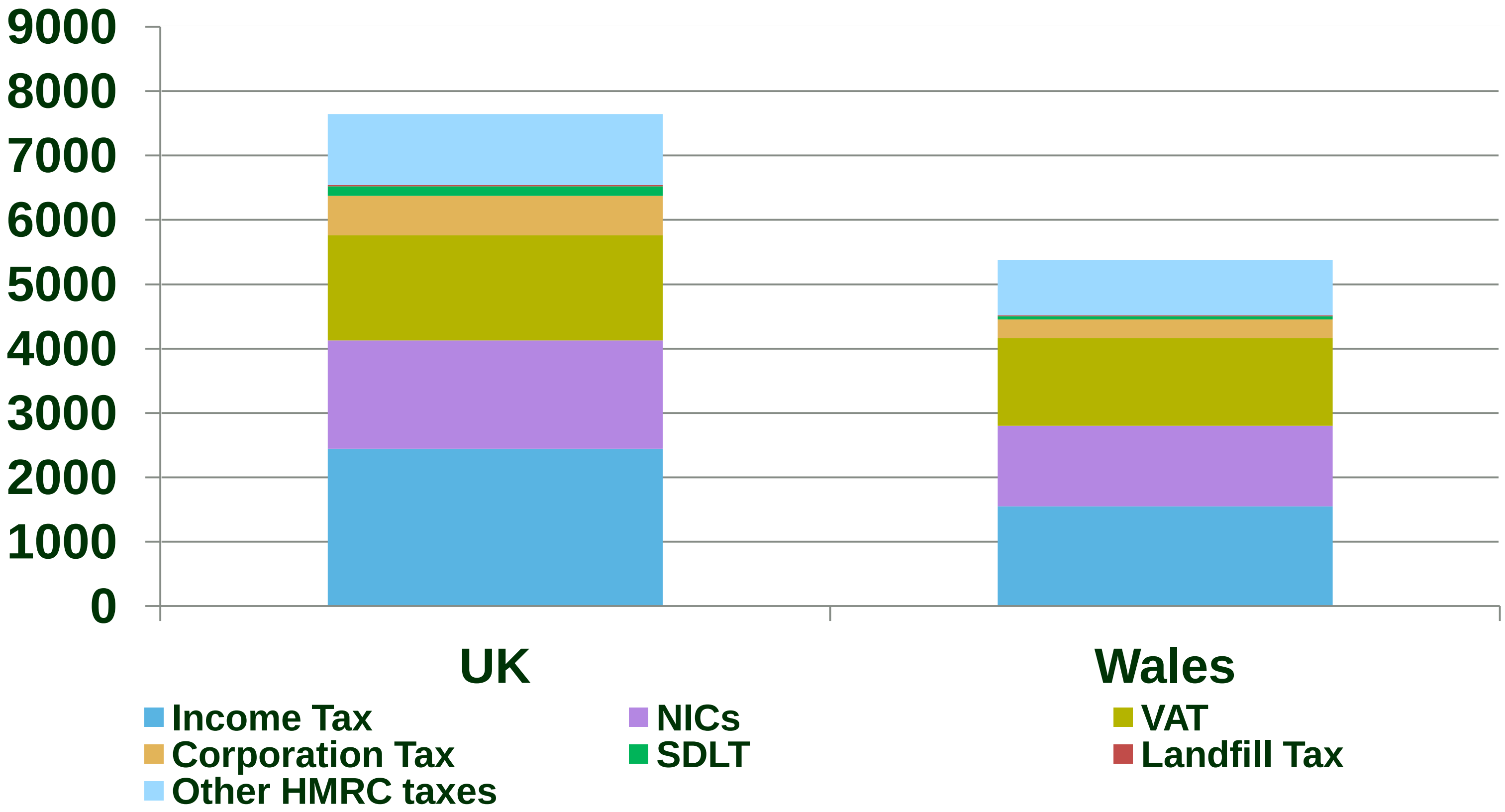
Welsh Tax Revenues per person

- HMRC raised £16.6 billion of taxes in Wales in 2013-14
  - £5370 per person, 30% less than UK average



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What taxes are being devolved?

What is being devolved under Wales Act (2014)?

- Stamp Duty Land Tax (SDLT)
  - “Land Transactions Tax”
- Landfill tax
  - “Landfill Disposals Tax”
- Welsh Variable Rate of Income Tax (on non-savings income)
  - Subject to a referendum – requirement removed in Wales Bill 2016
  - UK rates of tax in Wales would be reduced by 10 percentage points (ppt)
  - Welsh Government set Welsh Rates on top of these (lower) UK tax rates
  - E.g. Welsh Govt. set rates of 10, 10, and 15 ppts on top of the UK rates for basic, higher and additional rates
    - Overall basic, higher, and additional rates of 20%, 40% and 50%

What is the rationale for these taxes?

- SDLT and Landfill Tax
  - Small, and therefore add little to overall financial accoutability
  - But closely linked to key devolved policy areas (housing, economic development and environment)

- Income Tax
  - Large, visible and highly salient tax, so increase financial accountability
  - Direct financial stake in improved Welsh economic performance
  - Ability to increase/reduce to increase/reduce spending

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How much scope for income tax changes?

- 1 percentage point increase across all bands would raise approx £200m.
- What about increases in the top rate of income tax in Wales?
  - HMRC estimates 50% top rate would raise virtually nothing for UK
- Difference in rate between England and Wales could be subject even more to revenue-reducing behavioural response
  - Migration between Wales and England
  - Shifting income into dividends to avoid the Welsh rate of tax
- But while Welsh Govt. keeps the full “mechanical” effects of higher rate, only bears the behavioural effects on its share of income tax
  - UK Government bears impact on remaining UK income tax in Wales
- So difficult to forecast impact of higher top tax rates

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Property tax – room for radical reform?

- Land Transactions Tax bill introduced – rules broadly mirror UK SDLT
  - A number of simplifying changes (e.g. residential leases)
  - Rates and thresholds to be set in future
- But transactions should not be taxed at all
  - Why impose heavier tax on properties that change hands more often?
  - Reduced labour mobility one symptom
- Set LTT rate = 0, and make up revenues elsewhere
  - Revalue council tax and make proportional to value (currently regressive)
  - Replace NDRs with a business land-value tax
  - Immobility of property means easier for Wales to have a distinct (and better) policy than England than for other tax bases

New taxes for Wales?

- Wales Act 2014 also allows for Welsh Government to request power to legislate for new taxes
  - Bevan Foundation looked at a number of options
- Key questions for thinking about new tax
  - What is the rationale for a tax?
    - Encouraging or discouraging particular behaviours?
    - Raising new revenues to boost public spending?
  - How will it be administered and enforced?
  - How does the tax fit in with existing Welsh and UK tax system?
    - Will it have knock-on effects for other tax revenues?
    - Are legislation and definitions consistent?
  - Will people respond by shifting activity out of Wales?
    - Wales has a very porous border with England
    - Could such response make underlying problem worse?

How new taxes will be assessed

- UK Government will judge requested new taxes
  - Does it affect UK macro or fiscal policy or UK single market?
  - Is it compliant with UK (or EU) legislation?
  - Does it affect tax avoidance risks?
  - How significant are compliance costs?
  - Is it aligned with devolved powers?
- Welsh Govt will have to prep detailed impact assessment
  - On Welsh revenues and economic activity
  - On individuals and businesses
  - Against all relevant legislation (e.g. equalities, state aid, etc)
  - Knock on effects for UK government and rest of UK

What is a Fiscal Framework?

A Fiscal Framework is…

- Set of rules on
  - How to adjust block grant funding given newly devolved revenues
  - Financial transfers if policies affect other governments
  - Dispute resolution
  - Borrowing powers
  - How revenue forecasts are made

Calculating a block grant adjustment (BGA)

- Adjusting the block grant in year 1 is conceptually simple:

Initial Block Grant

- Additional revenues

New Block Grant

- But what about in subsequent years?

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Adjusting block grant in subsequent years

- Cannot just keep making the same cash-terms adjustment
  - Need to account for inflation and economic growth
- But cannot adjust based on how much is raised from devolved taxes and spent on devolved welfare each year
  - Remove incentive to grow tax revenues
  - Changes in block grant would neutralise such efforts

Revenues up £500m | **Block grant cut £500m** | **= no net change**

- Instead need a way to index the block grant adjustment (BGA) over time
  - Many ways to do this and precise way can have a big impact on devolved govt budget

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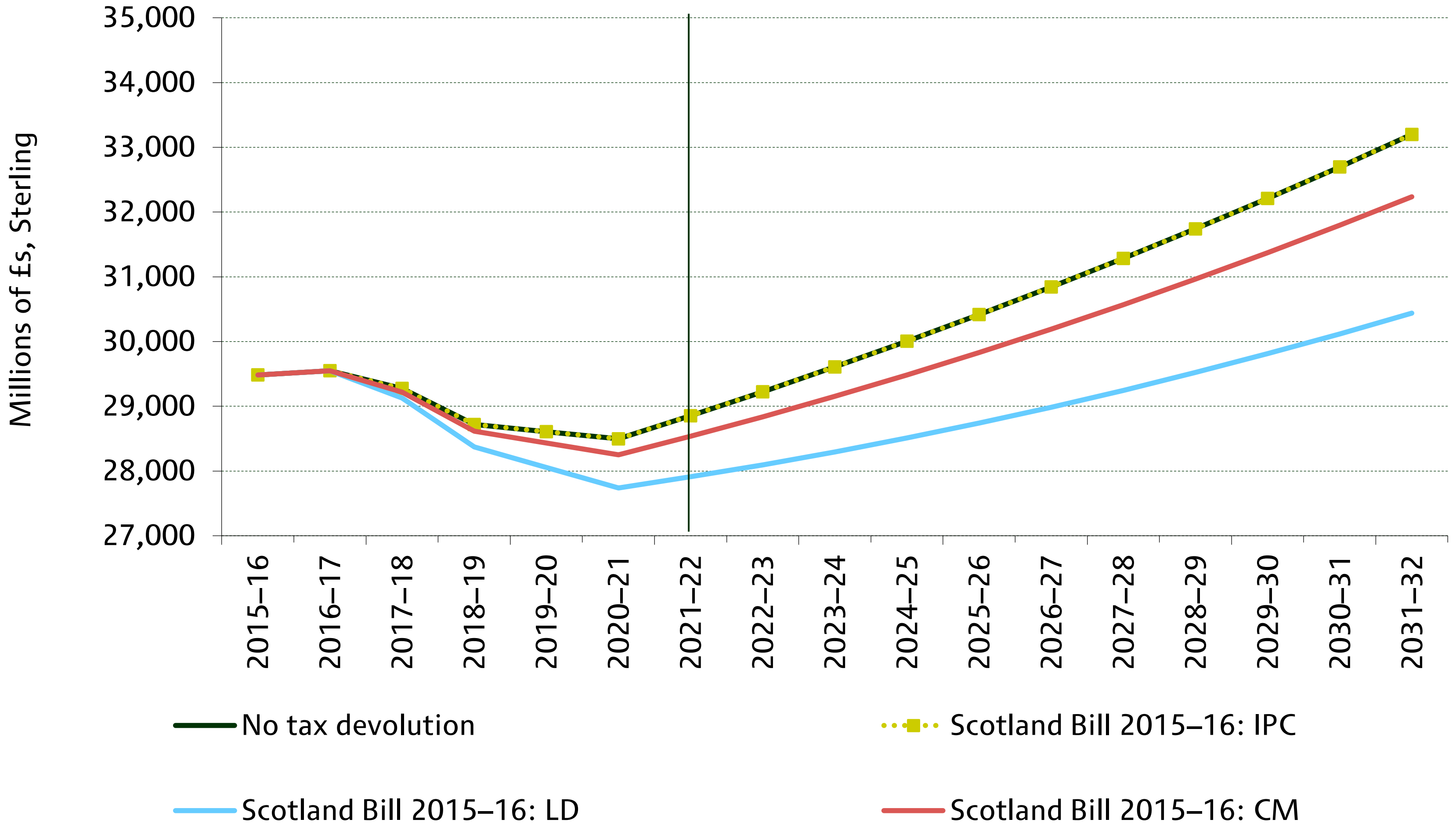
What was agreed for Scotland?

- For 5-years, BGA will be indexed according to
  - % change in revenues per capita in rest of the UK (rUK)
  - % change in Scotland's population
- Example:
  - rUK revenues per capita up 5%
  - Scotland's population up 0.3%
  - BGA would therefore increase by 5.3%, whatever happened to rUK population and aggregate rUK revenues
- Scotland's budget unaffected by devolution if revenues per capita grow at same % rate as rUK
  - Does not lose out from its lower initial revenues
  - Nor its slower population growth

Impact of tax devolution if same per capita revenue growth…



Implications of this approach to indexing BGA

- Scotland is insulated from revenue/welfare spending shocks that affect it in same way as rest of UK
  - e.g. a global recession
- But Scotland bears 100% of risk at margin for faster/lower *relative* growth in revenues/spending per capita
  - Incentives to grow its revenues
  - But Scotland bears all risk of short or long-term divergence in revenue/welfare spending trends

What about Wales? (I)

- Welsh revenues per capita and (recently) population growth even lower than in Scotland
  - Relatively more costly to Wales if UK government imposed its model
- Welsh Governance centre showed Wales may struggle to generate same % growth in revenues per capita
  - Increasing income tax allowance relatively more costly
  - Lack of high value properties (concentrated in South East England)
- If true, Wales would lose from devolution under IPC method
  - Exclude South East of England from BGA calculations?
  - Calculate and index BGAs for each tax band separately?

What about Wales? (II)

- More fundamentally, does Wales want to bear 100% of risk of convergence/divergence in devolved revenues?
  - Scottish Govt sees devolution as stepping stone to independence
  - Will Wales want a method with more risk-sharing?
- How much extra borrowing powers will Wales get?
  - If income tax partly devolved, existing plans for £500m capital borrowing limit about pro-rata with Scotland
  - Needs enough resource borrowing to smooth shocks that affect Wales differently to rUK
- Is it worth setting up independent Welsh Fiscal Commission?
  - Fewer taxes and less revenue to forecast
  - At very least budget documents need to be much better at setting out revenues as well as spending

Summary

Summary: where scrutiny most needed?

- Specific taxes and tax bills
  - What are the costs/risks versus benefits of deviating from UK policy?
  - Is there scope to be more radical (e.g. property taxes)?
- When costing policies are assumptions about behavioural responses plausible? How much risk policies will cost more / raise less?
- Fiscal Framework
  - BGA calculations right for Wales?
  - Sufficient borrowing powers
- Transparency of devolved revenues and how fit into budget
  - Otherwise how will tax devolution improve accountability?