Empowerment and Responsibility: Financial Powers to Strengthen Wales

November 2012
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Foreword

To be commissioned by the United Kingdom Government to make recommendations that could affect the lives of every single fellow citizen of Wales is a challenge, a responsibility and a privilege. The challenge, responsibility and privilege are all the greater when the recommendations are about financial matters, and made at a time of economic uncertainty and public austerity.

Seven Commissioners, with diverse experience and differing views about many things, have worked as a team over the last year with a determination to fulfil the task we accepted in October 2011. We have been assisted by excellent officials. This foreword is an opportunity for me to thank most sincerely my fellow Commissioners and our staff.

It is also an opportunity to thank equally sincerely all those who contributed in any way to our work – from telling us their views at a drop-in session to sending us substantial pieces of evidence.

It was of cardinal importance to us that we did all we could to ensure that our proposals would command a wide degree of support – something that our terms of reference require. We have consulted widely and always asked ourselves whether our recommendations would indeed achieve the broadest consensus. I am delighted that this report was agreed unanimously.

We were required to make proposals that would improve financial accountability while remaining consistent with the United Kingdom’s fiscal objectives. We believe we have done this. Our recommendations would empower the Welsh Government and bring greater responsibility by giving Wales its own taxation and borrowing powers.

Our terms of reference also required us to produce a package of recommendations. Our recommendations should indeed be treated as a package. I am proud to commend that package to Her Majesty’s Government for early implementation.

Paul Silk
November 2012
Executive Summary

Introduction
The establishment of the Commission on Devolution in Wales was a commitment in the UK Government’s Coalition Agreement. The Commission was launched on 11 October 2011, with the support of the Welsh Government and the three opposition parties in the National Assembly for Wales.

In this summary we set out how we have gone about our work, how we have drawn upon the evidence presented to us, the principles which underpin our thinking, and the recommendations we have reached as a result.

Our Commission (Chapter 1)
Our remit is divided into two parts. During Part I, we have been asked to consider the National Assembly for Wales’s current financial powers in relation to taxation and borrowing and report by Autumn 2012. Our terms of reference for Part I were:

“To review the case for the devolution of fiscal powers to the National Assembly for Wales and to recommend a package of powers that would improve the financial accountability of the Assembly, which are consistent with the United Kingdom’s fiscal objectives and are likely to have a wide degree of support.”

Following the publication of this report we will begin work on Part II, reviewing the current non-financial powers of the National Assembly for Wales. We will report on Part II by Spring 2014.

Consideration of the Holtham Commission’s proposals for funding reform in Wales and Welsh Ministers’ existing borrowing powers was excluded from our terms of reference. These issues are being taken forward through a separate bilateral process between the UK and Welsh Governments.

The Secretary of State for Wales appointed Paul Silk to chair the Commission. In addition, two other members were appointed independently of political parties, Dyfrig John CBE and Professor Noel Lloyd CBE.

Each of the political parties in the National Assembly for Wales also nominated a member to the Commission. They are: Professor Nick Bourne, the Welsh Conservative nominee; Sue Essex, the Welsh Labour nominee; Dr Eurfyl ap Gwilym, the Plaid Cymru nominee; and Rob Humphreys, the Welsh Liberal Democrat nominee.

Our method of working
We have approached our task with an open mind, a keenness to engage with the people of Wales and to consider the views of other parts of the United Kingdom, and a commitment to base our thinking on evidence and experience. We have sought to be open, transparent and consensual in our work.
We have heard the views of the public by holding 28 public meetings across Wales and through our questionnaire and opinion poll, the most focussed and in-depth held in Wales on this subject.

We placed our call for evidence on our website, and wrote to hundreds of individuals, businesses and other organisations, inviting them to contribute to our discussions and considerations. We have received invaluable contributions. We have consulted extensively with the Welsh and UK Governments and with Members of the National Assembly for Wales and of both Houses of Parliament. We also visited Scotland and Northern Ireland.

On our website, we published extensive information about our work and meetings, our public engagement, evidence presented to us and our own research and public debates.

We have been fortunate to be able to draw on the final report of the Holtham Commission, which has wide support among the main Welsh political parties. We have also been able to draw on the Commission on Scottish Devolution’s Report and on the Scotland Act 2012 that implements many of its proposals, as well as other developments both in Scotland and Northern Ireland.

We are grateful to all those who took the time to give us the benefit of their views and experience. We have drawn on their contributions, as well as our own research, to reach our conclusions. Our agreed report marks the conclusion of our work on the first part of our remit.

How Wales is currently funded (Chapter 2)

Spending by the Welsh Government and Welsh local authorities amounts to well over 50 per cent of identifiable public spending in Wales, with the UK Government responsible for the remainder.

The bulk of the budget of the National Assembly for Wales and the Welsh Government comes from a block grant from the UK Parliament. Changes in this block grant largely reflect spending decisions made by the UK Government for programmes in England that are devolved in Wales, using a mechanism called the Barnett formula. This formula has been used since 1978, long before devolution, to decide how the Welsh Office was funded as a department of the UK Government. It has carried on largely unchanged from that time. Once the block grant is transferred, it is up to the Welsh Government, with the National Assembly’s approval, to decide how it will be spent.

The Welsh Government and National Assembly for Wales cannot change the size of the Welsh budget. The Welsh Government has wide spending powers, but it does not have tax powers, apart from local taxation - it sets the level of non-domestic rates and influences rates of council tax.

Wales, along with most other parts of the United Kingdom, receives more in spending than it raises in taxation. This characteristic of fiscal transfers is important for the economic success of the Union and is maintained in our proposals.

Principles of fiscal devolution (Chapter 3)

In international terms, while there is no single best devolved funding model, the National Assembly for Wales is unusual, if not unique, in having legislative and spending powers but not tax and borrowing powers. Other similar ‘sub-national’ governments in other countries have these powers.

We have considered what the principles should be for assessing a funding system and, from evidence received, we decided these to be: accountability; autonomy; cooperation and constructive engagement between the UK Government and the devolved administrations;
We believe that any change in the system of funding for Wales should be judged against these principles, with particular emphasis on accountability, empowerment, efficiency, economic incentivisation and equity. Changes to the way in which the Welsh Government is funded should benefit Wales and therefore the United Kingdom.

These principles have underpinned the recommendations we have reached throughout this report, while recognising that it may be difficult to meet all the principles to the same extent.

**What funding model should be in place?**

We have then turned to possible models for funding the Welsh Government and assessed these against our principles. The four most common models are the existing block grant system; block grant plus assignment of tax receipts without devolving the power to vary tax rates; block grant plus some tax devolution; and moving towards full fiscal devolution where spending in Wales would be determined by taxes raised in Wales.

In assessing these models, we have had regard to our terms of reference, which asked us to suggest how to improve the financial accountability of the National Assembly for Wales. The existing system has certain strengths. The freedom which the Welsh Government has in how to spend the money it receives has provided some financial accountability for the devolved institutions.

But the present system also has shortcomings. Most significant to our remit is the shortcoming that, because the budget comes largely in a grant from the UK Parliament, the Welsh Government and National Assembly for Wales are not accountable to the Welsh electorate for how revenue is raised in the same way that they are for how it is spent. This is unlike local authorities in the United Kingdom or devolved governments overseas. We believe changes to the existing system could deliver greater responsibility and empowerment to the Welsh Government.

We believe the block grant alone, or with assigned taxes, does not provide sufficient financial accountability and empowerment. Fuller fiscal autonomy would remove the fiscal transfer on which the successful Union is based. We have therefore concluded that a combination of block grant with some tax devolution would be best for Wales.

**Which taxes should be devolved? (Chapters 4 and 5)**

We have then considered which taxes should be devolved. We have assessed any potential benefits of devolving specific taxes, focussing on the principles discussed above, as well as the potential consequences and costs, including cross-border impacts if tax rates were different in Wales, administrative consequences and the interaction between the devolution of tax powers and the block grant.

There is a range of smaller taxes that, if devolved, while only going a limited way to increasing financial accountability would better empower the National Assembly for Wales to deliver policy objectives in devolved areas. We have therefore recommended that Stamp Duty Land Tax, landfill tax and (subject to on-going state aid discussions) aggregates levy should be devolved to the Welsh Government. We have also recommended the devolution of long haul rates of Air Passenger
Duty, and consideration of full devolution in the future. We do this in the context of the wider consideration of regional airport developments across the United Kingdom associated with the independent commission on airport capacity, chaired by Sir Howard Davies.

In addition, we have recommended that business rates should be fully devolved to the Welsh Government in the same way as in Scotland and Northern Ireland, provided the UK Government and Welsh Government agree the appropriate adjustment to the Welsh block grant.

However, for the financial accountability and empowerment of the National Assembly for Wales to be improved sufficiently, it should be responsible for raising a more substantial proportion of its spending. It should be responsible for a tax that most people pay and are conscious of, so that decisions made by the National Assembly for Wales are ones in which most people have a stake. Of the four larger taxes (corporation tax, Value Added Tax, National Insurance Contributions and income tax), we have concluded that income tax would be appropriate for partial devolution. As in Scotland, the taxation of income on savings and dividends should not be devolved.

We have recommended that the Welsh Government should share responsibility for income tax at all rates with the UK Government. The most straightforward way for this to happen is for the UK Government to decide the structure of income tax, including the personal allowances and the income thresholds to which income tax rates are applied. The UK Government would then reduce each rate of income tax that applies in Wales by ten pence in the pound, and also reduce the grant to the Welsh Government by an equivalent amount.

The National Assembly for Wales would then vote to decide the level of Welsh income tax for each rate (currently basic, higher and additional) individually. This could restore the 10p that was deducted (to restore the status quo) or different rates could be applied to each rate. The power to individually vary income tax rates that are applied to each band in Wales is essential to the design of the devolved income tax system in Wales. If the tax rates were raised, the Welsh budget would be higher; and if they were reduced, the Welsh budget would be lower.

Over time the revenue from the devolved Welsh income tax may increase more or less than the block grant depending on whether the Welsh income tax base grows faster or slower than the rest of the United Kingdom. Recent trends have been favourable for Wales; and devolving the responsibility for powers over income tax would further incentivise the Welsh Government to improve the performance of the Welsh economy. In this context we have recommended that the block grant adjustment mechanism in the Holtham report (the indexed deduction method), which has been adopted by the UK Government in Scotland, should be applied in Wales.

We have considered carefully the arguments which we have heard against devolving income tax. There are, for example, concerns about the porous border with England. If income tax were devolved as we propose, the Welsh Government would need to consider carefully any cross-border impacts in setting Welsh income tax rates, but we think that any such impacts should be manageable under our proposed system.

In summary we believe that our income tax proposals will create a fairer public finance system for Wales by enabling the size of the Welsh budget to be decided in Wales and by giving Wales a share of increased tax revenues when the Welsh economy performs better than the UK average.
We have not recommended that corporation tax be devolved, as the costs would outweigh the benefits – unless it is devolved in Scotland and Northern Ireland, in which case devolution would also need to be offered to Wales. We have, however, recommended that the Welsh Government should be able to introduce more Enterprise Zones in Wales that benefit from increased capital allowances than its population based share, provided the Welsh Government bears the cost.

We have also made a number of detailed recommendations on how devolved taxation should be administered, on future UK taxes and on a power enabling the Welsh Government to introduce innovative Welsh taxes if it wishes, similar to the power in the Scotland Act.

While these recommendations will reduce the National Assembly’s reliance on the grant from the UK Parliament, the grant will still provide a substantial share of its funding. We think that this is right because it reflects the principle of the Union that taxes are pooled together and shared out in the form of a grant.

The intergovernmental talks between the UK and Welsh Governments have been considering the basis of this grant, referred to as ‘fair funding’. We welcome these talks. ‘Fair funding’ is outside our terms of reference, but we have recommended that the transfer of income tax powers to the Welsh Government should be conditional on resolving the issues of fair funding in a way which is agreed by the UK and Welsh Governments.

**Borrowing (Chapter 6)**

At present, the Welsh Government can only borrow from HM Treasury to manage its cash flow. Its capital expenditure, like its current expenditure, is determined by the Barnett formula (with the exception of presently unused capital borrowing powers inherited from the Welsh Development Agency - these are beyond our remit and are being considered in the intergovernmental talks).

The tax powers we have recommended will give the Welsh Government some control over its total spending, but to be fully accountable for its spending decisions it should be able to influence the total of its capital spending in any one year as well. So we have recommended the Welsh Government has the capacity to borrow for capital investment on a prudent basis subject to limits agreed with HM Treasury. Borrowing does not, of course, increase the total that is available to spend in the long run because it has to be repaid, with interest. But it does provide useful flexibility for the Welsh Government to manage major capital investment projects and, like the Scottish Government’s borrowing powers, can be managed within the United Kingdom’s overall macro-economic framework.

In addition, the Welsh Government should be given similar powers to the Scottish Government over borrowing for current spending to manage the volatility of tax receipts under the new funding system.

We have also recommended that the UK and Welsh Governments should work together to promote other innovative ways of increasing investment in Wales, although we do not believe that new powers are required in these areas.
Further improving financial accountability (Chapter 7)

We have also made a number of recommendations about how financial accountability can be improved through ways other than devolving tax and borrowing powers. It was clear from the evidence we received that people would like to see better information on the Welsh public finances, economy and public services; the strengthening of institutional arrangements for devolved funding; improvements to the way public spending is planned and controlled in Wales; and greater transparency.

We have recommended a series of measures which aim to achieve this. These include improved tax and other financial data for Wales; consideration of a possible wider role for the Office for Budget Responsibility on the public finances and economy of Wales; strengthened consultation and working arrangements between institutions; and improvements to the Welsh public spending system.

Implementation (Chapter 8)

Our recommendations represent significant changes and therefore need to be introduced on a step-by-step basis.

We believe a new Wales Bill should be introduced in this Parliament to take forward the recommendations we make which require legislation. Changes which do not require legislation should be introduced as soon as possible.

The devolution of income tax represents a fundamental constitutional shift in powers from London to Cardiff. We believe that the devolution of income tax should be subject to a referendum. The provision for this referendum should be contained in the Act which devolves tax and borrowing powers.

Institutional arrangements need to be strengthened. We recommend a number of possible ways of achieving this such as setting up a Welsh Treasury function in the Welsh Government and building the National Assembly for Wales’s capacity for financial scrutiny.

The overall impact and looking to the future (Chapter 9)

Throughout our work, we have worked as a team and we are satisfied our package of recommendations meets the Commission’s remit.

The package would result in changes that are significant, rational and practical. Taken together these recommendations would create a Welsh tax and borrowing system for the first time. They would mean that around a quarter of the Welsh budget would be funded by taxes decided and raised in Wales. In our view that would provide real financial accountability, empowerment, fiscal responsibility and choice for the National Assembly for Wales.

The taxation and other proposals we have made should be kept under review as circumstances change. Particularly important in this context will be the outcome of the Scottish referendum on independence.

We believe the package we recommend meets the fiscal principles that we adopted:

- it would strengthen accountability by empowering the National Assembly for Wales to set its own budget, so linking taxation and representation at the Welsh level as well as the UK level;
• it would promote efficiency and growth by providing additional levers and incentives to strengthen the Welsh economy and to develop other devolved policies;

• it would promote equity and fairness by ensuring Welsh spending is related in some measure to Welsh taxation, by enabling the National Assembly for Wales to develop a Welsh tax system that accords with the Assembly’s democratic mandate, and by providing Wales with borrowing powers following those in Scotland and Northern Ireland;

• it would promote a funding settlement based on the principles of agreement and mutual consent;

• it would promote the principle of fiscal discipline by maintaining fiscal credibility at the United Kingdom and Welsh levels, and would maintain a stable and predictable funding system;

• it would promote the principle of transparency in the operation of the new system; and

• it would promote the principle of simplicity by avoiding devolution in more complex areas of the tax system while offering the opportunity for the Welsh Government to introduce more simple devolved taxes.

We have ensured that our recommendations are firmly based on the available evidence, and we have drawn extensively on the wide range of views presented to us through all the methods we have used to garner opinion.

We have assessed the impact of our recommendations on Wales and other parts of the United Kingdom. We believe they will strengthen the Welsh economy and business, and benefit all parts of Wales and the United Kingdom as a whole.

Central to our work has been a desire to secure a wide degree of support. This report has been agreed by the whole Commission and we commend it to the UK Government for speedy implementation in consultation with the Welsh Government.

RECOMMENDATIONS

We set out below the recommendations we have made in the order they appear in the main report.

Chapter 3

R.1. The current funding arrangements for the Welsh Government do not meet the requirements of a mature democracy and are anomalous in an international context. The funding model of a block grant and some devolved taxes best meets sound principles for funding the Welsh Government. We therefore recommend that part of the budget for the Welsh Government should be funded from devolved taxation under its control.

Chapter 4

R.2. Business rates should be fully devolved subject to the Welsh and UK Governments agreeing the details and assessing any risks involved.

R.3. Stamp Duty Land Tax should be devolved to the Welsh Government with Welsh Ministers given control over all aspects of the tax in Wales. A fixed deduction should be made to the block grant with the value of this agreed between the Welsh and UK Governments taking due consideration of the volatility of receipts.
R.4. Landfill tax should be devolved to the Welsh Government with Welsh Ministers given control over all aspects of the tax in Wales. A fixed deduction should be made to the block grant with the value of this agreed between the Welsh and UK Governments taking due consideration of the declining taxable base.

R.5. Subject to the outcome of discussions between the UK Government and the EU Commission on state aid issues, aggregates levy should be devolved to the Welsh Government, with Welsh Ministers given control over all aspects of the tax in Wales. A fixed deduction should be made to the block grant with the value of this agreed between the Welsh and UK Governments taking due consideration of the declining taxable base.

R.6. We recommend that APD should be devolved for direct long haul flights initially and recommend that devolving all rates for APD to Wales should be part of the UK Government’s future work on aviation taxation, which should include considering the wider case for regional differentiation for APD or airport congestion charging. We recommend that this issue should be considered in the context of the Davies review and any developments in Scotland and Northern Ireland. A fixed deduction should be made to the block grant with the value of this agreed between the Welsh and UK Governments taking due consideration of the forecast tax revenues in Wales.

R.7. We do not recommend that fuel duty should be devolved. We recommend that in the light of experience of the fuel rebate pilot scheme, the UK Government should assess the extension of the scheme to some rural and remote areas in Wales, subject to EU agreement.

R.8. We recommend that the following taxes should not be devolved:

- alcohol and excise duties;
- Vehicle Excise Duty;
- Capital Gains Tax;
- Insurance Premium Tax;
- stamp duty on shares;
- Inheritance Tax;
- betting and gaming duties; and
- Climate Change Levy.

R.9. We recommend that when the UK Government is considering introducing new taxes in devolved areas of policy, there should be a presumption in favour of devolving powers over the tax to the Welsh Government.

R.10. Where UK-wide taxes and reliefs are not devolved, we recommend that:

a. the UK Government should keep under review the scope for introducing tax reliefs which would help to support the Welsh economy in an affordable and cost effective way subject to EU state aid constraints; and

b. if the UK Government changes the thresholds and allowances or rates for a tax that is not devolved, which includes an element of geographical targeting (for example, capital allowances in Enterprise Zones in selected areas), then an assessment should be made in consultation with the Welsh Government as to whether the Welsh Government should be able to fund additional coverage.
R.11. The National Assembly for Wales should be given a power to legislate with the agreement of the UK Government on a case by case basis to introduce specified taxes and any associated tax credits in Wales. The Welsh Government should retain the revenue from these without a deduction to the block grant. The UK Government should adopt a flexible approach to any proposal for these taxes from the Welsh Government.

Chapter 5

R.12. We do not recommend devolving corporation tax to Wales. However, if the UK Government were to agree to devolve corporation tax to both Scotland and Northern Ireland, we recommend that the same powers should be given to Wales.

R.13. We recommend that the enhanced capital allowances should be able to be offered within more enterprise zones in Wales subject to state aid rules and provided the Welsh Government pays the incremental cost.

R.14. Variation of VAT rates within a member state is prohibited by EU law. We therefore have no option but to rule out the devolution of VAT, although we recognise that there are also other arguments against the devolution of VAT. To make devolved budget adjustments when those adjustments are not the result of the actions of the Welsh Government could be regarded as the opposite of improved accountability. As a result we do not recommend assigning VAT.

R.15. We do not recommend that NICs in their current form should be devolved. There is an intrinsic link between contributions and the National Insurance Fund which funds social security benefits. We recommend that the UK Government should give further consideration to regionally differentiated adjustments, such as the employers NICs holiday, to support the labour market within state aid rules. The Welsh Government should be able to fund extra such geographically differentiated adjustments within Wales, if compatible with EU commitments and the UK social security system.

R.16. We recommend that the UK and Welsh Governments should share the yield of income tax. The Welsh Government should have responsibility for setting income tax rates in Wales and we recommend the following package:

a. income tax on savings and distributions should not be devolved to the Welsh Government;

b. there should be new Welsh rates of income tax, collected by HMRC, which should apply to the basic and higher and additional rates of income tax;

c. the basic, higher and additional rates of income tax levied by the UK Government in Wales should be reduced initially by 10 pence in the pound. Over time the Welsh Government’s share could increase if there is political consensus;

d. the Welsh Government should be able to vary the basic, higher and additional rates of tax independently;

e. the Welsh Government should not be restricted in its rate setting above the reduced UK rates;

f. the block grant adjustment mechanism should be based on the indexed deduction method as advocated by the Holtham Commission and being implemented in Scotland, which automatically incorporates the principle of ‘no detriment’; and
g. there should be transitional arrangements following the introduction of income tax devolution, in particular to help manage the transfer of risk.

R.17. We recommend that the Office for Budget Responsibility (OBR) should produce Welsh income tax forecasts in a similar way to Scotland and the amounts forecast should be assigned to the Welsh Government prior to the introduction of legislation, without any impact on the Welsh Government’s spending power.

R.18. We recommend that the transfer of income tax powers to the Welsh Government should be conditional upon resolving the issue of fair funding in a way that is agreed by both the Welsh and UK Governments.

Chapter 6

R.19. We recommend that Welsh Ministers should be given an additional power to borrow to increase capital investment above the Welsh Government DEL budget. There should be an overall limit to such borrowing, at least proportionate to that in Scotland, whilst taking into consideration the relative lack of exposure to PFI in Wales. The agreed annual profile should provide some flexibility and be subject to review in each spending review. Borrowing should be from the National Loans Fund and commercial sources. We also believe that the Welsh Government should be able to issue its own bonds.

R.20. We recommend that new powers for Welsh Ministers to borrow for short term purposes should be introduced to manage cash flow and volatility in taxes when devolved taxes are in place, similar to those in the Scotland Act 2012.

R.21. We recommend that the Welsh and UK Governments should work together to promote increased investment in Wales through the variety of funding mechanisms available.

Chapter 7

R.22. There is opportunity for improving the availability of information to increase financial accountability, public understanding and transparency, and we recommend the following, subject to a detailed assessment of the costs and benefits involved by the UK Government and Welsh Government as appropriate:

a. estimates of spending in England on services which are devolved in the case of Wales should be made available to help inform the debate on public finances in Wales;

b. consideration should be given to whether the ONS United Kingdom accounts should include a ‘sub-national’ tier of government spending;

c. figures on the amount of tax collected in Wales should be produced. Such figures should also include estimates of the Welsh fiscal balance. This country and regional analysis should be done on a consistent basis across the United Kingdom;

d. we encourage the UK Government and the devolved administrations to publish annually key comparative statistics in devolved and non-devolved areas; and

e. the Welsh Government should consider whether more information could be published on the economy in Wales including on Welsh GVA or other income measures, as well as on economic forecasting.
R.23. The following institutional changes should be made to improve financial accountability:
   a. consideration should be given to the OBR or another body having a wider role in either
      producing or validating information on public finances and the economies of Wales,
      Scotland and Northern Ireland; and reviewing and auditing technical aspects of the
      devolved funding system where appropriate;
   b. changes to the Statement of Funding Policy should be agreed between the UK
      Government and devolved administrations wherever possible and transparently
      recorded;
   c. the current finance ministers’ meetings should be formalised;
   d. the present arrangement whereby the Chief Secretary to the Treasury has attended the
      National Assembly’s Finance Committee to answer questions on the UK Budget should
      be formalised; and
   e. more information should be made available on the current scrutiny and accountability of
      public spending in Wales.

R.24. The Welsh Government should be allowed to switch spending from capital to resource
       spending within the terms of a concordat agreed with HM Treasury, in the light of the
       Welsh Government’s record on budget management and provided the UK Government’s
       fiscal targets are not put at risk.

R.25. The UK and Welsh Governments and other devolved administrations should review
       experience of the devolved budget exchange scheme in the next spending review and
       agree appropriate flexibility provided the UK Government’s fiscal targets are not put at risk.

Chapter 8

R.26. Devolution of income tax should be subject to a referendum in Wales. Provision for such a
       referendum should be contained in the Act which introduces tax and borrowing powers.

R.27. A new Wales Bill should be introduced in this Parliament to devolve tax and borrowing
       powers. A bill to devolve tax and borrowing powers should not wait until the completion of
       Part II of our work. Changes which do not require legislation should be introduced as soon
       as possible.

R.28. The Welsh Government should set up a Welsh Treasury to manage the new powers we are
       recommending.

R.29. The new funding system will require a strengthening of the institutional arrangements to
       deal with finance:
   a. a joint Intergovernmental Bilateral Committee on Welsh Fiscal Devolution should be
      established to meet at least twice a year following the OBR’s biannual forecasts to
      discuss taxation and macroeconomic policy;
   b. the relationship between HMRC, the Department for Work and Pensions, and the Welsh
      Government on income tax should be set out in a Memorandum of Understanding,
      which should be published in advance of implementation;
   c. for the National Assembly for Wales and Welsh Government, the lines of accountability
      of HMRC in relation to the Welsh rate of income tax should be similar to those of HMRC
      to the UK Parliament and Government. An HMRC Additional Accounting Officer should
      be made specifically accountable for the collection of the Welsh rate of income tax;
d. the Wales Bill should enable the National Assembly for Wales to compensate HMRC for the net additional costs associated with implementing and maintaining the Welsh rate of income tax. For the taxes that are to be wholly devolved (SDLT and Landfill tax) and any new taxes, the Assembly will need to agree formal arrangements, for example a contract or accompanying service level agreement, with the body, either new or existing, which they decide to administer the taxes;

e. where a varying tax rate could lead to an increase or decrease in liabilities for the UK Government, the principle which is set out in the Statement of Funding policy that ‘the body whose decision leads to the additional cost will meet that cost’ should be adhered to;

f. the UK Government should make sure that the Welsh funding system is as transparent as possible with the key components either verified independently or dependent on independent sources. The OBR should be responsible for forecasting Welsh tax receipts, based on data that will include information provided by the Welsh Government. A memorandum of understanding between the OBR, HMRC and HM Treasury should be published in the lead up to implementation alongside more detail on the forecasting methodology. The ‘no detriment’ principle should apply as in Scotland; and

g. the UK Government should invite the Comptroller and Auditor General as head of the NAO to prepare a report to the National Assembly for Wales on HMRC’s administration of the Welsh rate of income tax. If the Welsh Government decides to approach HMRC to administer the smaller taxes, and HMRC agree, then it will be up to the Welsh Government to decide how any audit arrangement should work.

**R.30.** The Welsh Government and UK Government should work closely together to use both devolved and non-devolved economic powers to strengthen the Welsh tax base.

**R.31.** These changes should be introduced in a phased way to manage the risks of instability in public finances and of windfall gains or adverse shocks to the Welsh Budget.

**R.32.** The National Assembly for Wales should have legislative control of its own budgetary procedures.

**R.33.** The National Assembly Commission may need to consider modest building-up of capacity for financial scrutiny.
Chapter 1 – Our remit and approach

1.1 OVERVIEW

1.1.1 This chapter describes the Commission’s remit and how we went about gathering evidence and analysis to inform our recommendations.

1.2 BACKGROUND

1.2.1 The idea of some form of self-government for Wales has a long history. But it is easy to forget how very recently devolution became a reality when the National Assembly for Wales was created by the Government of Wales Act in 1998. Polling repeatedly shows that there has been a growing acceptance over the last 15 years that devolved government has become a fixture of the constitution.¹ Most of the people of Wales now know that policies in important areas like health and education are decided in Cardiff rather than London. Devolution has developed institutionally from a corporate body to a Welsh Government and a National Assembly for Wales with primary legislative powers.

1.2.2 As Welsh democracy has developed, it was inevitable that the questions about tax devolution and borrowing that this Commission has been asked to consider should be addressed. There is logic in expecting legislative maturity to be complemented by fiscal maturity.

1.2.3 At the same time, Welsh opinion on the devolved institutions remains somewhat divided, and there is a variety of views on the constitutional future ranging from support for an independent Wales to opposition to any devolution at all, let alone more devolution. There are also arguments for consolidation rather than further change, and for a cautious approach to the development of the devolution settlement, especially at a time of economic uncertainty and public austerity.

1.2.4 We have approached our task with open minds, although we have always recognised the need to be prudent and measured. Reckless experimentation is the last thing Wales needs. Our report is written in the context of a Wales, a United Kingdom and a European Union where constitutional ideas are in flux and economic forecasts are gloomy. But while we must be cognisant of where we are now, we also must recognise that we live in a dynamic world and that we are planning for the long as well as short term. As well as proposing changes for today, we will assess our proposals against future developments.

1.2.5 The way in which Wales is currently funded is set out in further detail in Chapter 2. In essence, as with the pre-devolution model, changes in funding are determined by a formula related to changes in comparable funding in England rather than directly negotiated with HM Treasury as is the case for UK departments. The case for reviewing this model has

Empowerment and Responsibility

been raised by many over the years. The Welsh Government established the Independent Commission on Funding and Finance for Wales (the ‘Holtham Commission’), whose report argued the case for improving existing arrangements for financing Wales. We benefited greatly during the course of our work from stimulating discussions with Professor Gerald Holtham, and, on separate occasions, with both other members of his Commission, Professor David Miles and Professor Paul Bernd Spahn.

1.2.6 The progress of devolution within the United Kingdom has also brought with it the case for review. In Scotland, the independent Commission on Scottish Devolution (the ‘Calman Commission’) was set up in 2008 to look at the provisions of the Scotland Act 1998 and to recommend changes to the constitutional arrangements for Scotland. The Calman Commission reported in June 2009. Most of the report’s recommendations that required UK legislation were accepted and taken forward through the Scotland Bill, enacted as the Scotland Act 2012.

1.2.7 Following the UK General Election in May 2010, a Coalition Government was formed between the Conservative and Liberal Democrat parties and a Programme for Government was agreed. In this Coalition Agreement, the UK Government made a commitment that, depending on the result of the March 2011 referendum on primary legislative powers for the National Assembly for Wales, a process similar to the Calman Commission would be established for Wales. The Commission on Devolution in Wales was the result.

Establishing the Commission

1.2.8 Our Commission was established by the UK Government on 11 October 2011, with the support of the Welsh Government and all four political parties in the National Assembly for Wales. By contrast, the Scottish National Party did not participate in the Calman Commission in Scotland.

1.2.9 The Commission’s remit was divided into two parts. We were asked to consider Wales’s current financial powers in relation to taxation and borrowing during Part I and report by Autumn 2012. Following the publication of this report, we will review the current non-financial powers of the National Assembly for Wales and report in Spring 2014.

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Box 1.1: Terms of Reference
An independent Commission will be established to review the present financial and constitutional arrangements in Wales. It will carry out its work in two parts:

Part I: financial accountability
To review the case for the devolution of fiscal powers to the National Assembly for Wales and to recommend a package of powers that would improve the financial accountability of the Assembly, which are consistent with the United Kingdom’s fiscal objectives and are likely to have a wide degree of support.

Part II: powers of the National Assembly for Wales
To review the powers of the National Assembly for Wales in the light of experience and to recommend modifications to the present constitutional arrangements that would enable the United Kingdom Parliament and the National Assembly for Wales to better serve the people of Wales.

1.2.10 Our terms of reference, set out in Box 1.1, focus particularly on improving financial accountability. There is no simple definition of what financial accountability means, although a standard definition might be responsibility for the way resources are used and managed, respecting principles of transparency, scrutiny and public understanding. It is argued that this includes responsibility for how money is raised. When referring to financial accountability throughout this report, we focus on whether political parties should be able to offer Welsh voters the choice between different levels of taxation, spending and borrowing. On this view, an accountable Welsh Government should be empowered to be involved in determining the resources available to it based on the decisions it makes. However, as emphasised earlier, we have approached this subject with an open mind, and we note that some argue that the Welsh Government is already politically accountable for the money it spends. We also examine possible reforms to improve financial accountability other than devolving tax and borrowing powers.

1.2.11 The Commission's remit for Part I did not include consideration of the Holtham Commission’s proposals for funding reform in Wales or Welsh Ministers’ existing borrowing powers. Those issues are being taken forward through a separate bilateral process between the UK Government and the Welsh Government and are referred to in further detail in Chapters 2 and 6.

4 It goes on to state that “in undertaking Part I, the Commission should:
• Provide independent advice on the case for improving the financial accountability of the National Assembly for Wales consistent with the fiscal and constitutional framework of the United Kingdom;
• Consult widely on a package of fiscal powers which would improve the financial accountability of the National Assembly for Wales;
• Make recommendations on whether a package of fiscal powers could be devolved to the National Assembly for Wales which are likely to have a wide degree of support; and
• Consider and make recommendations on how best to resolve the legal and practical implementation issues from devolving a package of fiscal powers, including consistency within the United Kingdom.”
Membership

1.2.12 The Secretary of State for Wales appointed Paul Silk to chair the Commission. In addition, two other members were appointed independently of political parties, Dyfrig John CBE and Professor Noel Lloyd CBE.

1.2.13 Each of the political parties represented in the National Assembly for Wales also nominated a member to the Commission. They are Professor Nick Bourne, the Welsh Conservative nominee; Sue Essex, the Welsh Labour nominee; Dr Eurfyl ap Gwilym, the Plaid Cymru nominee; and Rob Humphreys, the Welsh Liberal Democrat nominee. Biographies of Commission members can be found at Annex A.

1.2.14 A small secretariat of officials from the Wales Office, Welsh Government and HM Treasury supports the Commission. The Commission has a budget of approximately £1 million to fund both Part I and Part II of the Commission’s work, funded by the Wales Office. Throughout the Commission’s work, we have been very conscious of the need to avoid unnecessary expenditure. The Commissioners are not paid, no visits outside the United Kingdom have been undertaken and our research has been conducted in-house by the secretariat, apart from opinion polls commissioned from ICM.

1.2.15 We would like publicly to commend the secretariat for the superb quality of their work and their commitment to the Commission’s success. Our work would have been impossible without them.

1.3 OUR APPROACH: PUBLIC AND STAKEHOLDER ENGAGEMENT

1.3.1 The Commission met formally at least on a monthly basis and held a number of informal meetings and discussions around those meetings. Minutes of our formal meetings are available on our website.

1.3.2 From the outset, we agreed that our eventual recommendations should be in the interests of Wales and the United Kingdom as a whole and that we should only propose change where it brings benefit. We have been determined to be consensual in our approach and base our findings on the evidence presented to us.

1.3.3 We had a clear remit – our recommendations must have a wide degree of support. We strongly believed that to do this, we would need to engage as widely as possible with individuals, stakeholders and businesses inside and outside Wales to hear their views.

Awareness Raising

1.3.4 We were aware that knowledge of how devolution is funded and of options for change in the future is somewhat limited in Wales. We have wanted to raise awareness of our work and give as many people as possible the opportunity to share their views. We have also been determined to operate in an open and transparent manner throughout our work. We agreed a wide ranging communications and public engagement strategy and used a wide variety of communication tools to achieve this.

1.3.5 Our website (http://commissionondevolutioninwales.independent.gov.uk and http://comisiwnarddatganoliyngnghymru.independent.gov.uk) hosts information about our work, our Commission meeting agendas and minutes and the evidence presented to us. We
have sought to stimulate debate in Wales through our website, introducing an interactive section for visitors to get involved and share their views. This included an online forum which hosted four debates on taxation, borrowing, a referendum and the results from our public opinion poll. Although the forums are now closed, a record of the contributions can be found on our website.

1.3.6 We have regularly encouraged awareness and engagement via the media, by issuing press releases on our work and publishing a communiqué following each formal Commission meeting, summarising what was discussed. Copies of all our press releases and communiqués are available on our website. Building a good profile with the media has been important to us, especially in order to highlight the many ways in which people could get involved and share their views. The Chair and other Commissioners have undertaken a number of press, radio and television interviews on a national and regional basis. We also wrote a number of articles for newspapers, including local papers, to highlight our call for evidence, our public events and to target particular sectors such as business.

1.3.7 Our twitter account (@silkcommission) provided short, regular updates and linked to our website, related sites and articles of interest to our work. We have regularly tweeted throughout Part I and our followers have engaged with us and continued to debate issues raised.

1.3.8 In order to summarise the Commission’s remit and outline the areas on which we were seeking the public’s views, we produced a short information leaflet. This was used at our public events and distributed to stakeholders and the public, including at events such as the Royal Welsh Show.

1.3.9 A questionnaire was also devised to gather views. The questionnaire had six multiple choice questions with areas to provide comments and this was made available in paper form and online. Questionnaires could be submitted up to 31 August 2012 and we received 220 responses. A summary of the responses is available on our website under “Papers”.

1.3.10 We have participated in stakeholder events throughout Part I, such as holding a Question Time-style event with Funky Dragon (the Youth Parliament for Wales) with over 50 young people attending. We have also delivered keynote speeches at events such as the Institute of Welsh Affairs’ Wales and the Changing Union conference, the Institute for Government’s ‘Redesigning Devolution: International lessons for the UK’ conference and at the Societies Pavilion at the National Eisteddfod.

Public Events

1.3.11 In order to hear as many views as possible, we made a commitment to visit every local authority area in Wales to consult directly with people. Over the first few months of 2012, we held 28 public events across Wales.

1.3.12 A variety of different types of events were held in order to cater for the needs of as many people as possible. These included public events, panel discussions, coffee morning drop-in sessions, business breakfasts and formal evidence-gathering sessions.

1.3.13 The aim of the events was to disseminate information, and to provide opportunities for citizens throughout Wales to speak to Commissioners, ask questions and share their views.
1.3.14 A summary of the evidence gathered at these events can be found on our website under “Evidence”.

**Box 1.2: Our events**
The map below summarises where we held public events across Wales.

Further details on the events, including dates and the points raised, can be found on our website.
Public Opinion

1.3.15 In addition to our visits throughout Wales, we believed it was vital that we gathered statistical data on people’s attitudes to devolving tax and borrowing powers.

1.3.16 When we began our work, there was limited opinion polling in this area which we could draw upon. As part of the BBC’s St David’s Day opinion poll, we funded a small number of questions exploring the public’s views on these important issues and a random sample of 1,000 Welsh adults over the age of 18 was interviewed over the telephone.

1.3.17 Our St David’s Day poll results showed that 62 per cent of people believed the Welsh Government should be able to vary some taxes in order to vary spending. They also revealed that 66 per cent were in favour of the Welsh Government being able to borrow money to spend on capital projects such as building roads and hospitals. A summary of the results can be found on our website, under “papers”.

1.3.18 These results were similar to findings from polls run earlier in the year for the Western Mail and results from questions funded by the BBC.5

1.3.19 We wanted to explore these issues in greater detail and, after a competitive tendering exercise, commissioned the well-respected public opinion company ICM (advised by distinguished academic consultants) to undertake independently an in-depth opinion poll for us to understand further people’s attitudes to tax and borrowing powers. The poll is the most comprehensive survey to date on those issues in Wales.

1.3.20 The researchers held six focus groups across Wales in April to discuss people’s views on the devolution of fiscal powers. The focus groups were also used to help refine the questions to be used in the main opinion poll. A representative sample of 2,000 Welsh adults was polled by telephone between 11 and 25 May 2012. The interviews were conducted across Wales, and results were weighted to fit the demographic profile of all Welsh adults.

1.3.21 The results were striking in that they were broadly consistent with the earlier polls referred to above, corroborating the finding that the majority of the Welsh public support the devolution of some tax and borrowing powers to the National Assembly for Wales.

1.3.22 But the poll also confirmed that Welsh opinion remains somewhat divided and we have sought to address concerns which emerged. The poll also revealed that knowledge of funding arrangements in Wales is rather limited.

1.3.23 The results can be found throughout the report as evidence in each chapter. The full results and a summary of the findings can also be found on our website.

Evidence

1.3.24 We issued our Call for Evidence on Part I of our remit to over 450 key interest groups, representative bodies and individuals on 25 November 2011 to help inform our thinking and to gauge what might command a wide of support. The Call for Evidence was also published on our website to encourage people across Wales to submit their views by 3 February 2012. Over 50 written submissions from a wide range of organisations and

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5 In addition to our questions in the St David’s Day poll, the BBC also funded some questions relating to the devolution of taxation powers to the Welsh Government.
individuals were received by this deadline, with further submissions following over subsequent months. In total, we received 78 submissions.

1.3.25 A range of organisations was invited to present oral evidence to the Commission, representing a wide spectrum of views. Formal oral evidence sessions with various organisations and individuals were also held in locations across Wales as part of our public engagement programme. A list of those who gave oral and written evidence can be found at Annex B.

1.3.26 Briefing sessions were held for Members of Parliament, Peers and Assembly Members; and the Chair, Dyfrig John and Noel Lloyd gave evidence to the UK Parliament’s Welsh Affairs Select Committee and met the National Assembly for Wales Finance Committee.

1.3.27 We found it helpful that our work was debated in both the House of Commons (3 November 2011) and the House of Lords (19 July 2012), and we have drawn on these debates.\footnote{HC Deb, 3 November 2011, c1122; HL Deb, 19 July 2012, c344.}

1.3.28 We are also grateful that the National Assembly for Wales Finance Committee chose to produce a report Borrowing powers and innovative approaches to capital funding in July 2012, and we have drawn on the evidence in that report.\footnote{National Assembly for Wales Finance Committee (2012) Borrowing powers and innovative approaches to capital funding.}

1.3.29 Our report has been able to draw on the report by the review chaired by Professor Brian Morgan on business rates, commissioned by the Welsh Government, although most of its recommendations are devolved matters for the Welsh Government.\footnote{Business Rates Task and Finish Group (2012) Business Rates Wales Review: Incentivising Growth.}

1.3.30 Tomorrow’s Wales, the Institute of Welsh Affairs and the Wales Governance Centre established a joint project Wales in a Changing Union in response to the setting up of our Commission and we received evidence from their finance working group.

1.3.31 In our report we have summarised in boxes in each chapter some of the evidence which we have received on each aspect of our work. We received a wide range of views from a number of individuals, stakeholders and political parties. The evidence summarised throughout the report aims to provide a flavour of the evidence provided to us. All evidence submitted to us is available on our website.

**Perspectives from elsewhere in the United Kingdom**

1.3.32 As a Commission we have been clear from the outset that, while our work would focus on what is right for Wales, we also needed to consider experiences elsewhere in the United Kingdom and beyond. It is an interesting time for devolution across all of the United Kingdom and we were aware of the potential impact developments elsewhere in the United Kingdom might have on our work. We visited Scotland and Northern Ireland to hear their experiences of devolution. Both visits were invaluable in informing our thinking in Part I of our remit.
1.3.33 In Scotland, we met Sir Kenneth Calman, who chaired the Commission on Scottish Devolution; and representatives from Confederation of British Industry (CBI) Scotland and Trade Union Congress (TUC) Scotland. We also met Scottish Government officials, members of the Scottish Parliament Finance Committee, Reform Scotland and representatives from political parties.

1.3.34 In Northern Ireland, we held meetings with the First Minister and deputy First Minister, CBI Northern Ireland, the Committee for Finance and Personnel of the Northern Ireland Assembly and the Northern Ireland Congress of Trade Unions.

1.3.35 Unlike Scotland and Northern Ireland, there was no such ready way of obtaining the views of England, the largest and most populous nation in the United Kingdom. Yet parts of England, much more than Scotland and Northern Ireland, might be affected by any transfer of fiscal power to Wales. The porous border between Wales and England was well illustrated by the Holtham Commission. Our main opinion poll found that the potential for cross-border issues with England was a concern to people in Wales, particularly in the North East of Wales – and was corroborated by what we heard during our visits there.

1.3.36 We wrote to 16 Members of Parliament representing constituencies bordering Wales or in major cities nearby and to all local authorities bordering Wales to ask for views. We received a limited, though very useful, response. We also contacted bodies in England (such as Manchester and Bristol airports) that might have views about specific aspects of our remit. Those views were not given on behalf of England, and it has not been easy to hear what might be described as the voice of England. However, we were also able to discuss with the Institute for Public Policy Research its important report on English attitudes to devolution, referred to in Chapter 2.9

The International perspective

1.3.37 In addition to considering experiences from across the United Kingdom, we have been mindful to draw upon the research of examples of the devolution of fiscal powers across the world. We produced a research paper on this which is published on our website and the international view is also considered in further detail in Chapter 3.

Research and Analysis

1.3.38 This report is evidence-based, drawing on the evidence submitted to us and what we have heard through our public events and opinion poll during Part I of our work. We have also used the evidence and analysis presented in the Holtham and Calman reports and further analysis was undertaken internally by the Secretariat. This analysis is drawn on throughout this report. In addition, copies of research papers by the Secretariat, which helped set the context of our work, are available on our website under “Papers”.10

10 Papers on an analysis of our questionnaire evidence; and the international, economic, historical, Scottish and Northern Ireland contexts.
1.4 CONCLUSIONS

1.4.1 The Commission was established to consider how the scope of devolution might be changed to serve the people of Wales better within the United Kingdom.

1.4.2 Our remit is divided into two parts. During Part I, we were asked to consider the National Assembly for Wales’s current financial powers in relation to taxation and borrowing and report by Autumn 2012. Following the publication of this report, we will begin work on Part II reviewing the current non-financial powers of the National Assembly for Wales. We will report on Part II by Spring 2014.

1.4.3 The Commission approached its task with an open mind, a determination to engage with the people of Wales and to consider the perspectives of other parts of the United Kingdom and internationally, and a commitment to base its thinking on evidence and experience. We have sought to be open, transparent and consensual in our work.

1.4.4 We are grateful to all those who took the time to give us the benefit of their views and experience. We have drawn on their contributions, as well as our own research, to reach our conclusions. Our agreed Report marks the conclusion of our work on the first part of our remit.

1.4.5 In the next chapter, we look at the current funding arrangements for Wales.
Chapter 2 – Current funding arrangements

2.1 OVERVIEW

2.1.1 This chapter describes the current system for funding the Welsh Government; and sets this in the context of wider developments in devolution across the United Kingdom, including the intergovernmental talks on ‘fair funding’ between the UK Government and Welsh Government.

2.2 HOW WALES IS FUNDED

2.2.1 The current system for funding devolved governments is based broadly on the model used to fund the Welsh Office, Scottish Office and Northern Ireland Office prior to devolution, when they exercised the functions which are now devolved. We describe the system in more detail later, but, in effect, a block budget is provided by HM Treasury to the devolved administrations. Changes to the block budget are made in spending reviews based on their territories’ population and changes in expenditure by the UK Government in England on responsibilities that are devolved in the case of Wales, Scotland and Northern Ireland.

2.2.2 The system is not set out in statute. Instead the rules that govern the funding available to the Welsh Government and National Assembly for Wales, as well as the devolved administrations in Scotland and Northern Ireland, were initially set out in the 1999 Statement of Funding Policy (SFP) published by HM Treasury. The SFP is updated in each Comprehensive Spending Review (CSR) by HM Treasury and is used to calculate the funding available over the Comprehensive Spending Review period (historically three years, but four in 2010). It also sets out any changes to the rules for expenditure. These updates are made in consultation with the devolved administrations and with the agreement of the Secretaries of State for Wales, Scotland and Northern Ireland. The latest version was published in October 2010.\(^{11}\)

2.2.3 By way of background, key figures on Welsh public spending are set out in Annex C. A short history of Welsh funding is set out in a research paper published on our website. Key terms are explained in our glossary.

2.2.4 The public expenditure system in Wales is part of the overall UK public expenditure system. The Welsh Government and National Assembly for Wales are responsible for more than half of public spending in Wales, including spending on health, schools and roads. This is called ‘devolved spending’. Some of these public services are directly within the control of the Welsh Government; and some are delivered by public bodies such as Health Boards. Others are provided by local government in Wales, funded by the council tax which they raise and by the Welsh Government’s budget.

\(^{11}\) HM Treasury (2010) Statement of Funding Policy.
2.2.5 The remainder of public spending in Wales is the responsibility of the UK Government and Parliament, and is called ‘non-devolved spending’. The main part is social security payments like pensions and unemployment benefit. There is also ‘non-identifiable’ public spending by the UK Government, which benefits the United Kingdom as a whole and cannot be apportioned to individual parts of the nation state. This includes most defence expenditure and debt interest.

2.2.6 All of this spending, devolved and non-devolved, is paid for by taxation and borrowing by the UK Government, with the exception of spending in Wales financed by council tax and Non-Domestic Rates (business rates as they are commonly known\(^{12}\)). Council tax amounts to around 18 per cent of councils’ budgets or about £1.3 billion and represents a material proportion of local government spending.

2.2.7 Central government taxes are collected by HM Revenue and Customs (HMRC) in Wales and are pooled centrally in the UK Consolidated Fund. Money is then drawn down to finance public spending across the United Kingdom including Wales, so there is currently no direct relationship between the amount of central government taxes raised in Wales and the amount of money spent in Wales.

The Welsh Government’s budget

2.2.8 Devolved funding in Wales, or the Welsh Budget, has two components: the Departmental Expenditure Limit (DEL) and Annual Managed Expenditure (AME). DEL is by far the larger element: it is calculated at the CSR along with the budgets of UK Government departments over the review period, normally three years.\(^{13}\) Welsh Government AME is additional expenditure which is demand-led, such as some aspects of student loans, and is set on an annual basis updated in the UK Budget and in the autumn. The total DEL and AME budget is known as Total Managed Expenditure (TME). It should be noted that most AME spending in Wales, including social security spending, is the responsibility of the UK Government. In addition the element of Welsh spending by local authorities in Wales financed by council tax is local authority AME spending.

2.2.9 The Welsh TME budget is mainly financed by a block grant paid by the Secretary of State for Wales to the National Assembly (having first deducting the Wales Office’s running costs) from funds voted by the UK Parliament. The full detail of the relationship between DEL, AME, TME and the block grant to the National Assembly for Wales is set out each year in the Annual Report of the Wales Office.

2.2.10 With the National Assembly for Wales’s approval and oversight, the Welsh Government is entirely responsible for how it spends this block grant. The only constraint imposed by the UK Government in passing on the grant is the split between capital and revenue expenditure, which is intended to help meet its macro-economic targets for the UK economy as a whole.

2.2.11 In addition to their own budget, Welsh Ministers have control or substantial influence over local authorities’ taxation and spending. Although business rates are collected by local authorities, the level of business rates is decided by Welsh Ministers. Additionally, Welsh Ministers exercise a high degree of influence over council tax through their powers to fund local authority spending by grants and the power to “cap” increases in council tax levels.

\(^{12}\) Throughout the report we use the term business rates when we refer to Non-Domestic Rates.

\(^{13}\) ‘Departmental’ is effectively analogous with a UK Government department.
2.2.12 The Welsh Government and its agencies, and local authorities, are also able to raise income by levying user charges (but not taxes) on devolved services if they so wish.

Welsh public finances – key figures

2.2.13 We provide below some key figures\(^{14}\) on Welsh public finances (in each case using the latest available year)\(^{15}\):

- the Welsh Government Departmental Expenditure Limit in 2012-13 is £14.6 billion;
- total devolved Welsh spending including the Departmental Expenditure Limit, Welsh Government Annually Managed Expenditure and Welsh local government spending was £18.5 billion in 2010-11;
- total identifiable public spending in Wales, including non-devolved spending by the UK Government which identifiably benefits Wales such as social security spending as well as the above devolved spending, was £30.1 billion in 2010-11;
- total Welsh spending, including a Welsh per capita share of non identifiable spending such as defence and debt interest as well as the identifiable Welsh spending above, has been estimated to be around £35.3 billion in 2009-10. In 2010 Welsh Gross Value Added (GVA), which is similar to GDP, was £45.5 billion, so total public spending in Wales represented about 78 per cent of GVA\(^{16}\);
- Welsh tax receipts per head in 2009-10 have been estimated to be £5,760. The Welsh balance of public spending less tax receipts (the excess of spending over receipts is sometimes called the fiscal deficit) has been estimated to be £6,008 per head, or £18 billion in that year (around 40 per cent of Welsh GVA);
- in terms of Wales relative to the rest of the United Kingdom, identifiable public spending per head in 2010-11 is 13 per cent above the UK average; in England it is 3 per cent below the UK average; in Scotland it is 14 per cent higher; and in Northern Ireland it is 20 per cent higher;
- tax as a proportion of the Welsh household sector’s outgoings in 2010 was 36.3 per cent (the second lowest ranking country/region in the United Kingdom); and
- social benefits as a proportion of the Welsh household sector’s resources in 2010 was 25.9 per cent (the highest ranking country/region in the United Kingdom).

2.2.14 It is worth noting the following points arising from these data:

- well over half of identifiable public spending in Wales is devolved;
- public spending represents a high proportion of Welsh GVA and Wales has a large fiscal deficit (most other regions of the United Kingdom are also in a deficit position). However it is worth noting that public spending per head is lower than in Scotland and Northern Ireland; and the majority of people work in the private sector in Wales (over 70 per cent); and

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\(^{14}\) Some data on trends over time are shown in Annex C.

\(^{15}\) Sources: HMT (figures in indents 1, 2, 3 and 6), ONS (GVA figures and figures in 7 and 8), Gerald Holtham/Bob Rowthorne IWA July 2012 and Commission calculations (figures in 4 and 5).

\(^{16}\) Based on allocating non-identifiable expenditure on a population share rather than a GVA share, which would give a lower number.
there are two reasons why the Welsh fiscal deficit is higher than the UK average: there is higher public spending per head and lower tax receipts per head.\textsuperscript{17} Lower tax receipts tend to reflect the fact that Wales has the lowest GVA per head in the United Kingdom, which in turn reflects Wales’s high labour market inactivity rate and low productivity rate. A devolved funding system which successfully incentivised higher economic growth could therefore help to improve Welsh public finances.

The Barnett Formula

2.2.15 HM Treasury calculates changes in the level of DEL given to devolved administrations in a similar way to the block and formula arrangements which set the budget of the Welsh Office before devolution. The mechanism in question is referred to as the ‘Barnett formula’, after Joel (now Lord) Barnett who introduced it as Chief Secretary to the Treasury in 1978. In earlier times the 1888 Goschen formula, introduced by Chancellor George Goschen, allocated 80 per cent of changes in funding to England and Wales, 11 per cent to Scotland and 9 per cent to Ireland. Since devolution, the way in which the Barnett formula works has been set out publicly in the Statement of Funding Policy updated in each spending review by HM Treasury.

2.2.16 The Barnett formula is a relatively simple system for determining changes to the Welsh DEL budget, as well as to the DEL budgets of the Scottish Government and Northern Ireland Executive. Just like a UK Government department, the Welsh Government has a ‘baseline’, essentially the budget inherited from the previous spending review. When spending is reviewed, a revised budget is calculated by adding, or subtracting, from the baseline an amount calculated using the Barnett formula. The formula comprises a population share of the change in ‘comparable’ English spending programmes. ‘Comparable’ means the extent to which the UK department’s functions or a specific programme is the responsibility of the Welsh Government. This then creates a new baseline for future years.

2.2.17 There is, however, no requirement that any increase or decrease in the block budget, known as a Barnett consequential, has to be spent specifically on the corresponding spending programme in Wales, as the Welsh Government is able to allocate the block grant to best meet Welsh needs. The block grant is, therefore, unhypothecated.

2.2.18 An example of how the Barnett formula works is set out in Box 2.1.

\textsuperscript{17} This issue is explored further in ap Gwilym, E (2012) ‘Wales breaks £10,000 spending per head barrier’ published by the IWA. He estimates that about one third of the higher deficit is accounted for by higher spending per head and two thirds by lower tax receipts.
Box 2.1: Worked example of the Barnett formula

The following is a worked example of how the Barnett formula operates.

If for example:

- the UK Government decides to increase the DEL budget of the Department for Transport by £100 million; and
- the comparability percentage for that particular department for the Welsh Government is 73 per cent (because that UK Government department carries out some expenditure in Wales, so it is less than 100 per cent); and
- the population proportion is 5.8 per cent for Wales of England’s population;

then the following change is added to the Welsh Government’s overall budget:

- £100 million (change in UK Government department’s budget) x 73 per cent (comparability percentage) x 5.8 per cent (population proportion as a percentage of England’s) giving an increase of £4.2 million.

So the Department for Transport has an increase of £100 million and the Welsh Government has an increase of £4.2 million.

This provides Wales with the same monetary increase in comparable spending per head as in England.

Accountability

2.2.19 A key aspect of our terms of reference is to consider how to improve financial accountability, and we therefore set out in Box 2.2 the current financial accountability arrangements. One noteworthy feature of these arrangements is that they refer solely to spending issues. In this context, while it is a strength of the current system that the Welsh Government determines and is accountable for how the block grant is allocated, changes in the Welsh DEL budget are determined through the Barnett formula by reference to spending decisions for England by UK Government departments, in which the Welsh Government has no say. Reducing the dependency on the block grant by increasing the revenue raising capacity of the National Assembly for Wales would help to address this concern.

2.2.20 There is, therefore, little accountability in the current funding system in Wales for how the Welsh budget is funded, other than areas such as council tax and business rates, because as noted above there is currently no direct relationship between central government taxes raised in Wales and money spent in Wales. This is a central issue which we address in later chapters of this report.
Box 2.2: Current financial accountability arrangements

HM Treasury is accountable to the UK Parliament for the UK Government’s spending plans including the Welsh Government’s DEL. These spending plans are published at the end of each spending review.

The Wales Office, which is a department of the UK Government, is accountable to the UK Parliament for the annual block grant to the Welsh Government and is audited by the National Audit Office (NAO). The NAO also has in theory powers to scrutinise the Welsh Government’s spending of the block grant although in practice has not done so. The block grant is part of the Wales Office Estimate approved each year by Parliament. The Wales Office is scrutinised by the Welsh Affairs Committee of the House of Commons.

The Welsh Government is accountable to the National Assembly for Wales for how it allocates the block budget to its devolved spending programmes and on delivery of public service and economic outcomes. The Welsh Government is audited by the Wales Audit Office (WAO). The Welsh budget is scrutinised by the Finance Committee of the National Assembly for Wales.

2.3 PERCEIVED STRENGTHS AND WEAKNESSES OF THE EXISTING FUNDING SYSTEM

The Barnett formula: strengths and weaknesses

2.3.1 The devolved funding system, particularly the Barnett formula, has been the subject of much debate in recent years. The future of the Barnett formula is not part of our remit but was the subject of a cross-party House of Lords inquiry in 2009 and of the work of the Holtham Commission. A summary of the House of Lords’s assessment of the Barnett formula is set out in Box 2.3 below. The Holtham Commission drew broadly similar conclusions though their analysis was within the context of funding the Welsh Government and not the other devolved administrations. Holtham concluded that the Barnett formula was unfair, particularly for Wales in relation to Scotland, and should be replaced by a formula based on needs, although in the interim a ‘Barnett floor’ should be implemented in Wales to prevent further convergence of per capita spending towards the level for England (that is, the allocation to Wales relative to England should be fixed at a certain floor level to prevent spending in Wales falling further towards the comparable spend per head in England).

18 HL Paper 139.

19 Convergence is an arithmetic property of the Barnett formula. The Barnett formula provides all four countries of the Union with the same monetary change in comparable spending per head. But this change is a smaller percentage of existing spending in Scotland, Wales and Northern Ireland than of England because the existing spending per head is higher in these countries. So when spending is increasing and provided the population share of Wales relative to England does not fall, spending per head will fall over time towards that in England. This is set out in more detail in the Holtham report.
Box 2.3: The views of the House of Lords Select Committee on the Barnett formula

The House of Lords Select Committee on the Barnett formula was appointed by the House in 2008 “to examine the purpose, methodology and application of the Barnett formula as a means of determining funding for the devolved administrations of the United Kingdom, to assess the effectiveness of the calculation mechanism to meet its purpose and to consider alternative mechanisms”.

The Committee said that “the advantages of the Barnett formula—simplicity, stability and the absence of ringfencing—are important and should be maintained whatever the future method of allocating funds to the devolved administrations.” It concluded that “any new system of allocating funds should retain the clarity of the Barnett formula and the stability over time which it affords. But unlike Barnett, it should also be related explicitly to an assessment of need. To do that it should be based on the following principles:

- The new system should consider both the baseline and any increment in funds. The entire block grant for each devolved administration should be subject to regular review to ensure that it continues to be appropriate for the needs of each administration and fair in relation to the needs of the other administrations.

- The new system should be fair and seen to be fair. By relating resources to current relative needs the system should help distribute funding to those areas of particular need across the United Kingdom as a whole and avoid the anomalies which arise from the present arrangements. Consequently it should ensure a substantial degree of territorial justice—something that is not achieved presently.

- The new system should be comprehensible. Although the Formula is clear in its method of calculating the proportion of incremental changes in the block grant, the basis on which the baseline—and therefore the block grant as a whole—rests is not. The statistics on which each allocation is made and the details of the allocations themselves should be placed on record and published. There should also be an audit process to ensure that the system is being appropriately administered.

- The new system should respect territorial autonomy. The new system must leave the devolved administrations free to decide what to do with their block grant. There should be no ring-fencing. Neither should the new system attempt to duplicate the detailed assessments of local needs that the devolved administrations must themselves necessarily make.

- The new system should be stable and predictable. Each administration must be able to make budgetary decisions in advance and to plan their spending as they see fit. The new system needs to reconcile flexibility (so resources change when relative needs change), with consistency of funding over budgeting periods to enable planning for both financial matters and service provision by the devolved administrations."

The report also said “while we are not in a position to reach a conclusion about precise relative needs in the four countries and regions, on the basis of our initial analysis, we believe that Scotland now has markedly lower overall need than Wales and Northern Ireland in comparison to England. The current allocation of spending does not properly reflect this basic pattern across the devolved administrations.”
The existing devolved funding system more broadly: strengths and weaknesses

2.3.2 In relation to the wider question whether tax and borrowing powers should be devolved, a key strength of the existing system (leaving aside the strengths and weaknesses of the way the block grant is decided using the Barnett formula) is that there is central management across the United Kingdom by HM Treasury of fiscal risks: the system devolves spending risks but centralises and pools macroeconomic risks. A dramatic example of the benefits of pooling financial risks at the UK level occurred when Scottish based banks were capitalised by the UK Government in 2008. Our proposals set out later in this report ensure that HM Treasury retains central oversight and responsibility for fiscal policy across the United Kingdom.

2.3.3 The existing UK fiscal system also delivers substantial transfers of resources (sometimes known as fiscal equalisation) from richer to poorer regions of the United Kingdom, which are necessary to underpin a successful fiscal and monetary union. We believe that it is vital for Wales that this characteristic of the Union is retained, and our report is predicated on that assumption.

2.3.4 However there are also weaknesses in the existing system. Wales is anomalous in the world in having an elected body with legislative and spending powers but not borrowing or tax powers. This will be discussed further in the next chapter.

2.3.5 The absence of tax powers means that the Welsh Government is not able to determine the size of its budget: it does not make taxation and spending decisions reflecting Welsh fiscal choices. In addition the Welsh Government is not able to use tax levers for economic, social and environmental purposes.

2.3.6 Furthermore, the absence of borrowing powers creates inflexibility and means that capital spending on (albeit infrequent) very large-scale projects have to be accommodated within Welsh capital DEL limits that have been set by reference to changes in English capital spending through the Barnett formula without reference to Welsh circumstances.

2.3.7 These strengths and weaknesses are explored further in later chapters.

2.4 INTERGOVERNMENTAL TALKS BETWEEN THE UK AND WELSH GOVERNMENTS

2.4.1 Our remit excludes consideration of the Holtham Commission’s proposals for funding reform in Wales, and we have therefore not sought evidence on this nor considered the alternative funding mechanisms to the Barnett formula seen internationally. The “fair funding for Wales” issue has been considered separately in intergovernmental talks between the UK and Welsh Governments. These talks examined the operation of the Barnett formula as it applies to Wales and the use of existing Welsh Government borrowing powers.

2.4.2 However, we have heard a large number of views highlighting the need for the UK Government and Welsh Government to consider the case for reforming the Barnett mechanism in Wales as a prerequisite to tax devolution.\(^\text{20}\) This is on the grounds that if the Welsh Government is to take on the risks associated with devolved tax powers, it should be on the basis of a block grant system that better reflects the needs of Wales within a wider UK funding system that takes into account territorial equity.

\(^\text{20}\) Examples of such evidence are those from the Welsh Government, the Changing Union Partnership, PwC and others. All the main parties in Wales have broadly supported the Holtham recommendations.
2.4.3 We note the views of the Welsh Government and the main political parties in Wales, who strongly support the case made by the Holtham Commission for reforming the Barnett formula as applied to Wales – this was unanimously endorsed by the National Assembly for Wales.\textsuperscript{21} Much of the evidence received by the Commission from other organisations and individuals makes a similar point.

2.4.4 The UK Government’s Programme for Government noted the concerns expressed by the Holtham Commission but said that at this time the priority must be to reduce the deficit, and therefore any change to the system must await the stabilisation of the public finances.\textsuperscript{22} The Calman report in Scotland said that the block grant should be justified by need but, until such time as a proper assessment of relative spending needs across the United Kingdom is carried out, the Barnett formula should continue to be used as the basis for calculating the block grant.

2.4.5 We also note the international evidence discussed further below highlighting the need for a well-functioning fiscal equalisation system to be in place for the devolution of taxation powers to be successful.

2.4.6 However, we also recognise that there is no UK-wide consensus at present on the case for reforming the Barnett formula across the United Kingdom as a whole.

2.4.7 We therefore welcome the work on the intergovernmental talks. We look forward to a speedy resolution.

2.5 DEVELOPMENTS ACROSS THE UNITED KINGDOM

2.5.1 The United Kingdom is unusual in having a system of asymmetric devolution. The three devolution settlements in Wales, Scotland and Northern Ireland are each different from one another in terms of the spending programmes and the taxation and borrowing powers that are devolved, while England itself has no powers devolved to it.

2.5.2 Against this background, the work of the Commission has taken place within a wider set of developments in devolved funding across the United Kingdom. We have received a good deal of evidence that it is important to assess the case for devolution of tax and borrowing powers to Wales within the context of these developments across the United Kingdom as a whole, and to ensure that the funding and public expenditure system remains coherent across the United Kingdom. We agree in principle with this view, and we also recognise that our recommendations, under our terms of reference, must be consistent with the United Kingdom’s fiscal objectives.

2.5.3 Many developments elsewhere in the United Kingdom are relevant to our work. The Scotland Act 2012, based largely on the recommendations of the Calman Commission, gave Scotland taxation and borrowing powers and is a model for how a devolved system might work inside the United Kingdom.\textsuperscript{23}

\textsuperscript{21} On 12 October 2010 and 5 July 2011 respectively.

\textsuperscript{22} This was debated in Westminster Hall on 11 September 2012: http://www.publications.parliament.uk/pa/cm201213/cmhansrd/cm120911/halltext/120911h0002.htm

\textsuperscript{23} Further information on the Scotland Act’s financial features is set out in our research paper published on the Commission’s website.
2.5.4 A referendum on Scottish independence is expected to be held in 2014 and will therefore probably take place before full implementation of our recommendations. We recognise that change is likely in the powers of the Scottish Parliament and Government, whatever the outcome of a referendum.

2.5.5 In Northern Ireland, work is currently being undertaken on the possibility of devolving corporation tax, and Air Passenger Duty for direct long haul flights was devolved to Northern Ireland in the Finance Act 2012.24

2.5.6 The Commission on the Consequences of Devolution for the House of Commons, established by the UK Government on the so-called West Lothian question, is currently under way. This is not looking specifically at funding issues but its work and ours have an important linkage: through the Barnett mechanism, decisions for England can affect spending in Wales, but that is a matter that can only be raised in the UK Parliament with UK Ministers.

2.5.7 We are also conscious that attitudes to devolution in England are changing. The IPPR published a report in 2012 on this matter. It found a somewhat negative view in England on Welsh devolution. Asked about the perceived impact of the National Assembly for Wales on how Britain is governed, 31 per cent thought it was worse compared to only 17 per cent who believed it was improved. Asked about attitudes in England to the Welsh share of UK public spending, only 7 per cent thought that Wales received less than its fair share compared to 26 per cent who thought it received more than its fair share.

2.5.8 We also note that the Mayor of London has established a London Finance Commission to examine whether London should keep a higher share of its tax revenues.

2.5.9 Against this background it is vital that our recommendations are seen as being in the interests of not only Wales but also of the United Kingdom as a whole.

2.6 CONCLUSIONS

2.6.1 Spending by the Welsh Government and local authorities in Wales amounts to well over 50 per cent of identifiable public spending in Wales, with the UK Government responsible for the remainder.

2.6.2 The bulk of the budget of the National Assembly for Wales and the Welsh Government comes from a block grant from the UK Parliament. Changes in the block budget are decided on the basis of spending decisions made by the UK Government for its responsibilities in England, using a mechanism called the Barnett formula. Once the block grant is transferred, it is up to the Welsh Government, with the National Assembly’s approval, to decide how the block budget is spent.

2.6.3 The Welsh Government and National Assembly for Wales cannot change the size of the Welsh budget. The Welsh Government has wide spending powers, but does not have tax powers.

24 Further information on developments in Northern Ireland is set out in our research paper published on the Commission’s website.
2.6.4 Wales, like most other parts of the United Kingdom, receives more in spending than it raises in taxation. This characteristic of fiscal transfers is important for the economic success of the Union and is maintained in our proposals.

2.6.5 The proposals in our report not only take account of the interests of Wales, but take account of developments across the United Kingdom and satisfy UK fiscal objectives.

2.6.6 The next chapter assesses how Wales is funded compared to international devolved funding systems and general principles of devolved funding.
Chapter 3 – Principles of fiscal devolution

3.1 OVERVIEW

3.1.1 In this chapter we begin by considering various approaches that other countries have adopted to fund sub-national governments. We use the term ‘sub-national government’ throughout the report as this is the technical term used in international literature. The term is generally used for governments such as devolved administrations, provinces, states or länder, though some, such as Wales or Catalonia, are actually governments of distinct nations within a larger state.

3.1.2 Using the international examples, this chapter then outlines the principles on which we believe the future funding arrangements for the Welsh Government should be grounded. We then assess the various models of funding the Welsh Government against those principles and identify a preferred model.

3.1.3 Given a number of the funding models explored include some degree of devolved taxation, we go on to discuss the criteria for assessing whether individual taxes should or should not be devolved to Wales.

3.1.4 It is worth considering, in a more fundamental way, what the role of taxation is before we discuss the international models, principles, and future funding arrangements for the Welsh Government. Box 3.1 describes the role of taxation in modern economies.

Box 3.1: The role of taxation

Oliver Wendell Holmes, the famous American jurist, once said “Taxes are the price we pay for a civilized society”.

Revenue from taxation funds the resources required to pay for the delivery of public services and it also funds major investment and infrastructure projects that any modern society needs. As a wide ranging review of the UK tax system undertaken by the Institute for Fiscal Studies chaired by the Nobel Prize-winning economist Sir James Mirrlees\(^2\) highlights “Modern states could not exist without a tax system which raises large amounts of revenue to pay for public services”. The taxation system, therefore, plays a crucial role in the lives of every citizen of the United Kingdom.

While the tax system needs to be designed for the economy in which it is to operate, the political context is a driving factor in explaining the tax system that results and the manner in which it is applied. Policymakers have multiple objectives for the tax system that go beyond the capacity to generate tax revenue. As a result, the tax system is the outcome of a number of competing objectives.


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benefits are taken into account, the ratio between the average incomes of the top and the bottom fifth households is reduced to four-to-one. This redistribution plays a central role in territorial equity – including common levels of certain public services across territories - and is essential to provide the necessary investment to promote growth and thus a movement towards more equal levels of prosperity between territories.

The tax system also plays an important role in managing the level of demand in the economy within the government’s overall fiscal and monetary policy. Taxation helps to establish the conditions for the private sector to generate wealth. It can be used to encourage certain activities, such as the purchase of books, or discourage certain activities seen as being socially harmful such as the consumption of tobacco or alcohol.

During our public engagement sessions, we found that people generally recognise that taxation is a necessity and even a public good – though they may disagree on what constitutes a fair level of taxation or how tax revenues should be spent.

There is great variation between countries in the amount of tax collected. This can only partly be explained by variation in income levels. In Denmark and Sweden taxes are equivalent to around 48 per cent and 46 per cent of national income respectively while in Japan and the USA taxes only account for 28 per cent and 26 per cent of national income respectively. Much of the variation is explained by preferences for services to be funded publically and by wider societal values.

In Switzerland there is a principle that wherever possible individuals should contribute towards the funding of public services. As a result taxes are levied at low levels of income at a low rate to maintain the principle of participation.

### 3.2 INTERNATIONAL COMPARISONS

#### 3.2.1 Debate surrounding the funding of sub-national governments is by no means unique to the United Kingdom. In the context of our work we have sought to find guidance from the evidence available from other countries with sub-national governments. We have summarised this international evidence in our research paper which is available online and we highlight some of the key lessons here.

#### 3.2.2 There is a range of interesting examples of funding models of sub-national governments, including those in Canada, Spain, Australia, the USA and Germany, although it is not simple to make direct comparisons between federal systems typically found abroad and the United Kingdom’s system of devolved government. The system of devolved funding which is evolving in the United Kingdom shares some characteristics with Spain (asymmetric fiscal system) and Canada (shared tax base).

#### 3.2.3 We provide further details of those specific models in our published research paper.

#### 3.2.4 In comparison to those countries, and indeed the majority of the members of the Organisation for Economic Co-operation and Development (OECD), only a very small proportion of tax revenue in the United Kingdom is not collected at the central level. Figure 3.1 shows the proportion of tax revenue that is collected at the sub-national level for the

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Office for National Statistics 2012.
countries of the OECD. Tax revenue at the sub-national level includes both regional and local taxes. At just under 5 per cent the United Kingdom has one of the most centralised taxations systems. The low figure for the United Kingdom reflects the limited tax devolution at both devolved and local levels in the United Kingdom.

Figure 3.1: Sub-national tax revenue as a percentage of total tax revenue, 2005

Source: OECD

3.2.5 The OECD position is that there is a general case in principle for the devolution of tax powers in terms of promoting efficiency, democratic accountability of public spending and enhanced incentives for developing the economic and revenue base. We use the principles highlighted in this international literature later in this chapter.

3.2.6 According to the OECD, it is typical for the central government to retain the power over the redistributive elements of taxes, such as setting the thresholds at which tax rates are then applied. The OECD also argues that, as economic stabilisation is a function of the central government, the central government should also retain the power over taxes where revenues are highly sensitive to economic conditions. Finally, taxes should not be exported to other jurisdictions, meaning that if the sub-national government decides to change tax rates then that change should impact primarily on the residents of the sub-national area. All these issues are pertinent to our consideration of tax devolution in Wales.


3.2.7 Reflecting this, property and personal income taxation represent the largest share of tax revenue at the sub-national level of government, as property and to a lesser extent individuals are not likely to move in response to different tax rates set by the sub-national government. Property and personal income taxes are also likely to be paid by residents of the sub-national territory, so limiting the potential for exporting the tax. Sales and corporate income taxes, which are volatile and mobile, represent a smaller share of tax revenue at the sub-national level.

3.2.8 The degree of autonomy that sub-national governments have over taxes for which they are responsible varies. This variation broadly reflects the potential consequences outside the territory of tax alterations inside the territory. Across OECD countries sub-national governments have much greater autonomy over setting the rates and the design of taxes on property than any other tax. Generally, greater restrictions are placed on the autonomy that sub-national governments have over personal income tax – they are usually restricted to setting only the rates for the tax and not the thresholds to which the rates are applied. Sales taxes are commonly on a tax assignment model with sub-national governments having much less autonomy if the tax is devolved, especially so in the EU due to the tax harmonisation rules in place (we discuss this further below).

3.2.9 A significant issue discussed in the international literature is tax competition. Where sub-national governments have autonomy over mobile tax bases such as corporate income, competition between tax authorities may arise, where governments reduce sub-national taxes compared with neighbouring areas to compete for businesses and individuals. While tax competition may have some positive effects by enabling poorer regions to strengthen their tax bases, it may also have negative effects as it may erode the wider tax base and create an inefficient resource allocation.

3.2.10 One aspect that is common across most countries which have devolved or federal financing systems is the operation of the process known as fiscal equalisation. Equalisation payments are used as a method of achieving equity where payments are made to areas with relatively low capacity to generate tax revenue or areas where the cost of providing a standard level of public services is relatively high due to higher relative need for public services. While the principle of fiscal equalisation is well established, the extent of equalisation is often a matter of debate and involves difficult political judgements. The OECD believes that some degree of fiscal equalisation is a necessary companion to tax devolution and that the success of tax devolution is likely to depend on a well functioning equalisation system.

3.2.11 We consider the international evidence on borrowing powers of sub-national governments with our wider consideration of borrowing in Chapter 6.

29 This is particularly important for larger taxes where if devolved a significant proportion of the budget available for the sub-national government would become highly dependent on economic conditions. For smaller taxes this is seen as less of an issue.
30 Tax assignment for Value Added Tax is discussed further in Chapter 5.
31 This would include restrictions placed on the extent that sub-national governments can change the rate of tax applied.
3.3 PRINCIPLES FOR FUNDING A SUB-NATIONAL GOVERNMENT

3.3.1 Box 3.2 below summarises the evidence we have received discussing the principles for funding the Welsh Government. We believe that we can deduce some fundamental principles for funding sub-national governments from this evidence, as well as from the work of the Holtham and Calman Commissions and from the international evidence referred to earlier. These principles are set out below:

- **Accountability** – the level of spending by the sub-national government should be affected by the sub-national government’s taxation choices. The sub-national government should have the responsibility for raising some of the money that it spends. The impact of decisions on taxation made by the sub-national government should be clear to taxpayers, and taxation and spending choices should be offered to the electorate in sub-national government elections;

- **Autonomy** – sub-national governments should have some freedom to decide the level of spending and how it is spent. This is also related to the principle of subsidiarity;

- **Cooperation and constructive engagement between the central and sub-national governments** – the two governments should engage with each other in a spirit of negotiation, agreement and mutual consent;

- **Economic incentivisation** – the sub-national government should have sufficient incentives to grow the economy;

- **Efficiency** – the funding system should ensure that sub-national governments can manage their resources in the most efficient way and promote economic growth. It may be more efficient for a sub-national government to set a different taxation and spending arrangement from that at the central level so as to better meet the preferences of its citizens in line with principles of subsidiarity. Different taxation arrangements should minimise administration and compliance costs, economic distortions\(^{33}\) and tax avoidance;

- **Empowerment** – the funding system should enable the sub-national government to use fiscal powers as tools to achieve desired outcomes in areas of policy under its control. The sub-national government should have the powers to be able to implement policies which are different from those of the central government to better meet its perception of the needs of its citizens. With empowerment comes responsibility for delivering successful fiscal policies;

- **Equity** – resources should be allocated in a way that makes it possible for a standard level of public services to be made available in all parts of the state, subject to variation to reflect sub-national policy preferences. Equalisation payments can be used as a method of achieving equity by making payments to areas with a lower capacity to generate tax revenue or areas with a higher cost of providing a standard level of public services due to higher need. Those payments are essential to address the underlying issues that generate higher need, and should therefore have the effect of reducing this need in the future. Tax systems should also promote fairness between taxpayers;

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\(^{33}\) Economic distortion refers to a situation where changes to the taxes that individuals and businesses pay result in them changing their economic activities (such as working patterns, location decisions and investment decisions) solely to minimise the amount of tax that they pay. While this activity results in individuals and businesses minimising their tax bill it can also impose an economic cost.
• **Fiscal discipline** – the financing arrangements of a sub-national government should not undermine the macro-economic stability objectives of the central government;

• **Simplicity** – the funding system should be designed to minimise complexity in its administration and in its compliance arrangements for individuals and businesses. The devolution of fiscal powers almost inevitably increases complexity: the goal, therefore, is to assess the potential benefits against the potential costs associated with a more complex system;

• **Stability, predictability and sustainability** – the funding system should minimise volatility to enable public spending to be managed properly and be predictable in its operation. The funding system should also meet the needs of the present and those of future generations; and

• **Transparency** – taxation and spending decisions should be readily understood and the justification for them made evident.

3.3.2 There may be tension between those principles. For example, the system with greatest simplicity to administer might be a uniform model across the central and sub-national government with the same tax rates and spending levels applied. However, uniform taxation and spending levels may not best meet the tests of accountability, autonomy, efficiency or equity. Nevertheless, we believe that any change in the system of funding for Wales should be judged against its compliance with these principles, while recognising that it may be difficult to meet all the principles to the same extent. We, therefore, place particular emphasis on accountability, empowerment, efficiency, economic incentivisation and equity.

**Box 3.2: Evidence on principles**

We received a significant amount of evidence on funding principles and how they apply to Wales, which we have drawn on in this chapter.

Our ICM opinion poll found that a majority of respondents thought that if the Welsh Government had some tax powers “the Welsh Government would be held more accountable for its decisions”, “public services in Wales will only ever improve if the Welsh Government can make its own decisions about taxation and spending”, “the Welsh economy would be stronger if the Welsh Government could decide the level of taxes and spending in Wales” and “the Welsh Government should be able to determine the size of its budget by changing taxes in Wales”.

Many of the submissions, including from the Welsh Local Government Association, the Finance Working Group for the Wales in a Changing Union project and members of the public, believe that the broad principles of the Holtham Commission should form the basis for our work:

• accountability;
• autonomy;
• efficiency;
• equity;
• simplicity and transparency; and
• stability.
In addition to accepting the broad principles from the Holtham Commission, the WLGA also believed that “the principles of subsidiarity should underpin any devolved funding framework”.

True Wales on the other hand noted that the Oxford English Dictionary definition of accountability is about being obliged to give a reckoning or explanation for one’s actions, which does not require greater devolution of powers.

The Federation of Small Businesses Wales “welcomed moves to strengthen accountability of the National Assembly and Welsh Government in order to ensure that economic considerations are involved in the decision making process”. The Confederation of British Industry Wales noted that “Welsh business is concerned, first and foremost, with the effective operation of government policies and their ability to grow the economy. The principles of multi-level governance mean that certain policy levers are more effectively implemented at different levels of government”.

The submission from Professors Ball and King and David Eiser (University of Stirling) noted that tax devolution enables the sub national government to alter its spending level, enabling it to raise tax revenues if it thinks its needs are underestimated in its grant receipts, and giving its voters a clearer idea of the cost of its services.

During our evidence gathering event at Aberystwyth, a group of students from Aberystwyth University emphasised the benefits of potentially greater policy diversity in the National Assembly for Wales from having fiscal choices.

Evidence from individuals included:

“It is far from ideal for funding arrangements within a state to be highly asymmetric”.

“Wales desperately needs government accountable to local people”.

“I broadly agree with the Holtham Commission’s principles, but advocate the addition of a principle regarding the long term sustainability of the Welsh economy”.

“While the devolution of taxation powers to the Welsh Assembly would have the appearance of improving its financial accountability, in practice it is unlikely to bring any benefit to the people of Wales”.

At our public event in Aberystwyth there was consensus that if the budget of the Welsh Government was to some extent dependent on tax revenues collected in Wales then this would provide a greater incentive to the Welsh Government to stimulate the economy in Wales.

At our public event in Welshpool there was a discussion on “tax with representation”- devolving taxation would give the Welsh Government more accountability.

There was some scepticism at our St Asaph evidence session as people believed, despite wanting to see the Welsh Government more accountable, that giving it tax varying powers is not the way to make this happen.

Gwynedd county council noted ”The Council strongly believes the devolution of taxation powers to the Welsh Assembly Government would strengthen democratic accountability. On every other government tier, there is a direct relationship between local accountability to the electorate and taxation powers.”
3.3.3 The UK Government also has principles for the UK tax system as a whole. These principles resonate well with the general funding principles we have outlined above. The consistent view from the UK Government is summarised as:

- taxes should be efficient and support growth;
- taxes should be certain and predictable;
- taxes should be simple to understand and easy to comply with; and
- the tax system should be fair, reward work, support aspiration and ask the most from those who can most afford it.

3.4 BROAD FUNDING OPTIONS FOR WALES

3.4.1 We now turn to possible models for funding the Welsh Government and assess these against our principles. As there is a wide spectrum of possible funding models available, we have limited our assessment to the four main models that the Holtham and Calman Commissions considered for Wales and Scotland respectively as the most viable models within the UK context. The evidence we received confirms that these cover the main spectrum of possibilities for funding the Welsh Government.

(i) Block grant funding: the current system

3.4.2 The current system for funding the Welsh Government is through a block grant. Taxes raised in Wales (excluding council tax and non-domestic rates) are set, collected and pooled at the UK level, from which the UK Parliament provides a sum of money to the Secretary of State for Wales to pass on to the Welsh Government to fund devolved public services. Currently, the Barnett formula is used to determine changes in the level of funding (as described in Chapter 2). Welsh Ministers have autonomy over how to allocate those funds but are not able to alter the total amount that is available to spend on devolved public services by either raising or reducing taxes.

3.4.3 It is worth noting that the UK system is unusual in the degree of autonomy it gives to the devolved administrations by allocating a block grant that can be spent entirely according to the choices of the devolved government, with the authorisation of the devolved legislature.

3.4.4 In principle it would be possible to consider alternatives to block grant formula based funding such as a specific grants provided to fund devolved public services or a system where the budget for the Welsh Government is decided by direct negotiation between the Welsh and UK Governments each year.

3.4.5 We outlined some of the strengths and weaknesses of the current funding system in Wales in Chapter 2. The current arrangements are relatively simple and relatively stable. The main weakness of the wholly block grant funded model is that while it may be suitable for a spending agency it is argued that it is not suitable for a well-established and well-functioning devolved government and legislature.

3.4.6 While the Welsh Government has the autonomy to make spending decisions, Welsh political parties, at the time of elections, cannot offer Welsh citizens choices over spending and taxation levels. The current system could be improved to enhance the incentives for the Welsh Government to encourage economic growth. The Welsh Government currently has neither the responsibility for determining the size of its budget nor the empowerment...
to use taxation to achieve desired policy outcomes. In addition, under the current
determination of the block grant, changes to the size of the Welsh Government’s budget
are determined by changes to spending decisions in England rather than as a consequence
of changes in relative need.

3.4.7 We clearly see the case for a move away from the wholly block grant funded model.

(ii) Block grant plus tax revenue assignment

3.4.8 Under this model, part of the budget allocated to Wales would be dependent on the
assignment of the amount of tax revenue generated in Wales, with a block grant comprising
the remainder. There are two main models of tax assignment. Under both models of tax
revenue assignment, control of the assigned taxes would be retained at the UK level; Welsh
Ministers would not be able to vary the size of their total budget by varying the rates of the
assigned taxes.

3.4.9 The first model of tax assignment would have a real budgetary impact and is termed
outturn assignment. In this model a forecast of tax revenues is made for the assigned tax
and then deducted from the block grant. Outturn tax revenues generated in Wales would
then be assigned and transferred to the Welsh Government. If outturn revenues were
below the forecast, the budget available would be lower than in a block grant-only funded
model, whereas if the outturn were above forecast, the budget would be higher than in
a block grant-only model. There would therefore be a stronger link between what is spent
in Wales and the amount of tax revenue generated in Wales than is currently the case. This
model would work best in the case of taxes where revenues for Wales are not based on
broad estimates.

3.4.10 The second model of tax assignment does not have a real budgetary impact and is termed
forecast assignment. Again, a forecast of tax revenues is made for the assigned tax. This
forecast is then deducted from the block grant. However, if outturn tax revenues differ
from forecast, no adjustment is made to the block grant to reflect this. This model of tax
assignment is essentially presentational and would not have any impact on the budget of
Wales.

3.4.11 Tax assignment is not our preferred model. While it could be argued that the Welsh
Government’s economic policies have some influence over, for example, the amount of
Value Added Tax (VAT) receipts in Wales, UK-wide economic factors are likely to have the
major influence. VAT assignment is considered in more detail in Chapter 5 below.

3.4.12 As the Welsh Government would not have the power to change taxes under a tax
assignment model this does not deliver financial accountability or empowerment. In fact,

34 For example, if the assigned tax is forecast to generate £1 billion in Wales then the block grant will be reduced by £1
billion, creating no change in resources. Under the forecast assignment method no further change is made. Under the
outturn assignment method, outturn revenues for the assigned tax would be transferred to the Welsh Government.
If outturn revenues for the assigned tax were £900 million then the budget for the Welsh Government would be £100
million lower than if the budget were wholly funded by a block grant, and if outturn revenue were £1.1 billion, then
the budget would be £100 million higher than if wholly funded by a block grant.

35 For many taxes the amount of revenue raised in Wales is not calculated by HMRC. For these taxes, it is possible to
estimate the likely revenues in Wales using a variety of methods. Those methods may not give an accurate figure for
the actual amount of revenue raised by the tax in Wales. As a result, it is not possible to precisely compare a forecast
with the actual revenues, and comparisons based on broad estimates could be contested based on the methods used.
under tax assignment, adjustments would be made to the budget of the Welsh Government when those adjustments are not the result of the actions of the Welsh Government (as the Welsh Government would not have the power to vary tax rates). To make adjustments in these circumstances could be regarded as the opposite of accountability.

(iii) Block grant plus tax devolution

3.4.13 This model also involves linking part of the funding that is provided to the Welsh Government directly to the amount of tax revenue generated in Wales, as would occur with tax revenue assignment. However, under tax devolution, Welsh Ministers would also acquire powers to vary the devolved taxes (by changing the rates and/or the structure of the tax or fundamental reform including not having the tax applied in Wales), making it possible to increase or reduce the total resources available to spend on devolved public services in Wales.

3.4.14 Revenue raised in Wales by non-devolved taxes would be pooled at the UK level as at present, and the Welsh Government would therefore still receive a block grant, although the grant would be reduced by an appropriate amount to reflect the part of the budget funded by tax revenues in Wales.

3.4.15 If some taxes were devolved to Wales, the Welsh political parties could offer voters a choice in Assembly elections between spending and taxation levels. The Welsh Government would be further empowered with a range of fiscal powers to achieve desired outcomes. This has the potential to improve the allocation of resources between spending and taxation by better meeting preferences of Welsh citizens and incentivising economic growth. However the efficient allocation of resources may be impaired if differences in tax rates encourage individuals and businesses to relocate either into or out of Wales, which we consider in Chapters 4 and 5.

(iv) Towards full fiscal autonomy

3.4.16 There is a variety of models that can be seen as representing a movement towards full fiscal autonomy (by which we mean that all spending in Wales would be determined by taxes raised in Wales), none of which has a universally accepted definition.36 These models would devolve responsibility to the National Assembly for Wales for most or all taxes raised in Wales, but could involve a range of possible transactions between the Welsh and the UK Government depending on the extent of fiscal autonomy which is desired. There could be a transfer from the Welsh to the UK Government for non-devolved government services, like defence and social security; or possibly the payment to the Welsh Government of an equalisation grant to bring its per capita tax receipts or public expenditure to an appropriate union-wide level.

3.4.17 We do not think that models towards full fiscal autonomy are appropriate for Wales given the current fiscal context. As outlined in Chapter 2, tax revenues generated in Wales are currently well below the total level of public spending in Wales reflecting Wales’s relatively low level of GVA per head. Fiscal autonomy or versions of it would therefore potentially involve large cuts in spending or increases in taxation.

36 ‘Devo Max’ is one such model that has been discussed in the context of Scotland. Devo Max is typically described as a model where the devolved administration is responsible for raising all taxes and for all expenditure in Scotland on devolved areas, with most areas of policy being devolved. ‘Devo Plus’ has also been discussed in the context of Scotland where most but not all of the money spent by the Scottish Parliament is raised by the Scottish Government.
Concluding assessment of the funding models against our funding principles

3.4.18 In our assessment, drawing on the evidence we have received, we conclude that the funding model of a block grant and some devolved taxes best meets the principles we have adopted. For there to be a real change in its financial accountability, autonomy and empowerment there needs to be freedom for the Welsh Government to be able to vary tax rates in Wales in relation to the rest of the United Kingdom. Tax assignment does not offer this freedom.

3.4.19 There could however be a role for forecast tax assignment as a transitional phase before devolving taxation powers. This transitional phase would help improve information on the devolved tax including the potential impact on the Welsh budget from volatility in revenues. We return to this later.

3.4.20 Looking at the international examples, the current funding model is anomalous for a government with legislative, executive and spending powers. Looking within the United Kingdom the model of funding the Welsh Government appears even more anomalous as local authorities and even community councils in Wales have a greater range of financial powers.

Recommendation

R.1. The current funding arrangements for the Welsh Government do not meet the requirements of a mature democracy and are anomalous in an international context. The funding model of a block grant and some devolved taxes best meets sound principles for funding the Welsh Government. We therefore recommend that part of the budget for the Welsh Government should be funded from devolved taxation under its control.

3.4.21 This recommendation accords with the plurality view in Wales as established by our opinion poll. This showed that 39 per cent believed that a Parliament with both law-making and taxation powers was their preferred constitutional option for Wales. This compares to 8 per cent who said that Wales should become independent, separate from the United Kingdom; 31 per cent who said that Wales should remain part of the United Kingdom, with its own elected Assembly that has law making powers but not taxation powers; and 18 per cent who said that Wales should remain part of the United Kingdom, without an elected Assembly.37

3.5 CRITERIA FOR ASSESSING WHETHER SPECIFIC TAXES SHOULD BE DEVOLVED TO WALES

3.5.1 The majority of this report will consider which taxes are the appropriate candidates to be devolved to the Welsh Government. However, we first need to recognise that there are international obligations that constrain tax devolution, particularly in the context of the United Kingdom’s membership in the European Union. These obligations are summarised in Box 3.3.

37 4 per cent did not know their preferred constitutional option for Wales.
Box 3.3: Treaties of the European Union other international obligations

The Treaties of the European Union set out the EU’s constitutional basis. The Treaty on the Functioning of the EU (TFEU) provides for provisions for the harmonisation of Member States’ rules in the area of indirect taxation (principally Value Added Tax and Excise Duties). As far as other taxes are concerned, Article 115 TFEU provides for the Council to issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the internal market. Some recommendations and legislation have been adopted in personal tax, company tax and capital taxation. The TFEU also provides the core provisions for State Aid.38

A good example that outlines the practical application of the Treaty of the EU is the Azores case.

In 1999 the Government of the Autonomous Region of the Azores introduced a reduction of the rates of national Portuguese tax on company revenue. The reduction was to apply in the Azores only. The purpose of the rules was to allow economic operators in the region to overcome the structural disadvantages deriving from their location on the periphery of the EU.

The European Commission initiated a formal investigation procedure on the grounds that the measures were selective aid. It concluded that the measure constituted aid and that the aid was incompatible with the Treaty that established the European Community.

The case was considered by the Constitutional Court of the European Court of Justice. The Court ruled that determination of whether the tax constituted selective aid required an examination of whether that measure provided an advantage for certain undertakings in comparison with others which were in a comparable legal and factual situation. The “normal” tax rate was the rate in force in the geographical area constituting the “reference framework”.

The reference framework may be limited to the area of geographical competence of a sub national body (such as the National Assembly for Wales) in circumstances where the sub national body plays “a fundamental role in the definition of the political and economic environment in which undertakings operate”. In other words, the sub national body must exercise “sufficiently autonomous” powers. A tax measure has been adopted in the exercise of sufficiently autonomous powers when three conditions are met:

i) The decision must have been taken by a regional or local authority which had, from a constitutional point of view, a political and administrative status separate from that of the central government (“institutional autonomy”). Institutional autonomy only exists where the infra-state body assumes the political consequences of a tax reduction measure.

ii) It must have been adopted without the central government being able to directly intervene as regards its content (“procedural autonomy”).

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38 State Aid refers to forms of assistance from a public body, or publicly-funded body, given to selected undertakings (any entity which puts goods or services on the given market), which has the potential to distort competition and affect trade between member states of the European Union. Further details are available from: http://www.bis.gov.uk/policies/europe/state-aid
iii) Finally, the financial consequences of a reduction of the national tax rate for undertakings in the region must not be offset by aid or subsidies from other regions/areas or central government. (“financial autonomy”). Financial autonomy only exists where the infra-state body assumes the financial consequences of a tax reduction measure.

On the facts of the case, the Azores corporate tax proposal did not fulfil all of those conditions. The reduction in tax revenue which might result from cutting tax rates in the Azores was offset by a financing mechanism which involved a budgetary transfer from the Portuguese central government. The measure therefore failed to meet the test of financial autonomy. For this reason the disputed measures were assessed in relation to whole of Portuguese territory. The court held that the Commission had properly classified them as selective and incompatible aid.

There are also bilateral agreements on the operation of the tax system between the United Kingdom and other countries. Many of those relate to ‘double taxation treaties’ which are designed to protect against the risk of double taxation where the same income is taxable in two states and to outline the taxation arrangements for goods and services that are traded between countries.\(^\text{39}\)

3.5.2 Taking these international constraints into consideration, we will assess each tax in turn in succeeding chapters.

3.5.3 Figure 3.2 below shows the composition of Welsh tax receipts. In total we estimate that just over £16 billion was raised in Wales from taxes that are collected for the UK Exchequer in 2010-11. Annex D provides further details.

**Figure 3.2: Estimated composition of Welsh tax revenue from taxes collected by HMRC, per cent of total tax revenue 2010-11**

![Pie chart showing the composition of Welsh tax revenue](image)

Source: HMRC and Commission calculations

\(^{39}\) A summary of the current UK tax treaties are available for the HMRC: [http://www.hmrc.gov.uk/taxtreaties/index.htm](http://www.hmrc.gov.uk/taxtreaties/index.htm)
3.5.4 In making our assessment for each tax we have found it useful first to consider the potential benefits from devolving that particular tax and secondly the consequences and costs of so doing. In this assessment we have drawn on the key principles that we discussed earlier, placing emphasis on those principles that we feel are particularly important in the Welsh context.

3.5.5 The potential benefits from devolving a particular tax include:

- **Accountability and empowerment** – If a tax is paid by a high proportion of the population, is visible and well understood by the population then, if devolved, the Welsh political parties could offer Welsh voters the choice in Assembly elections between levels of the tax in question and spending on devolved services to best meet their preferences. This would enhance accountability and empowerment in Welsh governance;

- **Economic incentives** – Certain taxes are strongly linked to the performance of the economy in Wales and, if the economy performs well, tax revenues will increase, while tax revenues will decrease if economic conditions deteriorate. The devolution of powers over some taxes could enhance the incentives of the Welsh Government to encourage economic growth in Wales. This can have wider social benefits as a stronger economy in Wales can help achieve social objectives; and

- **A policy lever to achieve a defined outcome** – The autonomy to vary a particular tax can be an effective policy lever to achieve a defined devolved policy outcome. This may include improving the economic competitiveness of Wales by enhancing the incentives for investment or it could be that the tax in question might be used to change the behaviour of citizens, as in the case of the current charging system for single use bags in Wales. The autonomy to use fiscal levers to achieve a defined outcome would also enhance the empowerment of the Welsh Government and National Assembly for Wales.

3.5.6 The consequences of devolving a particular tax have been assessed in relation to the impact on:

- **Economic behaviour (including cross-border behaviour)** – Wales is highly integrated into the economy of the wider United Kingdom where economic activity (individuals or businesses) does not recognise the internal borders. Some 90 per cent of the Welsh population lives within 50 miles of the border with England. For some taxes the potential for differences in tax rates between Wales and the rest of the United Kingdom could impact on the location of individuals and businesses along border areas in particular, although the extent may sometimes be exaggerated;

- **Administrative impacts** – Historically HMRC applied a uniform set of rules and administrative processes in all parts of the United Kingdom. The Scotland Act 2012 introduces a change in this process which may have implications for the administration of payroll systems for businesses in Wales, England and Northern Ireland, as well as in Scotland. In addition, the Scottish Government has announced proposals to create a separate revenue collection body in Scotland (Revenue Scotland) to manage the administrative aspects of devolved taxes in Scotland. Inevitably, therefore, the devolution of any tax will potentially increase the administrative burdens on individuals and businesses and the administrative overheads of government in Wales. Those costs are likely to be greater for some taxes than others; and
• **Relationship with the block grant** – The interaction between the devolution of a particular tax and the block grant is crucial in the design of any future financial system for Wales. Even in the event of significant devolution of taxation powers, it is likely that the majority of resources available to the Welsh Government will come from the block grant. We consider this interaction for each tax in Chapters 4 and 5. It is particularly important to assess how the devolution of powers over taxes should interact with the block grant and we discuss this below with further details in Annex E.

3.5.7 So, while there may well be good reasons to devolve a tax to Wales, we also consider whether there may be undesirable consequences. The devolution of any tax will add a degree of complexity compared to a uniform UK-wide system and potentially increase the administrative and compliance burden. Differential tax rates between Wales and the rest of the United Kingdom may also increase the likelihood of individuals and businesses changing their behaviour to minimise the amount of tax they pay by moving, so distorting the economy.

3.5.8 There are therefore costs associated with change, but there are also costs and missed opportunities associated with keeping existing arrangements in place. The key is ensuring that any costs do not outweigh the benefits that underlie the reason for devolving the tax. This cost-benefit approach has been central to our assessment for each tax and has been carefully considered in making our recommendations.

3.5.9 To conclude, it is our view that, in considering whether any tax should be devolved, the benefits should be assessed against the tax principles set out in this chapter while also taking into account the costs involved. The tax should only be devolved if the benefits outweigh the costs both for Wales and the United Kingdom as a whole.

3.6 **THE RELATIONSHIP BETWEEN THE DEVOLUTION OF TAX POWERS AND THE BLOCK GRANT**

3.6.1 In the event of the devolution of tax powers, part of the Welsh budget would be dependent on its own tax revenues. These revenues would no longer be available to the UK Government and there would therefore need to be an initial deduction from the block grant. In the first year this deduction would be equal to revenue generated by that devolved tax in Wales, and the total level of resources available to the Welsh Government would not be affected by the devolution of tax powers.

3.6.2 In future years, the Welsh budget would vary according to the changes in tax revenue. However, there will also have to be future deductions to the block grant to reflect the part of the Welsh budget that is generated from devolved tax revenues in Wales - revenues which will no longer be available to the UK Government. The way those subsequent deductions are made in future years is crucially important to understand as it determines the extent that the Welsh budget is exposed to the risks associated with the devolution of tax powers.

3.6.3 We consider that it would be inappropriate for the Welsh Government to be exposed to all the risks associated with the devolution of tax powers as some of those risks may not be the result of actions by the Welsh Government. It is, however, right that the Welsh budget should be exposed to the risks associated with the choices of the Welsh Government.
3.6.4 We have reviewed the alternative block grant adjustment mechanisms and agree with the Holtham Commission’s detailed analysis of the risks and the interaction of tax devolution to the block grant.

3.6.5 Their analysis concluded that for large taxes the deduction to the block should change each year according to the change in the devolved tax across the United Kingdom as a whole. For example, if the revenue from the devolved tax increased by 5 per cent across the United Kingdom as a whole the deduction from the block grant would increase by 5 per cent. This method is called the indexed deduction. This means that if there is a recession that results in a fall in tax revenues across the United Kingdom including Wales the deduction to the block grant will also (in addition to the reduction in Welsh tax revenues) be reduced, thus mitigating cyclical risks.

3.6.6 The other key advantage of using this approach is that the Welsh budget would not be exposed to the UK-level risks that impact on the tax that has been devolved. The correct application of the indexed deduction method means that any policy changes to the UK tax base that impacts upon the Welsh tax base would automatically be compensated by an appropriate adjustment to the block grant. If, for example, the UK Government increased the personal allowance for income tax then Welsh tax revenues would fall. However, so would the deduction to the block grant as revenues across the rest of the United Kingdom would also fall as a result of this policy change.

3.6.7 The correct application of the indexed deduction method, therefore, automatically incorporates the principle of ‘no detriment’. Any policy changes to the UK tax base that impact upon the Welsh budget would be compensated by an appropriate adjustment to the block grant.

3.6.8 For smaller taxes the process of making changes to the deduction based on changes in the devolved tax across the United Kingdom would be too onerous and would add unnecessary administrative costs. As a result, for smaller taxes, the deduction should be an agreed fixed amount that reflects the amount that the devolved tax may raise in Wales in the future based on an appropriate forecasts of revenues. This method is called the fixed deduction.

3.6.9 If the Welsh Government decided to change the rate of tax in Wales either up or down compared to the rate in the rest of the United Kingdom, it would keep and spend the additional revenue or have to cut spending to reflect the reduced revenue. Both approaches (indexed deduction for income tax and fixed deduction for smaller taxes) are being adopted in Scotland following the Scotland Act 2012.

3.7 CONCLUSIONS

3.7.1 In international terms, the National Assembly for Wales is unusual, if not unique, in having legislative and spending powers but not having tax and borrowing powers. Other similar ‘sub-national’ governments have these powers, as the OECD clearly demonstrates.

3.7.2 We considered what the principles should be for assessing a funding system and, from evidence received, we decided these to be: accountability; autonomy; cooperation and constructive engagement between the UK Government and the devolved administrations; economic incentivisation; efficiency; empowerment; equity; fiscal discipline; simplicity; stability, predictability and sustainability; and transparency. These principles have underpinned the recommendations we reach throughout this report.
3.7.3 We believe that any change in the system of funding for Wales should be judged against those principles, with particular emphasis on accountability, empowerment, efficiency, economic incentivisation and equity. Changes to the way in which the Welsh Government is funded should benefit Wales and therefore the United Kingdom.

3.7.4 On the basis of this assessment, we believe the block grant alone, or with assigned taxes, does not provide sufficient financial accountability and empowerment. Fuller fiscal autonomy would remove the fiscal transfer on which the successful Union is based. We therefore conclude that a combination of block grant with some tax devolution is best for Wales.

3.7.5 In the next two chapters, we consider which taxes ought to be devolved.
Chapter 4 – Smaller yielding and local taxes

4.1 OVERVIEW

4.1.1 In this chapter we use the principles we outlined in Chapter 3 to assess whether relatively small taxes, including stamp duty land tax, aggregates levy, landfill tax and air passenger duty, should be devolved to the Welsh Government. We also consider local taxes including council tax and business rates. We discuss whether the Welsh Government should have the power to introduce different taxes in Wales. We also consider a range of other existing smaller taxes which we do not think meet our principles for tax devolution.

4.1.2 We consider these smaller taxes first, before considering larger taxes in the next chapter. By definition most of these taxes do not raise a large amount of revenue, so if devolved they would not materially impact on the ability of the Welsh Government to offer Welsh citizens major choices between spending and taxation levels. They would only go some way to increase the financial accountability of the Welsh Government compared with the taxes considered in the next chapter. However, taxes directly relating to devolved policy areas in Wales could, if devolved, better empower the Welsh Government to deliver its policy objectives. This increased responsibility would also help develop accountability, as the citizen would understand that all aspects (executive, legislative and financial) of a policy area are devolved.

Box 4.1: Evidence on smaller yielding taxes

The Institute of Directors said “Taxes that align with Welsh Government functions, and which are aimed at changing behaviour as much as revenue raising could sensibly be devolved to the Welsh Government. So, for example, landfill tax whose prime role is to help move to more sustainable waste management practices, could sensibly be devolved. Aggregates tax too seems to fall in much the same category and possibly airport tax. But devolving these fiscal instruments will do nothing to improve general accountability between the WG and their voters”.

The Federation of Small Business was also supportive of devolving taxes linked to devolved responsibilities “Minor taxes such as Air Passenger Duty and Landfill Tax could provide a beneficial tool for the Welsh Government. For example if air passenger duty were to be reduced then this could increase the flow of business and tourist visitors to Wales via Cardiff Airport, increasing economic activity and benefiting small businesses in Wales. Other corrective taxes that could increase the potency of Welsh Government policies include, for example, Landfill tax which has had a significant impact on behaviour with regards to the environment and also the development of new products or services”.

40 We have sought to give an indication of the approximate revenue in Wales from each of the taxes discussed in this chapter. For some, the data are available and for others we have had to estimate them. In preparing our estimations, we have applied Wales’s share of a relevant indicator to the total UK tax revenue. For example to estimate the amount of fuel duty generated in Wales we applied fuel consumption in Wales as a percentage of the UK total to overall UK fuel duty revenues. Annex D summarises the methodology we used.
PricewaterhouseCoopers told us that “As policy instruments to promote economic development, we accept that some ‘minor’ taxes may be suitable for devolution, should there be political consensus so to do. Such taxes might include Air Passenger Duty, Aggregates Levy and Landfill Tax”.

The Bevan Foundation told us that there was a strong case to devolve tax raising powers in areas where the Welsh Government has responsibility for expenditure on specific activities.

At our public event in Swansea there was considerable support for Welsh Government tax powers to improve accountability and as economic levers. At our public event in Flint there was support for a step-by-step approach where smaller taxes are devolved first before larger ones like income tax. This was also expressed at our public event in Cwmbran.

The Welsh Government told us that “the case for tax devolution appears strongest in areas where there is a substantial degree of devolved responsibility and where devolution would provide an additional lever for Welsh Ministers to deliver their policy objectives. The Holtham Commission saw no major barriers in principle to the devolution of stamp duty land tax, air passenger duty, aggregates levy and landfill tax and we agree that all of them could be good candidates for devolution”.

4.2 PROPERTY AND LAND TAXATION

4.2.1 Land and property taxation form an important part of the tax base in the United Kingdom and most developed countries. As the supply of property and land is not very responsive to the price (it takes some time to build new property and make new land available) taxes on them do not significantly distort behaviour. An additional benefit associated with property and land taxation is that ownership can be easily established and they are tied to a particular geographical location.

4.2.2 The international evidence we summarised in Chapter 3 highlights that revenue from property taxes is the joint largest source of tax revenue for sub-national governments across OECD countries. In total, property taxation represents 34 per cent of all sub-national government tax revenues. In the United Kingdom, 100 per cent of the taxation currently raised at the sub-national level is property related in the form of council tax and business rates.

4.2.3 It is perhaps not surprising that property taxation (in the form of council tax and non-domestic rates) determine the part of the budget for local authorities that is generated by local taxation in the United Kingdom. We discuss council tax and non-domestic rates first in this section before discussing the current UK-wide taxes on property and land.

41 Property taxation can take various forms from taxation on property transactions, taxation on the value of property in the form of a ‘wealth’ tax or taxes to fund public services as in the UK with council tax.

42 See Chapter 3 for a description of what we refer to as economic distortions.

Council tax

4.2.4 Council tax is already devolved and is therefore a matter for the Welsh Government. Council tax is an important aspect of the financial accountability and empowerment of local government and is so regarded by local authorities themselves. It comprises a little under 18 per cent of the total expenditure of local authorities in Wales. The remainder of local authority spending is funded through grants from the Welsh Government, the majority of such grants are non-hypothecated and there is also a series of grants for specific purposes, and the local authority’s share of re-distributed business rate income (see section below). Box 4.2 summarises the current arrangements for council tax in Wales.

Box 4.2: Council tax
Council tax was introduced in Wales (and England) by the Local Government Finance Act 1992. Council tax replaced the Community Charge and determines the way households contribute to local authority services.

Council tax in Wales is levied on residential properties by local authorities. All homes are allocated to one of nine bands (labelled A-I) based on their market value as at 1st April 2003. The council tax rate for each band is a fixed fraction or multiple of the rate for a Band D property. Homes occupied by students or by a single person qualify for a discount on the council tax, while those on low incomes have the tax paid in full in the form of council tax benefit. In 2010-11, council tax raised £1.3 billion in Wales (before taking account of council tax benefit). Local authorities retain their council tax receipts. Council tax benefit is being devolved in 2013.

4.2.5 At present, Welsh Ministers have significant powers to reform council tax. Wales is ahead of England in improving the way in which council tax is implemented along the lines of the recommendations of the Lyons Inquiry. The English council tax regime continues to be based on the 1993 property values that were calculated when the tax was first introduced. The English council tax regime has eight bands and the number of bands has also remained unchanged since 1993. In contrast, Wales held a revaluation exercise in 2005, and has a statutory commitment to a further revaluation by 2015. An extra band was also introduced at the time of the revaluation for properties over £424,000. There has also been divergence in policy between Wales and England with the Welsh Government not providing funding to support a council tax freeze in Wales unlike in England.

4.2.6 While we have not sought evidence on issues relating to council tax because it is already devolved, we have heard evidence discussing how council tax could be reformed in Wales.

4.2.7 As council tax is already a devolved tax, and is therefore outside our terms of reference, we make no recommendations on it.

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44 In 2012-13 this grant is over £4.0 billion and is distributed via a formula that is detailed in Local Government Settlement http://wales.gov.uk/topics/localgovernment/finandfunding/settlement/?lang=en.


46 The Scottish Government also decided to freeze council tax increases in Scotland.
Business rates (Non-Domestic Rates)

4.2.8 Business rates are a property tax paid on non-domestic properties. They are the means by which businesses and other users of non-domestic property contribute towards the costs of local authority services.

4.2.9 Business rates are calculated by taking the Rateable Value of a property and multiplying it by the non-domestic rates ‘multiplier’ or ‘poundage’ for the year in question. The Welsh Government sets the multiplier each year and can also set a range of reliefs to reduce the amount of tax that certain owners of non-domestic properties have to pay.

4.2.10 Box 4.3 summarises the evidence we have received on business rates.

Box 4.3: Evidence on business rates (NDR)
The Federation of Small Businesses considered “NDR to be one of the most important factors influencing the wellbeing of small businesses in Wales... reform of NDR system would have a far greater economic impact on small businesses in Wales and could become an important economic lever for the Welsh Government”.

The WLGA stated that “there is little apparent benefit to Wales of devolving Non Domestic Rates to Wales as the Welsh Government already has considerable powers to reduce NDR using various reliefs. In addition under the current regime the risk of NDR receipts being higher or lower than forecast is met by HM Treasury so fully devolving NDR would increase the volatility of the Welsh budget”.

The Finance Working Group for the Wales in a Changing Union argued that “Although it can be argued that many of the reforms that Professor Morgan suggests could be implemented under existing powers, we believe that the best path would be to devolve business rates now so that clarity can be quickly established”.

4.2.11 Legislative responsibility for business rates is fully devolved. At present the Welsh system operates under the same primary legislation as the English system because there has not yet been cause to use the legislative powers bestowed on the National Assembly for Wales following the 2011 referendum. The Welsh Government could now propose a change in the primary legislative framework if it so wished. Therefore, we do not think that further devolution of legislative powers over non-domestic rates is required.

4.2.12 Unlike council tax, the income from business rates does not have any impact on the amount of resources available to the Welsh Government. Box 4.4 summarises the financial arrangements for business rates in Wales.

Box 4.4: Business rates – financial arrangements
In England expenditure funded by business rates is part of the Department for Communities and Local Government (DCLG)’s Local Government DEL. In Wales this spending is part of the Welsh Departmental Expenditure Limit. The Welsh Government receives Barnett consequentials of changes in spending in England, and the DCLG Local Government Barnett formula comparability factor for Wales reflects this. Business rate income goes into the Welsh Consolidated Fund and is netted off the block grant.
The benefit to Wales is that Welsh business rate spending is tied to English spending through the Barnett formula. The overall revenue raised from business rates in Wales has no influence on the size of the Welsh budget. Changes in this total are determined by changes in the DCLG Local Government consequential. If Welsh business rates income fell or increased by £100 million, this change would not have any impact on the Barnett determined resources transferred to the Welsh Government. This removes risk and is an advantage to Wales if English rates are more buoyant than in Wales. But it also means there is no incentive to increase collection rates and grow the economy.

In Scotland this spending is not part of the Scotland Departmental Expenditure Limit. It is part of Scottish Annually Managed Expenditure. The Scottish Government sets, retains and spends business rate income without any reference to spending in England. The Scottish Barnett formula comparability factor is lower than in Wales reflecting the fact that it is not part of DEL.

As noted above, during a time when the DCLG DEL is increasing, the Welsh Government receives increases to its budget from Barnett consequentials of increases in the DCLG DEL even if the amount of revenue from business rates in Wales did not increase. Scotland and Northern Ireland get smaller consequentials than Wales, reflecting their lower comparability factors. When the DCLG DEL is reduced, Wales receives negative Barnett consequentials of the DCLG reduction, but Scotland and Northern Ireland do not receive these consequentials to the same extent because their comparability factors are lower. In other words Wales gets a bigger share than Scotland or Northern Ireland of reductions in the English Local Government DEL budget. This reflects the working of the Barnett formula and occurred in the 2010 Spending Review when the Welsh DEL saw a higher percentage reduction than both Scotland’s and Northern Ireland’s DELs.47

Even within these financial arrangements, the Welsh Government can introduce more generous rate reliefs than England. If the Welsh Government decided to do so, the Welsh Government resource DEL would be reduced by the amount of the reduced business rates in Wales.

4.2.13 In May 2012 the review of Welsh business rates set up by the Welsh Government and chaired by Professor Brian Morgan reported. While most of its recommendations were directed to the Welsh Government, it also recommended that our Commission should consider the case for devolving business rates to Wales. Specifically it said that “we believe devolving rates would introduce both a hard budget constraint and a considerable incentive effect for the Welsh Government and local authorities to widen the tax base”. But the Morgan review also noted that “the current system provides some protection from the downside volatility in rates yield”.

4.2.14 The Scottish system is better aligned to tax devolution accountability and empowerment principles because spending should be determined by the amount of business rates revenue raised in Wales, not on Barnett formula consequentials of English spending as is currently the case. Moving to the Scottish system would ensure that the amount of business rates revenue raised in Wales would have a direct impact on the resources available to the Welsh Government. This could promote economic development and give the Welsh Government greater flexibility to offer more or less generous reliefs than at present as the financial implication of doing so would be clearer.

47 Explained by Gerald Holtham in http://www.clickonwales.org/2010/11/why-wales-has-been-hit/
4.2.15 Furthermore, the Morgan review recommended that business rates should be localised to some extent to incentivise economic growth so that some business rates income is retained and spent by local authorities rather than centrally pooled by the Welsh Government as now. The UK Government also plans to introduce some localisation in England. Such localisation would reinforce the case for treating business rates as part of Welsh AME rather than DEL, by analogy with council tax funded spending. Spending financed by council tax in Wales is part of AME (known as local authority self financed expenditure) and is not part of Welsh DEL. Council tax is retained by local authorities and is not pooled.

4.2.16 The main potential disadvantage with moving to the Scottish system is the potential impact on public expenditure. Almost £1 billion a year of business rate spending would be transferred from Welsh DEL to AME, taking this sum out of the Barnett system. This spending would grow not through Barnett consequentials but through the growth of the Welsh business rate tax base. The Morgan review concluded that the current arrangement is good for Wales when spending in England is rising rapidly, as in the period from 2003 but could result in less resource for Wales when the consequentials are rising slowly, as now. Gerald Holtham argued in his Institute of Welsh Affairs paper (noted in the footnote above) that the reason why the Welsh resource DEL fell by 7.5 per cent in the 2010 Spending Review compared to Scotland’s 6.8 per cent and Northern Ireland’s 6.9 per cent reduction was the impact of negative business rate consequentials in Wales. Given that fiscal consolidation is set to continue, this may also be the case in the next spending review if the Scottish system is not adopted. In addition, if the local authority collection rate improved, more resources would be available for spending in Wales if business rates were fully devolved; the collection rate was 97.1 per cent in 2011-12, down from 97.3 per cent the previous year.

4.2.17 To conclude, we believe that fully devolving business rates would fit our tax principles well, increasing accountability and empowerment, improving growth incentives and providing equitable treatment with Scotland and Northern Ireland. We accept that the Welsh Government has historically benefitted in some years from the existing arrangements, although Wales may gain by the reforms we are proposing over the next few years. The Welsh and UK Governments should therefore consider the desirability of changing the financial arrangements for business rates in Wales to be the same as the current arrangements in Scotland and Northern Ireland. Part of this consideration should be an assessment of the risks associated with any change against the potential benefits that moving to the same financing model as in Scotland could bring.

4.2.18 In addition, the Morgan review made a number of other recommendations including in areas such as Tax Increment Funding (where local borrowing is financed by increased future business rates) and Business Improvement Districts (where a business rate levy is raised to finance spending which benefits the local business community) to incentivise growth. These recommendations are consistent with the principles set out in this report, and we look forward to the Welsh Government’s response to those and the other recommendations of the Morgan review.

Recommendation

R.2. Business rates should be fully devolved, subject to the Welsh and UK Governments agreeing the details and assessing any risks involved.
Stamp Duty Land Tax

4.2.19 Stamp Duty Land Tax (SDLT) is a tax payable on the purchase or transfer of property or land where the amount paid for that purchase or transfer is above a certain threshold. Box 4.5 summarises how SDLT currently operates in the United Kingdom. In Scotland, SDLT is being devolved and the Scottish Government recently began a consultation process on reforming SDLT in Scotland.\(^{48}\)

Box 4.5: Stamp Duty Land Tax

Stamp Duty Land Tax is charged as a percentage of the amount paid for property or land when it is bought or transferred - unless there is a relief or exemption.

Table 4.1 summarises the current rates and thresholds for residential land or property.

<table>
<thead>
<tr>
<th>Purchase price/lease premium or transfer value</th>
<th>Rate of stamp duty land tax (per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under £125,000</td>
<td>Zero</td>
</tr>
<tr>
<td>Over £125,000 to £250,000</td>
<td>1</td>
</tr>
<tr>
<td>Over £250,000 to £500,000</td>
<td>3</td>
</tr>
<tr>
<td>Over £500,000 to £1 million</td>
<td>4</td>
</tr>
<tr>
<td>Over £1 million to £2 million</td>
<td>5</td>
</tr>
<tr>
<td>Over £2 million</td>
<td>7</td>
</tr>
<tr>
<td>Over £2 million if purchased by certain persons including corporate bodies</td>
<td>15</td>
</tr>
</tbody>
</table>

The rates for non-residential land and property are slightly different and are shown in table 4.2.

<table>
<thead>
<tr>
<th>Purchase price/lease premium or transfer value</th>
<th>Rate of stamp duty land tax (per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to £125,000 – annual rent is under £1,000</td>
<td>Zero</td>
</tr>
<tr>
<td>Up to £125,000 – annual rent is £1,000 or more</td>
<td>1</td>
</tr>
<tr>
<td>Over £150,000 to £250,000</td>
<td>1</td>
</tr>
<tr>
<td>Over £250,000 to £500,000</td>
<td>3</td>
</tr>
<tr>
<td>Over £500,000</td>
<td>4</td>
</tr>
</tbody>
</table>

4.2.20 SDLT is one of the few UK-wide taxes where data on Welsh revenues are published by HMRC. In 2010-11 SDLT revenues in Wales were £115 million (around 2 per cent of the UK total). The tax is relatively volatile (see Annex D) as revenues are dependent on the wider trends in the land and housing markets. The SDLT tax base in Wales has been less buoyant than for the United Kingdom as a whole as a result of slower growth in Welsh property and land prices and a lower average number of transactions.\(^{49}\)

\(^{48}\) Further details are available at: http://www.scotland.gov.uk/Publications/2012/06/1301

\(^{49}\) Historically domestic property transactions in Wales represent between 4-5 per cent of the total housing stock compared to 6 per cent in England. That is, the turnover of property is lower in Wales than in England.
4.2.21 In addition to the evidence summarised in Box 4.1, Box 4.6 summarises the evidence that we have received specifically on SDLT.

Box 4.6: Evidence on Stamp Duty Land Tax

The results from our opinion poll showed that 67 per cent of respondents thought that the Welsh Government should have the right to change the level of “buying a house tax”. This was the joint highest level of support in respect of the major UK-wide taxes that were asked in the poll.

The Welsh CBI said “It is regarded as eligible for devolution due to the highly immobile nature of the tax base. Assuming that the tax could be ‘priced’ effectively in terms of reducing Wales’ block grant, we see some logic to stamp duty being devolved.”

The Finance Working Group of the Wales in a Changing Union told us that “Since this [stamp duty] is now being devolved to Scotland, there is no practical reason why it should not be devolved to Wales. It has a clear connection to a policy objective within devolved housing policies”.

4.2.22 As most aspects of housing policy are devolved to Wales, there would be a good policy fit if SDLT were devolved. The Welsh Government could design SDLT to fit Welsh housing and economic circumstances. It could also take account of other specific Welsh concerns in designing SDLT by changing the existing reliefs and exemptions that currently apply across the United Kingdom as a whole, subject to any state aid restrictions.50

4.2.23 As with all taxes, any differential (if such a decision is made) between SDLT in Wales compared to the rest of the United Kingdom may influence location decisions of individuals and businesses. While this might be regarded positively as a desirable policy outcome, it could also be viewed negatively as a market distortion by encouraging people to choose economically sub-optimal locations simply to reduce their tax bill.

4.2.24 Research51 shows that transactions costs (SDLT is a cost on purchasing property and land so is a tax on transactions) only marginally influence where individuals locate and are not a decisive factor in location decisions. This research shows that other factors such as the supply of suitable housing, the characteristics of the household (such as income level, age and employment status) and availability of finance play a larger role in location decisions. In addition, there is a range of evidence52 that shows that variations in property taxes are reflected in house prices so that lower taxes tend to result in increased house prices and vice versa. This evidence suggests that the potential for differences in SDLT between Wales and the rest of the United Kingdom is unlikely to have a significant direct consequence on location decisions.53

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50 There may be some state aid considerations if applied to non-domestic property transactions.
53 The Morgan review also found evidence that business rates tend to get capitalised in property values.
4.2.25 The administrative consequences of devolving SDLT are not likely to be significant. The purchaser of the property or land is responsible for notifying HMRC of the purchase or transfer by completing a Land Transaction Return - commonly referred to as the Stamp Duty Land Tax Return - and for ensuring that SDLT is paid on time. In practice, most people employ a solicitor or conveyancer to complete the return for them. The existing SDLT return already identifies the local authority area in which the transaction takes place, thus allowing HMRC to identify transactions undertaken in Wales.

4.2.26 There are different ways in which a devolved SDLT could be administered. The Welsh Government could discuss with HMRC whether it might have a role in operating a devolved system on the Welsh Government’s behalf under a service level agreement. The Welsh Government could also consider whether alternative administrative arrangements are desirable, as the Scottish Government is doing. It is conceivable that economies could be found through this process.

4.2.27 There is no reason in principle why the compliance burden for taxpayers purchasing a single property or land in any part if the UK should increase significantly if SDLT were devolved to the Welsh Government. While there may be a small increase in the compliance burden for those engaged in the purchase of land or properties simultaneously in Wales and elsewhere in the United Kingdom, such purchases are a small proportion of the market as a whole.

4.2.28 SDLT is a relatively volatile tax so its devolution could increase risks to the Welsh budget. The Welsh Government might require the use of revenue borrowing powers to help manage year-on-year volatility with borrowed resources used to meet any deficit when revenues are below those forecast. We discuss revenue borrowing powers in Chapter 6. In addition there may be a concern that stamp duty in Wales has a tendency to grow more slowly than the UK average. However if the tax were devolved this could incentivise the Welsh Government to grow the tax base and economy to increase its income.

4.2.29 Devolving SDLT to the Welsh Government would have consequences for the block grant, which would be reduced by the amount of SDLT collected in Wales while the Welsh Government would retain the amount of tax collected from the Welsh tax which replaced SDLT. As discussed in Chapter 3 the way that the block grant off-set is determined is important to manage the risks associated with tax devolution. Careful consideration is required to assess the appropriate grant offset for SDLT. As SDLT is a small tax we do not think that the indexed deduction approach is appropriate. Instead, we recommend that a fixed deduction is made to the block grant. The value of this deduction should be decided between the Welsh and UK Governments taking into account the volatility of the tax and forecast revenue in Wales.

4.2.30 In summary, the evidence shows that SDLT is a suitable tax to be devolved. While the tax is volatile, it is levied on immobile transactions and is closely linked to devolved responsibilities. Devolution would not result in a significant increase in administrative or compliance costs. The risk is low that any differential between SDLT in Wales and the rest of the United Kingdom would create strong incentives for individuals and businesses to locate elsewhere to avoid paying higher tax.

4.2.31 Devolution would increase the empowerment of the Welsh Government, by allowing it to design the tax to fit Welsh housing and economic circumstances. If Welsh Ministers were given control over all aspects of the tax then, before the UK-wide tax ceases to be charged...
in Wales, the Welsh Government would need to make provision for its re-introduction or replacement in legislation.

4.2.32 We make no recommendation about what the Welsh Government should actually do if SDLT were devolved to it, but examples of what might be possible could be targeted reductions to stimulate house-building, reliefs for first-time buyers or small agricultural businesses wishing to diversify, or differential rates of tax for first and second homes. These would be policy matters for the Welsh Government and the political parties in Wales.

4.2.33 In addition, if SDLT were devolved and if the Welsh Government were given a power to introduce innovative taxes such as a land tax, there would be scope for more radical reform of property taxation in Wales in line with the recommendations from the Mirrlees Review.\textsuperscript{54} While we accept the good economic arguments for reforming land and property taxation, we are aware of the practical and political difficulties involved. We do not ourselves make any recommendations about the future of property taxes in Wales, though we would expect the Welsh Government to assess carefully the potential and the pitfalls of reform.

**Recommendation**
R.3. Stamp Duty Land Tax should be devolved to the Welsh Government with Welsh Ministers given control over all aspects of the tax in Wales. A fixed deduction should be made to the block grant with the value of this agreed between the Welsh and UK Governments taking due consideration of the volatility of receipts.

### 4.3 OTHER SMALLER TAXES

4.3.1 We next consider a range of other smaller UK-wide taxes that could be devolved to the National Assembly for Wales and Welsh Government.

**Landfill tax**

4.3.2 Landfill tax is a tax on the disposal of waste. In Wales just over half of all waste that is land filled is industrial or commercial; the rest is municipal (the majority of which is local authority collected refuse). Landfill tax aims to encourage waste producers to produce less waste, to recover more value from waste (for example through recycling or composting) and to use more environmentally friendly methods of waste disposal.

4.3.3 The tax is charged by weight and there are two rates: a lower rate on inert or inactive waste, covering most building fabrics and excavated earth; and the standard rate, covering materials such as wood, piping and plastics. The current UK-wide tax return for landfill tax does not identify the geographical location of the taxable activity. Therefore, HMRC do not publish landfill tax revenues for Wales. However we estimate that landfill tax revenues in Wales for 2010-11 were in the region of £50 million (just under 6 per cent of the UK total. See Annex D for further details).

\textsuperscript{54} IFS (2011) *Tax by Design* Chapter 16.
4.3.4 The evidence that we have received supports the case for devolving landfill tax to the Welsh Government on the grounds that it would provide a useful policy lever in an area of devolved responsibility. The Scotland Act 2012 provides for complete devolution of landfill tax subject to any replacement tax remaining a tax on waste disposal to landfill. In addition to the evidence summarised in Box 4.1, Box 4.7 summarises the evidence we have received specifically on landfill tax.

Box 4.7: Evidence on landfill tax
The Welsh CBI said “The landfill tax base is relatively immobile, receipts are relatively stable and it is a key feature of environmental policy, which together means that it is a relatively strong candidate for devolution to Wales”.

The Finance Working Group of the Wales in a Changing Union told us that “Since this [Landfill tax] is now being devolved to Scotland, there is no practical reason why it should not be devolved to Wales. It has a clear connection to a policy objective within devolved environmental policies”.

4.3.5 As waste management is a devolved responsibility the devolution of landfill tax would provide a good policy fit. If landfill tax were devolved the Welsh Government could for example increase rates to promote environmental objectives or reform the tax completely to better meet policy objectives in Wales.

4.3.6 For taxpayers that dispose of large quantities of waste in landfill there may be an incentive to dispose across geographical borders if there were differential tax rates between Wales and England. This could be seen as an undesirable market distortion. Transport costs would limit the benefits from changing the location of disposal, but these transport costs would be less of a barrier the closer the activity was to the border. Thus different rates in Wales compared to England may result in some cross-border waste disposal. We do not believe that the potential for some cross-border waste disposal is sufficient to outweigh the potential benefits from devolution. However the Welsh Government would need to consider carefully any potential adverse cross-border distortions when designing and managing a devolved landfill tax.

4.3.7 Landfill tax is currently collected by HMRC from registered landfill operators. The compliance burden therefore falls on the landfill operators. In principle there should be little or no increase in the compliance burden for taxpayers operating at a single site in any part of the United Kingdom if the tax were devolved to Wales. Landfill operators operating across multiple UK sites may experience some increase in compliance as they would have to complete two landfill tax returns. However, as the location of the waste disposed would be clearly identifiable, any additional burden would be minimal.

4.3.8 There are some important consequences for the block grant that need to be reflected in any block grant deduction. As a smaller tax a fixed deduction should be made to the block grant. However, this would need to reflect the fact that the purpose of landfill tax is to discourage waste disposal in the land, and that this means that the taxable base (volume of waste land filled) is declining. Across the United Kingdom as a whole, the taxable base for landfill has fallen by 33 per cent in the last five years. The value of the grant offset would need to reflect the declining taxable base.
4.3.9 To summarise, there is a strong case to devolve landfill tax as it would be a useful policy lever in an area within the Welsh Government’s devolved responsibility. If devolved, the consequences would be relatively small and the risks to the block grant can be effectively managed with the declining taxable base reflected in the fixed deduction made to the block grant. We recommend that Welsh Ministers be given control over all aspects of the tax. As in the case of SDLT, if Welsh Ministers were given control over all aspects of the tax then, before the UK-wide tax ceases to be charged in Wales, the Welsh Government would need to make provision for its re-introduction or replacement in legislation.

Recommendation
R.4. Landfill tax should be devolved to the Welsh Government with Welsh Ministers given control over all aspects of the tax in Wales. A fixed deduction should be made to the block grant with the value of this agreed between the Welsh and UK Governments taking due consideration of the declining taxable base.

Aggregates levy
4.3.10 Aggregates levy is a tax on sand, gravel and rock that is dug from the ground or dredged from the sea in UK waters. Quarry operators currently pay £2 tax per tonne of excavated sand, gravel or rock. The tax is not levied on recycled material nor is it levied on aggregates extracted as a by-product or waste from other processes. The tax is essentially designed to reduce the amount of primary aggregates extracted. Importers of aggregates also pay the tax once the material is used commercially.

4.3.11 There are no official figures on the revenues from aggregates levy in Wales. An estimate can be made based on Wales’s share of aggregate excavated. Based on this, aggregates levy revenues in Wales are estimated to be in the region of £20 million in 2010-11 (just over 7 per cent of the UK total. See Annex D for further details).

4.3.12 Across the United Kingdom the tax has been fairly buoyant as a result of increases in the tax rate rather than a growing taxable base. Reflecting the design of the tax (to reduce the amount of primary aggregates extracted) the taxable tonnage for the United Kingdom as a whole in 2010-11 was only 70 per cent of the tonnage in 2002-03. While some of this decline is due to the weakening in demand as a result of weaker economic growth, a longer time series (1980 to present) shows that aggregate excavation has continued to fall across the United Kingdom and its regions. In addition to the evidence summarised in Box 4.1, Box 4.8 summarises the evidence we have received in relation to the aggregates levy.

55 We discuss the Crown Estate in Chapter 7.

4.3.13 The evidence that we have received supports the case for devolving aggregates levy to the Welsh Government on the grounds that it would provide a useful policy lever in an area of devolved responsibility. Environmental and planning policies are devolved so the Welsh Government could use the levy as a policy tool to help achieve policy objectives in those devolved areas. We now assess the potential consequences if devolved.

4.3.14 One of the advantages of devolving aggregates levy is that taxable activity is easily tied to a specific location. There may be some incentive for consumers and producers of aggregates to consume or operate in alternative locations if there was a differential in tax rates between Wales and the rest of the United Kingdom. However, transport costs may limit the economic benefits from changing the location. Evidence from the Mineral Products Association highlighted that as a general rule, the cost of aggregate doubles for every 30 miles travelled. This limits the potential that differential rates in Wales would lead to cross-border movement of taxable activity.

4.3.15 As the tax is payable by quarry and dredging operators the majority of any potential compliance burdens will fall upon them. Since the aggregates excavated are tied to a specific location it is unlikely that there would be a significant increase in compliance for quarry operators from single sites in Wales if there were any differential in tax rates between Wales and the rest of the United Kingdom. There may be an increase in compliance for operators of multiple sites both within Wales and other parts of the United Kingdom but it would be straightforward to identify the activity undertaken in Wales and elsewhere in completing their tax return.

4.3.16 The final consequence relates to the block grant. As stated earlier, the taxable base is declining across the United Kingdom and the revenues from the tax have only increased due to increases in the tax rate applied. As with the other smaller taxes discussed so far, we believe that a fixed deduction to the block grant would be appropriate. The value of this block grant deduction should reflect the declining taxable base.

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57 This compares to an average price for a tonne of aggregates in the region of £10.
4.3.17 Our view is that, in principle, aggregates levy should be wholly devolved to Wales. However, there has been a legal challenge in the European Courts that the levy relief applied in Northern Ireland involves unlawful state aid and distorts the market. The UK Government and Northern Ireland Executive are in discussion with the European Commission in an attempt to resolve the issue.\(^{58}\) It would not be appropriate to devolve the levy while any doubt as to the legality of doing so remains. The UK Government has made a commitment to keep the devolution of aggregates levy under review with the intention to devolving the tax to the Scottish Government.

**Recommendation**

R.5. Subject to the outcome of discussions between the UK Government and the EU Commission on state aid issues, aggregates levy should be devolved to the Welsh Government, with Welsh Ministers given control over all aspects of the tax in Wales. A fixed deduction should be made to the block grant with the value of this agreed between the Welsh and UK Governments taking due consideration of the declining taxable base.

**Air Passenger Duty**

4.3.18 Air Passenger Duty (APD) is an excise duty which is levied on the carriage, from a UK airport, of chargeable passengers on chargeable aircraft. It becomes due when the aircraft first takes off on the passenger’s flight and is payable by the operator of the aircraft (and will be passed on to the passenger in the ticket price). The amount due is dependent on the final destination and class of travel of the chargeable passenger. Box 4.9 summarises the current rates for APD in the United Kingdom.

**Box 4.9: APD**

For APD purposes chargeable aircraft are any aircraft, including helicopters, that carry any chargeable passengers, with the exception of any that are:
- small aircraft weighing less than 10 tonnes or with fewer than 20 seats; and
- private aircraft carrying no paying passengers.\(^{59}\)

Chargeable passengers are any passengers on an aircraft, with the exception of any that are:
- in transit when the aircraft lands in the UK and do not change aircraft;
- changing to a connecting flight at a UK airport;
- airline employees;
- children under two years of age who are not allocated a seat;
- specific passengers who are not carried for reward (such as deportees); and
- on short pleasure flights that begin and end at the same place and are no longer than 60 minutes.

\(^{58}\) The following provides an update on the latest position on this legal challenge: http://www.hmrc.gov.uk/briefs/excise-duty/brief2112.htm

\(^{59}\) Private aircraft flights are not normally liable to duty unless passengers pay for their carriage. Most private aircraft are, in any event, exempt because they satisfy the definition of ‘small aircraft’. From 1 April 2013 APD will be levied on private aircraft (including helicopters) which do not fall within the definition of small aircraft and where passengers are charged for their carriage.
The latest rates for APD are shown in Table 4.3. Reduced rates apply to economy class passengers and are half the standard rate.

### Table 4.3: APD rates

<table>
<thead>
<tr>
<th>APD distance bands (miles from London to the capital city of the destination country)</th>
<th>£ per passenger from 1 April 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Reduced rate</td>
</tr>
<tr>
<td>Band A (0-2,000)</td>
<td>13</td>
</tr>
<tr>
<td>Band B (2,001-4,000)</td>
<td>65</td>
</tr>
<tr>
<td>Band C (4,001-6,000)</td>
<td>81</td>
</tr>
<tr>
<td>Band D (Over 6,000)</td>
<td>92</td>
</tr>
</tbody>
</table>

4.3.19 APD raises only a small amount of revenue in Wales, and Cardiff Airport is currently the only airport in Wales from which chargeable flights depart. Using data from the Civil Aviation Authority we estimate that APD raised just over £7.5 million in Wales in 2011. This compares to around £2.2 billion across the United Kingdom as a whole. The Welsh share of total UK APD revenues is, therefore, only 0.35 per cent. Across the United Kingdom as a whole air passenger numbers have increased by just over 24 per cent between 2000 and 2011. In Wales, air passenger numbers have fallen by around 20 per cent over the same period. The number of air passengers using Bristol airport (the most direct competitor with Cardiff airport) over the same period has more than doubled.

4.3.20 In assessing the case for devolving APD we have, as with the other taxes, examined the case in principle. But we have to recognise that presently Cardiff Airport is the only commercial airport operating in Wales whose passengers pay APD. The presence of only one commercial airport does have specific implications for our assessment and we have considered these below. However, we have also been mindful that in the future there could be further airport developments across Wales including the expansion of current commercial operations at Valley airport and the potential for commercial development at Swansea and Hawarden airports.

4.3.21 The evidence we have received has highlighted the possibility of regionally differentiated APD in England to ease congestion in the south east of England. We are aware that there may be some discussion regarding the introduction of an air congestion tax. The UK Government has asked Sir Howard Davies to chair an independent Commission tasked with identifying and recommending to Government options for maintaining this country’s status as an international hub for aviation.60 It is possible that changes will be made to the nature of aviation taxation in the United Kingdom. Proposals to devolve APD in Wales should be considered against this wider background.

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60 The Terms of Reference for this Commission are available at: [http://www.dft.gov.uk/news/statements/mcloughlin-20120907a/](http://www.dft.gov.uk/news/statements/mcloughlin-20120907a/)
Box 4.10: Evidence on APD

The Welsh CBI said “in the case of Wales, high mobility between Wales and the UK (e.g. Bristol and Cardiff) is a reason for the rate to remain consistent between the countries. A lower Welsh rate would have a distorting effect on flight patterns in the UK, with a corresponding negative impact on UK airports and airlines, particularly those near Cardiff. However, the CBI would revisit our view in light of a government review into the feasibility and likely effects of devolving APD.”

The Finance Working Group of the Wales in a Changing Union told us that “as with corporation tax there may be a case for a wider UK Framework, but in the absence of a wider proposal APD should be devolved to the Welsh Government to allow for a comprehensive approach to both transport and tourism”.

We also sought evidence from airports in Wales and England.

Cardiff Airport told us that “APD is an appropriate tax to be devolved and offers the Welsh Government a tool which can be directly applied to support objectives of improved connectivity”.

Manchester Airport Group (MAG) “supports the concept of regional differentiation when it comes to APD…. That said we would have some concerns if the power to vary APD were to be devolved to Wales or Scotland, without any measures being taken to help regional airports. Such a move could potentially put English airports at a competitive disadvantage”.

Bristol Airport raised a number of concerns and concluded that “Bristol Airport strongly opposes the devolution of air passenger duty to Wales. Any reduction in the level of air passenger duty (APD) in Wales could cause a gross distortion of the market and would be contrary to State Aid regulations, whilst providing little or no additional accountability or use as a policy tool for the National Assembly for Wales. In our view devolution could be potentially very damaging for our business”.

The Welsh Government noted the intention to devolve APD to Northern Ireland and favoured the devolution of that tax to Wales.

4.3.23 As with the other smaller taxes discussed so far in this chapter, devolving APD would provide a useful policy lever to the Welsh Government – on this aspect of their evidence we disagree with Bristol Airport. While aviation policy is not devolved (the question whether aviation policy should be devolved would be a matter for Part II of our remit), regional economic development, aspects of environmental policy and tourism are all devolved. The importance of air travel to economic development, and the importance of APD in this context, has, in fact, already been recognised in Northern Ireland. Because of the importance of the direct air link to the USA for the economy there, and because of the

61 In addition to the direct economic impact of airports there is research evidence highlighting that airports can generate wider economic benefits by encouraging inward investment and inbound tourism together with the development of businesses associated with airport activities. There is also evidence that transport links can be a crucial factor for location decisions for businesses that are fairly mobile in their location choice.
potential for the economy and for tourism that a lower rate would bring, APD for direct long haul rates is being devolved to the Northern Ireland Executive.\footnote{http://www.hm-treasury.gov.uk/press_107_11.htm}

4.3.24 The evidence we have received shows that a large number of Welsh residents fly from airports outside Wales. Currently two-thirds of all air passengers from Wales depart from airports in England, and therefore the majority of Welsh air passengers would be paying APD at the rate set for the rest of the United Kingdom even if it were to be devolved to Wales. In our view it is important therefore that these airports outside Wales are further developed as gateways to Wales, not just to England. However, we must recognise that, especially for residents of mid and North Wales, there is no accountability benefit from devolving APD to Wales at present because they would not feel any of the consequences of doing so.

4.3.25 Nevertheless, if APD were to be devolved, there would be an accountability link between the decisions by the Welsh Government on APD and a large number of Welsh citizens as 93 per cent of the 1.13 million passengers who fly annually from airports in Wales live in Wales.\footnote{It is noteworthy that the percentage of passengers who fly from Cardiff and who live in Wales is a lot higher than the percentage of passengers who fly from other airports in England and who also live in that region of England. The corresponding figures for some airports in England are: Birmingham 68% (West Midlands); Bristol 84% (South West of England); Heathrow 74% (South East of England) Liverpool 82% (North West of England); and Manchester 62% (North West of England). All figures from the Civil Aviation Authority Passenger Survey Reports.}

4.3.26 Given the evidence above in relation to the impact on airports in England, the closest competitors being Bristol and Liverpool airports, we note that lower rates of APD in Wales might be challenged on state aid grounds. It is not possible to be conclusive on state aid before a specific complaint is raised and determined, but we note the fact that the number of flights from Cardiff is comparatively small and that APD has already been devolved to Northern Ireland for long haul flights.

4.3.27 If APD were to be devolved and then reduced in Wales this would lower the price that passengers from Welsh airports pay. This could be regarded as an economic distortion creating an uneven playing field. However international evidence on the factors that influence airport choice in multi-airport locations shows that non-price factors such as airport access times, airport delay and flight frequency are important factors in determining airport choice with airport access times being the dominant factor.\footnote{Ishii, J. et al (2009), ‘Air Travel choices in multi-airport markets’, Journal of Urban Economics 65 pp216-227} Price, while important, does not appear to be a decisive factor in determining airport choice.

4.3.28 An important factor that potentially limits the impact of any economic distortions is the forecast growth in the number of air passengers using UK airports. The total number of air passengers using UK airports is forecast to increase by nearly 60 per cent by 2035 and by nearly 125 per cent by 2050 compared to 2010.\footnote{See Department for Transport UK Aviation Forecasts for further details. http://assets.dft.gov.uk/publications/uk-aviation-forecasts-2011/uk-aviation-forecasts.pdf} The same forecasts highlight the increasingly important role that UK regional airports will have in meeting demand.

\footnote{http://assets.dft.gov.uk/publications/uk-aviation-forecasts-2011/uk-aviation-forecasts.pdf}
4.3.29 We are aware of the argument that the main effect of regional reductions in APD might be to redistribute passengers across the United Kingdom, not increase UK competitiveness overall. But even if this were the case, there remains a good argument for rebalancing the UK economy away from airports which are close to capacity. In addition the numbers involved in Wales are small compared to the United Kingdom as a whole.

4.3.30 As APD is currently paid to airlines by passengers as part of the total flight cost, much of the administrative burden of devolving the tax would fall on the airlines rather than HMRC. As the location of the airport and departing aircraft is known it is unlikely that the devolution of APD would create significant additional compliance burdens.

4.3.31 We can see the benefits that devolving APD to Wales could bring. However, we are also mindful of the potential impact that this could have on airports close to the border. We believe that airports such as Bristol and Liverpool may also have a case for having a lower rate of APD applied to flights leaving their airport. We support consideration of the case for regional differentiation for APD or an element of airport congestion charging and recommend that this issue is considered as part of the Davies review and any other UK Government review of airport policy or air taxation.

4.3.32 In the meantime we believe that APD should be devolved to Wales for direct long haul flights (those currently in Bands B-D) until further consideration of regionally differentiated APD is undertaken, or if there are any developments in Scotland or Northern Ireland. The devolution of long haul rates would resonate with the economic evidence that communication links with the USA and other major economic centres have the potential to generate economic benefits beyond those at the airport alone. In addition, the advantage of initially devolving direct long haul flights is that there is likely to be less of an adverse impact on airports close to the border with Wales as long-haul flights largely depart from airports in south-east England, which have existing capacity problems. The UK Government’s recently published aviation strategy emphasises the important role played by regional airports including in relation to long haul flights.

**Recommendation**

R.6. We recommend that APD should be devolved for direct long haul flights initially and recommend that devolving all rates for APD to Wales should be part of the UK Government’s future work on aviation taxation, which should include considering the wider case for regional differentiation for APD or airport congestion charging. We recommend that this issue be considered in the context of the Davies review and any developments in Scotland and Northern Ireland. A fixed deduction should be made to the block grant with the value of this agreed between the Welsh and UK Governments taking due consideration of the forecast tax revenues in Wales.

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4.4 **TAXES CONSIDERED NOT APPROPRIATE FOR DEVOLUTION**

4.4.1 There are a number of smaller taxes that we do not consider appropriate for devolution within the United Kingdom as the risk of tax avoidance measures would be too great, particularly given the porous border between Wales and England. These are outlined below.

**Box 4.11: Evidence on other smaller taxes**

In our ICM poll a majority said that the Welsh Government should or possibly should have the right to change alcohol tax and cigarettes tax.

However in responses to our questionnaire, fewer than 10 per cent favoured devolution of Vehicle Excise Duty, fuel duty, alcohol and tobacco duties, stamp duty on shares and Inheritance Tax.

The Holtham Commission advised against devolution of excise duties and capital taxes, and we received very little evidence in favour of devolution.

NFU Cymru said “we would agree with the Holtham Commission that fuel, alcohol and tobacco duty would all be poor candidates for devolution owing to the fact that if the differential in duty rates between England and Wales was at all significant then it would inevitably lead to cross-border movement of such products.”

Sustrans recommended that fuel duty should be hypothecated to Wales.

Professor Rob Ball, David Eiser and Professor David King noted the difficulties of cross-border shopping if alcohol, fuel and tobacco duties are devolved. This also tended to be highlighted in our visits to places close to the border.

At our public event in Wrexham there was a view that rural areas could benefit if allowed to set different rates of fuel duty.

**Fuel Duty**

4.4.2 Fuel duty is paid on motor and heating fuels produced, imported or used in the United Kingdom. The duty is payable at varying rates, dependent on the type of fuel and its use. We estimate that fuel duty raised just over £1.35 billion in Wales in 2010-11 (5 per cent of the UK total), in line with Wales’s share of the UK population.

4.4.3 Under the EU Energy Products Directive, member states must set a single rate for each fuel. Different fuel prices on either side of the English/Welsh border would be distortionary – we received evidence in Northern Ireland that emphasised the cross-border problems caused by different fuel taxation arrangements between the Republic and Northern Ireland. We would not want to see motorists incentivised to cross the Welsh/English border in search of cheap fuel.

4.4.4 However, we also heard some evidence that fuel duty should be devolved to Wales to help alleviate the impact of rising fuel bills, especially in rural areas. There are certainly areas of Wales where public transport is limited or non-existent and cars are a necessity but the price of fuel is higher than that paid by urban dwellers (who also have ready access to public transport). A precedent for aiding those in these circumstances was highlighted to us. The rural fuel duty rebate pilot scheme, for which the UK Government...
has obtained EU clearance, applies at present to remote island communities in the Inner and Outer Hebrides, Northern Isles, islands in the Clyde and the Isles of Scilly. From March 2012 islanders received a 5p cut in the pump price of petrol and diesel. European Union clearance for the islands scheme was necessary, because EU restrictions normally require a single duty rate across member states.

4.4.5 While we are not convinced of the case for devolving fuel duty in general, even if that were permissible under EU rules, we believe that the UK Government should assess the recent remote islands pilot and consider whether it would be feasible to extend it to the most remote and rural areas in Wales, subject to state aid rules.

**Recommendation**

R.7. We do not recommend that fuel duty should be devolved. We recommend that in the light of experience of the fuel rebate pilot scheme, the UK Government should assess the extension of the scheme to some rural and remote areas in Wales, subject to EU agreement.

### Alcohol and tobacco excise duties

**4.4.6** Alcohol Duty is a tax that is charged on alcohol produced or processed in the United Kingdom, or brought into the United Kingdom for consumption. Excise duties are charged at different rates according to the type of alcohol. Tobacco Duty is a tax charged on tobacco products if they are made wholly or partly from tobacco or from any substance used as a substitute for tobacco. Combined these taxes raised just under £900 million in 2010-11 in Wales (just under five per cent of the UK total).

**4.4.7** Both taxes are closely aligned to health policy which is of course devolved. However, alcohol and tobacco are extremely mobile goods and there is a history of cross-border trade between countries reflecting differences in price and tax arrangements. HMRC estimates that UK consumers already take measures to avoid paying alcohol and tobacco excise duties and that the illicit market for alcohol is in the region of 11 per cent and is as high as 50 per cent for rolled tobacco. While devolution would have a good link with devolved policy areas and could be a useful tool to improve health outcomes in Wales, we consider the potential for different tax rates to influence trade of alcohol and tobacco to be significant and sufficient to outweigh any potential benefits if the taxes were devolved. We do not recommend that alcohol or tobacco duties be devolved to the Welsh Government.

### Vehicle Excise Duty

**4.4.8** Vehicle Excise Duty (VED) is an annual tax on the ownership of road vehicles. The rate of VED is based in fuel type and CO2 emissions. We estimate that VED raised just over £250 million in Wales in 2010-11 (4.7 per cent of the UK total).

**4.4.9** There are over 1.7 million registered vehicles in Wales meaning that VED is paid by a large proportion of the Welsh population. VED is also a highly visible tax with a tax bill sent to the registered keeper of the vehicle. However, the registered keeper of the vehicle may not necessarily be the legal owner particularly for company cars and fleet vehicles. As a

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result differences in VED between Wales and the rest of the United Kingdom may create opportunity for vehicles to be registered in Wales when the legal owner is not a Welsh resident and vice versa. As a result, we do not recommend that vehicle excise duty be devolved to the Welsh Government.

Capital Gains Tax

4.4.10 Capital Gains Tax is levied on the gain or profit that is made when selling, giving away or otherwise disposing of an asset. In total, we estimate that Capital Gains Tax raised £110 million in Wales in 2010-11, (3 per cent of the UK total).

4.4.11 Capital Gains Tax has a close alignment with income tax as it discourages individuals from converting a large part of their income into capital gains in order to reduce their tax liability. Reflecting this close alignment, the UK Government increased Capital Gains Tax from 18 to 28 per cent for those with total income and taxable gains above the higher income rate threshold. Given this close alignment with income tax there could be an argument for devolving Capital Gains Tax if income tax were to be devolved to the Welsh Government. Indeed, the Holtham Commission recommended that devolution of Capital Gains Tax on property and land should be considered if the administrative costs were not prohibitive.

4.4.12 For many types of assets, particularly financial ones such as shares, in our view it would not be appropriate for Capital Gains Tax to be devolved due to the mobility of those assets increasing the risk of tax avoidance. The case for Capital Gains Tax on land and property is stronger as ownership can be easily established and both are tied to a particular geographical location.

4.4.13 We have received specific evidence in relation to Capital Gains Tax on property and land sales. The Institute of Chartered Accountants in England and Wales told us:

“We doubt whether this change for a tax [Capital Gains Tax on property and land sales] which, as Holtham recognises, raises only modest sums merits the downsides in terms of potential additional bureaucratic, and potentially financial, burdens on business”.

4.4.14 Capital gains is an integral part of the UK-wide self assessment process and, if devolved, there would be potential for tax avoidance or significant increased administrative costs to mitigate this risk. In addition we believe that devolving Capital Gains Tax on property and land only may distort the behaviour of individuals purchasing assets if rates on property and land sales were different in Wales. We do not believe that the potential benefits from devolving Capital Gains Tax in its entirety or on property and land sales only outweigh the costs. We do not recommend that it should be devolved.

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68 We discuss whether income tax should be devolved in Chapter 5.
69 The majority of tax in the UK is collected automatically via payroll systems or automatically paid during transactions. Individuals who have more complicated arrangements are required to fill in a self assessment form. Self Assessment involves completing a tax return each year. This return shows income and capital gains (profits on the sale of certain assets) made in that year. The appropriate tax rate is then applied based on the circumstances of the individual.
Insurance premium tax

4.4.15 Insurance Premium Tax is a tax on general insurance premiums. There is a standard rate of 6 per cent and a higher rate of 20 per cent for travel insurance and some insurance for vehicles and domestic/electrical appliances. We estimate that insurance premium tax raised just under £100 million in Wales in 2010-11 (just over 4 per cent of the UK total).

4.4.16 Insurance tax is paid by companies and intermediaries so it would be administratively complex to devolve. In addition, there is the potential for differences in tax rates between Wales and the rest of the United Kingdom to increase the risk of tax avoidance. We do not recommend that insurance premium tax be devolved to the Welsh Government.

Stamp duty on shares

4.4.17 Stamp duty on shares is levied on purchases of more than £1,000 at the rate of 0.5 per cent of the value of the shares bought. We estimate that stamp duty on shares raised just under £100 million in Wales in 2010-11 (just over 3 per cent of the UK total).

4.4.18 As discussed earlier in this chapter, financial transactions including transactions in shares are extremely mobile with transactions undertaken on behalf of individuals all over the world. As a result, different tax rates in Wales and the rest of the United Kingdom would increase the potential for individuals to avoid paying tax. We do not recommend that stamp duty on shares be devolved to the Welsh Government.

Inheritance tax

4.4.19 Inheritance Tax is payable on an estate when a person dies, though the calculation can include trusts or gifts made during a person’s lifetime. Most estates are not liable to pay Inheritance Tax as their value is below the threshold (£325,000 in 2012-13). Inheritance tax is one of the few UK-wide taxes where data on Welsh revenues are published by HMRC. In 2010-11 it raised £62 million in Wales (just under 2 per cent of the UK total).

4.4.20 Different Inheritance Taxes in Wales and the rest of the United Kingdom would increase the potential for avoidance. We do not recommend that Inheritance Tax be devolved to the Welsh Government.

Betting and gaming duties

4.4.21 Betting and gaming duties are levied on ‘gross profits’ from gambling, on the amount charged to gamble and on a licence to operate a machine. We estimate the duties raised £50 million in Wales in 2010-11 (just under 2 per cent of the UK total).

4.4.22 Betting and gaming activities have become increasingly mobile due to on-line betting. As a result it would be administratively difficult to devolve betting and gaming duties. We do not recommend that they be devolved to the Welsh Government.

Climate change levy

4.4.23 The climate change levy is part of a range of measures designed to help the United Kingdom meet its legally binding commitment to reduce greenhouse gas emissions. It is chargeable on the industrial and commercial supply of taxable commodities which include electricity,
natural gas as supplied by a gas utility, petroleum and hydrocarbon gas in a liquid state, coal and lignite, coke, and semi-coke of coal or lignite and petroleum coke for lighting. The levy does not apply to taxable commodities used by domestic consumers, or by charities for non-business use. We did not receive any evidence on the climate change levy.

4.4.24 All revenue raised through the levy is recycled back to business through a 0.3 per cent cut in employer’s national insurance contributions, introduced at the same time as the levy, and through support for energy efficiency and low carbon technologies.

4.4.25 We estimate that the levy raised just under £40 million in Wales in 2010-11 (just under 6 per cent of the UK total).

4.4.26 As outlined above, the levy is linked to the UK Government’s commitment to reduce greenhouse gas emissions and is closely aligned to energy policy, which is largely a non-devolved function. We do not recommend that climate change levy should be devolved to the Welsh Government. Whether energy policy should be devolved to the Welsh Government would be a matter for Part II of our remit.

**Recommendation**

R.8. We recommend that the following taxes should not be devolved:

- alcohol and excise duties;
- Vehicle Excise Duty;
- Capital Gains Tax;
- Insurance Premium Tax;
- stamp duty on shares;
- Inheritance Tax;
- betting and gaming duties; and
- Climate Change Levy.

4.5 **FUTURE UK GOVERNMENT TAXES**

4.5.1 As well as existing taxes, we have to consider the possibility that new taxes might be introduced by a Westminster Government. These might relate to matters that are devolved to Wales. Examples might be a proposal to tax unhealthy foods or drinks or the recent UK Government proposals which would have the effect of charging £1,000 for foreign lorries travelling on UK roads. In our view, the UK Government should always consult with the Welsh Government and assess whether a devolved tax structure might be appropriate for any new taxes that it is considering in devolved policy areas. This process should also allow the Welsh Government to decide not to introduce the tax in Wales, providing the block grant was adjusted appropriately.

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4.5.2 The UK Government may also make changes to the existing taxation arrangements by the introduction of tax reliefs in particular areas in the United Kingdom for taxes that are not devolved to the Welsh Government. A recent example of locally differentiated national taxes includes the rural fuel duty rebate pilot scheme discussed earlier. The UK Government should keep under review the scope for introducing tax reliefs or similar mechanisms which would help to support the economy in Wales.

4.5.3 In addition to locally differentiated UK-wide taxes, the UK Government has also introduced other policies in devolved areas that rely partially on taxation modifications. A recent example of this is the use of business rates relief and enhanced capital allowances for corporation tax in enterprise zones in England. Enterprise Zone policy is devolved but it is currently unclear how the funding arrangements for those enhanced capital allowances will be arranged as corporation tax is non-devolved. When the UK Government introduces changes to the thresholds and allowances or rates for a tax that is not devolved, which include an element of geographical targeting, we see the case for the Welsh Government to be able to decide whether it would like to fund additional coverage in Wales. This is discussed further in relation to Enterprise Zones in the following chapter.

Recommendation

R.9. We recommend that when the UK Government is considering introducing new taxes in devolved areas of policy, there should be a presumption in favour of devolving powers over the tax to the Welsh Government.

4.6 DOING THINGS DIFFERENTLY IN WALES

4.6.1 We received evidence in support of the Welsh Government being empowered to use levies to achieve specific outcomes. The introduction of the five pence charge for single use plastic bags is a precedent that many people find attractive, but is not a tax because the Welsh Government has no taxation powers. This has meant, for example, that the passing on of the revenue to good causes is by a voluntary agreement.

4.6.2 Other similarly innovative Welsh specific levies could be introduced by the Welsh Government either as replacements for existing devolved levies and taxes or as new ones. For example, several countries are considering health-related taxes such as a tax on sugary
drinks; the Welsh Government could replace the existing England and Wales Community Infrastructure Levy with a system that better meets circumstances in Wales; a land tax and a training levy have been mentioned to us; and levies in relation to Wales’s natural resources, which was also considered by the Holtham Commission. In particular, we have received strong support for the idea of taxation with a devolved policy purpose such as environmental improvement or flood defences, as well as other hypothecated taxes where the revenue generated by the tax is dedicated to fund a particular devolved service.

4.6.3 If the Welsh Government introduced a tax in Wales that was not levied in the rest of the United Kingdom, then the Welsh Government could use this additional revenue to fund increased public spending in Wales.

4.6.4 But the Welsh Government could equally decide that the new tax would fund reductions in other taxes for which it had responsibility. There is no necessary link between the introduction of a new tax and an increase the tax burden in Wales. The Welsh Government would of course retain all the revenues from the tax without a deduction to the block grant.

Box 4.12: Doing things differently in Wales - evidence

In our analysis of questionnaire responses, opinion was divided with 48 per cent being against the introduction of new taxes.

The results from our ICM opinion poll show that 72 per cent of respondents were in favour of the Welsh Government being able to introduce a new tax or charge to try and change people’s behaviour in a way similar to the charge for plastic bags in Wales.

The Federation of Small Business however was concerned that the power to introduce new taxes could lead to an over complicated tax system and a higher tax burden “as a general principle the FSB is of the opinion that it is important to avoid overcomplicating the tax system as it applies to small businesses and increasing their tax burden”.

We have received a number of suggestions for innovative taxes in Wales.

For example, the FSB highlighted the potential for the Welsh Government to have powers over natural resources taxation, “in principle small businesses in Wales support the Welsh Government attaining some powers over Wales’ natural resources, especially if they could be used to reduce costs to small businesses”.

A submission from an Assembly Member discussed the possibility of replacing the existing taxation arrangements on property in Wales and introducing a Land Value Tax (LVT) “A Land Value Tax would allow for the abolition of Council Tax, Business Rates and Stamp Duty Land Tax, by introducing a levy on the annual rental value of every site in Wales including all residential, commercial and farming land, as well as privately owned estates”.

A submission from a member of the public concluded that “After further research and consideration of available and potential powers, Wales could embark on a limited exercise focusing on the phased withdrawal of non-domestic rates and their revenue neutral replacement with LVT (including the extension to agriculture). It could commence with brownfield land at an appropriate part of the property cycle”.

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The Coalition for Economic Justice noted that “a land value tax would achieve certain revenue income whilst providing for greater equality and reducing taxes on production”.

At our event with Funky Dragon (the Youth Parliament for Wales) there was support for the introduction of new taxes to help support the management of the environment in Wales.

4.6.5 The Scotland Act 2012 enables new tax raising powers to be devolved to the Scottish Government following approval by both the UK and Scottish Parliaments. The detailed arrangements for this power in Scotland are set out in Box 4.13 below.

**Box 4.13: Criteria for introducing new taxes in Scotland**

In reaching an assessment of a proposal for a new tax, the UK Government will consider the impact against a number of predetermined criteria. The Scottish Government will be expected to provide supporting evidence confirming a proposed new tax complies with these criteria, which will include:

- the potential for the new tax to create or incentivise economic distortions and arbitrage within the United Kingdom;
- the potential the new tax might create for tax avoidance across the United Kingdom;
- the impact of the proposed tax on compliance burdens across the United Kingdom; and
- the compatibility of the new tax with EU legislation and rules, such as those covering State Aid and the Single Market, and the Human Rights Act.

The evidence expected from the Scottish Government to support such a proposal would include:

- the rationale, intended tax base/taxable activity and expected revenue;
- the expected distributional impact, impact on business and individuals and wider economic impact;
- an assessment of compatibility with the Human Rights Act, EU State Aid rules and other directives;
- plans for the collection and administration of the tax, including means of ensuring compliance;
- an assessment of any interaction of the proposed new Scottish tax with UK-wide taxes (including plans to protect policy and geographical borders). This should include the impact of any new tax on UK tax revenues; and
- any underlying material used to answer the questions above.

4.6.6 We would expect similar criteria to be applied in Wales, and we believe that it would be important for appropriate public consultation to be undertaken by the Welsh Government before any proposal is made. However, we also believe that the UK Government should apply the criteria in a reasonable and flexible way. While any tax has the potential to create some impact on the UK tax base, the question of substance is the magnitude of this impact when weighed against the potential benefits.
4.6.7 It would be for the Welsh Government to decide what use (if any) it wanted to make of a power to introduce innovative Welsh taxes and for Welsh political parties to propose any new taxes at the time of elections. Of course, a wide and full public consultation process would have to be completed before any such proposal was put into practice.

4.6.8 In addition to the use of taxes to achieve policy outcomes in devolved areas, credits can also be applied so that activities are effectively subsidised. While existing tax credits such as the working tax credits (and in future the Universal Tax Credit) should remain UK wide, the Welsh Government should be able to introduce its own credits in relation to devolved taxes and through use of devolved grants and subsidies to promote investment and getting people into work.

**Recommendation**

R.11. The National Assembly for Wales should be given a power to legislate with the agreement of the UK Government on a case by case basis to introduce specified taxes and any associated tax credits in Wales. The Welsh Government should retain the revenue from these without a deduction to the block grant. The UK Government should adopt a flexible approach to any proposal for these taxes from the Welsh Government.

**4.7 CONCLUSIONS**

4.7.1 There is a range of smaller taxes that, if devolved, while only going some way to increase the financial accountability of the Welsh Government, would better empower it to deliver its policy objectives. We recommend that Stamp Duty Land Tax, landfill tax and (subject to the current state aid discussions) aggregates levy be devolved to the Welsh Government. We also recommend the devolution of long haul rates of Air Passenger Duty, as in Northern Ireland, and consideration of full devolution in the future. We do this in the context of the wider development of regional airports across the United Kingdom associated with the Davies Commission on UK airport capacity.

4.7.2 In addition we recommend that business rates should be fully devolved to the Welsh Government in the same way as in Scotland and Northern Ireland, provided the UK Government and Welsh Government agree the appropriate adjustment to the Welsh block budget.

4.7.3 We also make a number of other detailed recommendations on how devolved taxation should be administered, on future UK taxes and on a power enabling the Welsh Government to introduce new taxes for specific purposes, similar to the power in the Scotland Act.

4.7.4 The next chapter turns to an assessment of larger taxes which might be devolved to give greater financial accountability.
Chapter 5 – Larger yielding taxes

5.1 OVERVIEW

5.1.1 This chapter assesses whether to devolve the larger taxes – corporation tax, Value Added Tax, National Insurance Contributions, and income tax. Together these account for most of the tax revenue raised in Wales.

5.1.2 Much of the evidence we have received supports the case for the Welsh Government to have greater responsibility in determining and managing the budget available to spend on devolved public services in Wales. It is clear to us that to improve the financial accountability and empowerment of the Welsh Government and to enhance the incentives to foster economic growth in Wales, a material part of the budget for the Welsh Government should be dependent on tax revenue collected in Wales. Materiality is difficult to define, but some might consider that the Welsh Government should have at least the same proportionate dependency on tax revenues as Welsh local authorities (council tax currently represents 18 per cent of the budget for Welsh local authorities).

5.1.3 Our analysis of tax revenues generated in Wales (see Chapter 3) shows that, of all the current UK-wide taxes, corporation tax, fuel duty, Value Added Tax, National Insurance Contributions and income tax raise the most in Wales. If a material part of the Welsh budget were to be dependent on tax revenue generated in Wales then those taxes are the only ones that individually generate sufficient revenues to achieve this. In the previous chapter we considered fuel duty. In this chapter we assess the other taxes against our principles outlined in Chapter 3 to consider whether they would be appropriate candidates for devolution. We do this in ascending order starting with the smallest tax revenue-raiser of the four, corporation tax, and finishing with the largest of all UK-wide taxes in Wales, income tax.

5.1.4 We also recognise that the devolution of a major UK-wide tax to the Welsh Government would be a very substantial step and much of the evidence we have received has expressed a degree of caution. We therefore have also considered carefully issues on phasing and risk management, which we discuss below alongside issues of principle.

5.2 CORPORATION TAX

5.2.1 Corporation tax is a tax on the taxable profits of limited liability companies and some organisations including clubs, societies, associations, co-operatives, charities and other unincorporated bodies.

5.2.2 Fewer than 20 per cent of all enterprises in the United Kingdom pay corporation tax. In Wales, we estimate that fewer than 30,000 enterprises (fewer than 15 per cent of all enterprises) are likely to be liable for corporation tax. The number of enterprises liable for corporation tax and the contribution from each industry sector varies greatly. The total amount of corporation tax revenue raised across the United Kingdom is highly dependent
on a very small number of large enterprises: over 75 per cent of all corporation tax revenue is paid by just 2.5 per cent of all UK enterprises liable for corporation tax.

5.2.3 HMRC does not estimate the amount that corporation tax raises in Wales. There are various ways to estimate Wales’s share of corporation tax. Our estimate is that corporation tax raised around £1.1 billion in Wales in 2010-11. We believe this is an upper end estimate as the method we have used includes all activity based in Wales rather than being based on the location of the company headquarters. We discuss the methods for estimating corporation tax revenues in Wales in Annex D.

5.2.4 On our visit to Northern Ireland we heard how it was felt that the lower rate of corporation tax in the Republic of Ireland was having a negative impact on the economy in Northern Ireland. The UK Government held a consultation on the rebalancing of the Northern Ireland economy from the public to the private sector, including the possibility of devolving the power to vary the corporation tax rate for profits in Northern Ireland. Following this consultation, a joint ministerial working group comprised of ministers from the UK Government and the Northern Ireland Executive was established to consider issues raised by the consultation. We heard strong support for the devolution of corporation tax from CBI Northern Ireland and from political leaders across the political parties. However the Northern Ireland TUC was opposed to devolution of corporation tax.

5.2.5 We have also heard evidence from the Scottish Government discussing their arguments in favour of devolving corporation tax to Scotland. Corporation tax was not one of the taxes devolved to Scotland in the Scotland Act 2012.

5.2.6 We have heard a range of views in Wales on the advantages and disadvantages of devolving corporation tax to Wales.

Box 5.1: Evidence on Corporation tax

Our ICM opinion poll found that, while 57 per cent favoured the devolution of corporation tax powers, this was the lowest percentage of all those in favour of devolving the major UK-wide taxes to Wales.

The Federation of Small Business concluded that “corporation tax is not the panacea to the Welsh economy’s problems”, while the CBI told us that the organisation “supports the retention of the unitary tax system for corporation tax”. The Institute of Chartered Accountants of England and Wales said “we are highly sceptical of the case for devolving Corporation Tax to Wales”. The Institute of Directors said “corporation tax raises issues of where tax arises (many companies, particularly those paying material tax, are likely to have operations in England as well as in Wales) with material practical issues, and complexities around the potential for transfer pricing”.

The Wales in a Changing Union Group said “the main concerns about the devolution of corporation tax relate to the inter-connectedness of the English and Welsh economies, the potential for distorting business activity across borders and the possibility of a ‘race to the bottom’... These are powerful arguments for retaining a single UK rate, although the experience of variations in corporation taxes in numerous border districts across Europe does not suggest

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that it is impractical. However, the case for devolving corporation tax to the Welsh Government would have to be reassessed if this tax were to be devolved initially to either the Northern Irish or Scottish governments.”

Two individuals jointly provided evidence on how taxation can be used to boost economic growth, noting “the success of low corporate tax economies has highlighted the use of this form of taxation as an important tool in economic development since it can be manipulated to encourage economic growth”.

At our public event in Llangefni there was support for the devolution of powers over corporation tax to the Welsh Government. This was also echoed at our event in Swansea where there was some support for the devolution of corporation tax and the use of capital allowances to stimulate economic growth citing international examples.

The Welsh Government noted that “Devolution of corporation tax could offer the Welsh Government a powerful tool to promote economic development, but this is a volatile tax which is strongly linked to the economic cycle. There would therefore be significant budgetary risks to Wales that would need to be mitigated in any proposal for devolution”.

EU constraints

5.2.7 One of the constraints in relation to business taxation, including corporation tax, is the European Court of Justice’s Azores judgment (see Box 3.3 in Chapter 3 for full details). Under this judgment, it would appear to be against EU state aid rules for the UK Government simply to reduce corporation tax in a devolved region, although experience in this area is relatively limited so far. Instead the setting of corporation tax would need to be fully devolved with the Welsh Government bearing the full budgetary implications of policy decisions. This has implications for the transfer of risk and we discuss this further below.

Benefits and costs of devolving corporation tax

5.2.8 Much of the evidence we have received has discussed how the use of the tax system could better support businesses in Wales. This has included the ability to vary corporation tax to help stimulate investment and economic growth in Wales. Reducing corporation tax rates would increase the post tax rate of return on capital investment, thereby increasing investment, growth and employment. We have received evidence highlighting those potential economic benefits from reducing corporation tax in Wales in particular for supporting indigenous businesses in Wales.

5.2.9 However, many have noted to us that having a single corporation tax system makes the United Kingdom an attractive destination for international investment. This would be put at risk by having different systems in different parts of the United Kingdom. This point was made strongly to us by CBI Wales and True Wales who argued that inward investors placed great importance on a stable and predictable business environment and that corporation tax rates play a key part in this. It is therefore not clear that devolving corporation tax to the Welsh Government would necessarily be a useful policy lever.
5.2.10 The devolution of corporation tax could help the Welsh Government to offer voters a choice over taxation and spending levels. However, decisions on the rate of corporation tax would most likely be taken after considering economic conditions and corporation tax rates in other jurisdictions and therefore not be taken to reflect the preferences of Welsh citizens. In addition, as corporation tax would be paid by businesses operating in Wales, the owners of the business may not be Welsh residents. Those factors weaken the accountability link.

5.2.11 One of the key consequences from devolving corporation tax is the risk transferred to the budget of the Welsh Government. Corporation tax is a highly volatile tax. Between 2008 and 2010 we estimate that annual corporation tax revenues ranged between £1 billion in 2009-10 and £1.425 billion in 2007-08 (see Annex D). Extensive revenue borrowing powers could be required to manage the volatility in corporation tax revenues if it were devolved.

5.2.12 Any reduction in the corporation tax rate that might attract investment would need to be substantial and would therefore initially result in a large reduction in tax receipts and thus in the Welsh budget. If, by way of example, the Welsh Government decided to set the rate of corporation tax in Wales to match that of the Republic of Ireland (currently set at 12.5 per cent) the cost could be over £500 million a year, although any figures are subject to a great deal of uncertainty. While in the longer term a lower corporation tax rate in Wales may stimulate economic activity resulting in an increase in revenues, this could take many years and is unlikely to become self-financing in the short run. In any case, tax competition may result in the relative advantage of lower rates being short-lived as there would be an incentive for other areas to cut their corporation tax rates in response to the actions of the Welsh Government. There is therefore a high degree of risk in trying to use corporation tax reductions to stimulate the Welsh economy without there being a substantial overall fall in public revenues.

5.2.13 Devolution of corporation tax would also impose administrative costs and compliance costs. Corporation tax is already the most complex of all UK-wide taxes in terms of its legislative framework. Estimates for Northern Ireland suggest that these administrative costs could be substantial. One of the complexities with corporation tax is that businesses have operations across the United Kingdom. As a result there would need to be a method for calculating how much corporation tax is generated in a particular part of the United Kingdom. This could be done by estimating what proportion of their profits was generated in each location, but this is in no way straightforward.

5.2.14 There would also be a substantial risk of tax avoidance with businesses finding ways of increasing their tax liability arising in lower taxation jurisdictions without bringing any real economic benefit to those regions. Corporate profits tend to be highly mobile and differential rates within the United Kingdom may result in businesses relocating or shifting their profits to locations that offer the lowest tax burden.

\[\text{Over a longer time period reductions in corporation tax rates could increase economic activity to the extent that some claim that the reduction might move towards self-financing. Some research evidence (Strulik and Trimbrown 2010) shows that reductions in corporation tax rates can, in some circumstances, be almost self-financing with between 70 and 90 per cent of the revenue lost due to the reduction in the rate off-set by an increase in taxable activity.}\]
5.2.15 The Institute for Fiscal Studies considered devolution of corporation tax in the United Kingdom in its 2012 Green Budget. It concluded:

“Implementing such a policy move would be difficult, and likely require a number of years of transition. A key decision would be how to adjust appropriately the block grant from Westminster. An increase in complexity and compliance costs is guaranteed. There are some compelling reasons to maintain a single rate of corporation tax across the UK: it is administratively much simpler (and cheaper) and reduces the potential for harmful tax competition, which could reduce the revenues of all administrations within the UK. Implementing devolution would at best be a calculated risk, with unknown long-term consequences for the UK tax system”.

5.2.16 In summary, corporation tax is not a clear candidate for devolution when judged against our devolution tax principles, and we see many advantages in corporation tax rate levels being set centrally. We conclude that corporation tax should not be devolved to Wales.

5.2.17 However, it is clear that corporation tax is a potentially useful policy tool. In this context, it is possible that Northern Ireland might have the power to set corporation tax rates devolved to it because of fiscal competition across its land border with the Republic. If the power to alter corporation tax rates were to be devolved to Scotland and Northern Ireland, then there would be a clear disadvantage to Wales if the two other devolved governments within the United Kingdom had the power to use variation of corporation tax as a means to support business in those territories. In those circumstances, we would recommend the devolution of the power to Wales as well.

**Recommendation**

R.12. We do not recommend devolving corporation tax to Wales. However, if the UK Government were to agree to devolve corporation tax to both Scotland and Northern Ireland, we would recommend the same powers be given to Wales.

**Corporation tax capital allowances within Enterprise Zones**

5.2.18 The headline rate of corporation tax is important, but as the Centre for Business Taxation at Oxford University has recently argued, businesses are concerned with the whole corporation tax package, including allowances and reliefs as well as the headline rate. While in general we do not recommend devolving the structure of taxes to Wales given the complexity involved and the need to comply with the Azores judgement, we see merit in using the capital allowances for corporation tax as a tool to promote economic growth in areas within Wales. There is also a case for the same principle to apply to Research and Development Allowances and profits from patents. However, these cannot be tied to a particular geographical location in the way that capital allowances can. We therefore believe that some flexibility over capital allowances for corporation tax in respect of capital investment in Wales may be a useful tool for stimulating investment in Wales.

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74 See Chapter 3.
5.2.19 In particular, in Enterprise Zones (EZs) the UK Government will offer the possibility of enhanced corporation tax capital allowances. The availability of enhanced capital allowances is at agreed sites within the relevant zone. It is expected that in Wales, Scotland and Northern Ireland, EZs will have a proportionate share of those sites where enhanced capital allowances will be available in relation to the share for England, though the details are yet to be finalised. Deeside EZ has already been designated as a zone where enhanced capital allowances will be available. As Wales has the lowest GVA per head of all UK regions, we believe that there is a case for the UK and Welsh Governments to consider whether proportionately more EZs in Wales might benefit from enhanced capital allowances. As there is already a structure for differential capital allowances within the United Kingdom through the use of EZs then this could be extended, especially if evidence shows the policy to be effective.

5.2.20 In Chapter 4 we made recommendations in relation to the ability of the Welsh Government to determine geographically targeted taxation policy for non-devolved taxes in Wales. The use of enhanced capital allowances within EZs is an example of such a tax policy.

5.2.21 Of course, there would be a cost associated with extending the use of enhanced capital allowances within defined EZs in Wales and the Welsh Government would have to bear that cost and assess the cost and benefits of such a policy. There are also a number of state aid issues that would need to be investigated as it may not be possible for businesses to benefit from both reduced business rates and enhanced capital allowances in relation to the same site. We note that it is the UK Government’s policy that EZs should not have both higher rate reliefs and higher capital allowances, but so long as this is not contrary to EU rules, we do not see why the Welsh Government would necessarily need to follow this policy if they met the cost.

**Recommendation**

R.13. We recommend that the enhanced capital allowances should be able to be offered within more enterprise zones in Wales, subject to state aid rules and provided the Welsh Government pays the incremental cost.

5.3 VALUE ADDED TAX (VAT)

5.3.1 VAT is principally a tax on consumption, levied on the value added at each stage of production of goods and services (‘supplies’). VAT is widely adopted throughout the world with over 130 countries employing some form of VAT (such as sales tax in the United States, Government Sales Tax in Australia, Taxe sur la Valeur Ajoutée in France).

5.3.2 In Wales we estimate that VAT raised just under £3.5 billion in 2010-11. If VAT were devolved, that would greatly increase the amount of the budget for the Welsh Government that is generated from tax revenues raised in Wales.
Box 5.2: Evidence on VAT

The results from our ICM opinion poll show that 60 per cent of respondents were in favour of devolving VAT to the Welsh Government, 36 per cent were against and 4 per cent did not know. There was also support for devolving VAT during our evidence gathering session in Caernarfon.

Most of the submissions that referred to VAT noted the current legal constraints on the variation of VAT within European Union member states. For example, the submission from the Finance Working Group of Wales in a Changing Union noted that “Devolution of VAT raises difficulties under EU law”.

The Parliament for Wales campaign suggested that VAT revenue should be assigned to the Welsh Government “We strongly suggest that the income from VAT forms part of a new formula for the Welsh Government”.

5.3.3 There are several reasons why VAT might be a desirable tax to devolve. While it is not necessarily the most visible tax, it is paid by everyone at some point in the purchase of most goods and services. As it is a tax on consumption there is a clear link between the performance of the economy and the amount of VAT revenue generated. Variations in VAT have recently been used to help achieve UK Government policy objectives so if devolved it could be a useful policy lever for the Welsh Government.

5.3.4 However, as discussed in Chapter 3, some taxes are subject to restrictions in European law. VAT is one of those taxes. Variation of VAT rates within a member state is prohibited by EU law which requires all member states to apply a common rate of VAT within their jurisdictions. As a result, if devolved to Wales, the Welsh Government would not be able to set a different rate of VAT in Wales from that in operation across the rest of the United Kingdom. We therefore have no option but to rule out the devolution of VAT. We also recognise that there are other arguments against the devolution of VAT including the potential for cross-border trade of goods to avoid paying tax in a jurisdiction with a higher rate of VAT.

VAT assignment

5.3.5 However, some evidence we have received argued the case for assigning VAT. The main argument in favour of assignment is that this would strengthen the link between the performance of the economy (VAT revenues increase the more individuals purchase) and the size of the budget for the Welsh Government. We discuss this argument below.

5.3.6 There are two variants of assignment (see Chapter 3 for an outline of what is meant by tax assignment). The first is outturn assignment where VAT would be assigned on the basis of forecast with a subsequent adjustment for differences between outturn and forecast. If VAT turns out to be different from forecast an adjustment is made to reflect that difference.

5.3.7 The other variant is forecast assignment, where VAT would be assigned on the basis of forecast but there would be no subsequent adjustment for differences between outturn and forecast. In this model a forecast is made on the amount that VAT might make in a given year and this amount is assigned or included in the Welsh budget. If VAT turns out to be different from forecast then no adjustment is made to reflect that difference. So, if
VAT revenues turn out to be higher than forecast, the budget for the Welsh Government remains unchanged.\textsuperscript{25}

5.3.8 Forecast assignment is purely cosmetic as the size of the budget for the Welsh Government does not change if VAT revenues are higher or lower than forecast. Under outturn assignment the size of the budget for the Welsh Government will vary depending on how actual VAT revenues in Wales differ from the forecast previously made.

5.3.9 VAT assignment is theoretically fairly straightforward and could be introduced without legislation. However there are two major problems which we discuss below.

5.3.10 First, neither the Office for Budget Responsibility nor HMRC produces Welsh VAT forecasts. The problem is as much conceptual as practical. Goods consumed in Wales may have most of their value added outside Wales and vice versa (for example, Welsh residents paying VAT for services supplied from outside Wales, or goods purchased outside Wales – particularly on-line). Of course it is possible to produce rough estimates as we have, but this does not reflect the actual amount of value added in Wales.

5.3.11 Secondly, even assuming these estimates were used for assignment purposes, the forecast assignment model does not deliver much if any real benefit – there is no real budgetary impact. The outturn model would have a real impact but it would mean that the Welsh Government would take on a risk for which it had very little responsibility. The Welsh Government would not be responsible for producing the VAT forecasts and the actions of the Welsh Government would have very little impact on differences between outturn and forecast, which would be mainly a reflection of the state of the UK and world economies. If these were different from forecast, or there were other unexplained factors, outside Welsh Government control, then Wales could suffer – or, indeed, benefit – because of changes for which the Welsh Government had no responsibility and over which it had no control. It is worth noting that the UK VAT forecasts, on which Welsh VAT forecasts would be based, can change quite markedly, for example the estimate for VAT in 2011-12 varied by over £2 billion between March 2011 and March 2012, which is around 2 per cent of the total yield and would correspond to around £70 million in Wales. This would imply a significant reduction to the Welsh budget under the outturn VAT assignment model.

5.3.12 We therefore do not favour VAT assignment.

\textbf{Recommendation}

\textbf{R.14.} Variation of VAT rates within a member state is prohibited by EU law. We therefore have no option but to rule out the devolution of VAT although we recognise that there are also other arguments against the devolution of VAT.

To make devolved budget adjustments when those adjustments are not the result of the actions of the Welsh Government could be regarded as the opposite of improved accountability. As a result we do not recommend assigning VAT.

\textsuperscript{25} See Chapter 3 for discussion of tax assignment.
5.4 NATIONAL INSURANCE CONTRIBUTIONS (NICS)

5.4.1 The UK Government does not strictly classify NICs as a ‘tax’, although they share many features of a tax (in particular income tax on employment income). The key difference is that NICs provide entitlement to benefits funded from contributions. Box 5.3 sets out how NICs work.

Box 5.3: How NICs work

NICs provide entitlement to benefits funded entirely from contributions. Applying the rates at time of publication, they work as follows:

- **Employee**: a main rate of 12 per cent is applied to earnings between £107 and £817 per week. An additional rate of 2 per cent is applied to earnings above £817 per week;
- **Employer**: there is a single rate (13.8 per cent) which applies on earnings above a set threshold. Employers do not pay NICs on employees under 16. There is no upper limit on contributions; and
- **Self-employed**: flat rate class of £2.60 a week is applied and a rate of 9 per cent is applied to profits between £7,605 and £42,475. The rate on profits above £42,475 drops to 2 per cent.

Approximately 20 per cent of NICs helps to fund the NHS and the rest goes into the National Insurance Fund from which contributory benefits are paid. The National Insurance Fund (NIF) is run on a pay-as-you-go basis with current income from NIC paying for current benefit expenditure. Formally, NICs cannot be allocated anywhere but the NIF or the NHS.

5.4.2 We estimate that in Wales NICs raised just under £3.5 billion in 2010-11 (see Annex D). If devolved to the Welsh Government a significant part of the budget for the Welsh Government would be dependent on tax revenue collected in Wales.

Box 5.4: Evidence on NICs

Our ICM opinion poll found that while 58 per cent favoured the devolution of powers to change NICs, 28 per cent thought that powers definitely should not be transferred. This was the highest percentage against devolution among any of the major UK-wide taxes.

The submission from PricewaterhouseCoopers states that, “there could be serious difficulties in respect of welfare policy in attempting to devolve NIC”.

During our evidence gathering with two of the United Kingdom’s major tax advisory firms, Deloitte and Grant Thornton, there was a discussion regarding the power to vary the employer NICs in Wales. Deloitte considered that powers over employer National Insurance could be attractive in Wales. Grant Thornton added that this could be used as a tool to encourage growth and was an area that could be explored.

5.4.3 The main reason for devolving NICs would be to increase the proportion of the budget for the Welsh Government that is dependent on tax revenue collected in Wales. In addition, the employer contribution is essentially a payroll tax and varying it could be a useful policy level to help encourage businesses to employ workers in Wales.

Further information is available from HMRC: http://www.hmrc.gov.uk/rates/nic.htm
5.4.4 Both employer and employee NICs are paid into the National Insurance Fund (NIF), which finances the non-devolved social security system, and is separate from the UK Consolidated Fund (into which general tax receipts are paid). However, this link between NICs and the social security system is sometimes deemed to be more perceived than real. Typically around 20 per cent of NICs funds the NHS and in years when there is a surplus in the NIF, funding can be used for general public services. Therefore, there is an argument that NICs performs the function of the main UK-wide taxes, contributing to the funding of general public services.

5.4.5 While it is true that the NIF can be in surplus, the amount paid into the NIF in each year can be more or less than the amount spent, and there are occasions where the flow of funds in any one year is in deficit. In years of a deficit (as seen in 2010-11) or balanced budget there is a clear link between NICs and funding of the welfare state as there are no in-year surplus funds that can be allocated towards funding general public services. Even in those years when there is an annual surplus, there is still a link between NICs and welfare funding and while the overall fund surplus will increase in those years, the size of the surplus will fall in other years.

5.4.6 The employee NICs operate in a different way from the employer NICs and are a hypothecated ‘levy’ with the money raised going into the NIF before it is paid out for a specific purpose, which is, in the main, retirement pensions. The employee contributions determine entitlement to certain state benefits and the amount individuals can receive depends on their NICs record. Therefore, there is a direct link between employee contributions and an individual’s entitlement to some state benefits.

5.4.7 While there is a good case for devolving revenue associated with devolved matters, the case cannot be made for devolving revenue associated with non-devolved matters. Whether social security should remain non-devolved or be devolved to the Welsh Government is more of a matter for Part II of our work. For now, we are not recommending the devolution of NICs.

National Insurance Contribution relief

5.4.8 While we rule out the devolution of NICs in its current form due to the link with the funding of non-devolved matters, variations of employer contributions have previously been used to help stimulate economic growth in some regions of the United Kingdom via employer NICs holidays.

5.4.9 New businesses set up outside London, the South East and East of England between June 2010 and September 2013 are eligible for a NICs holiday worth up to £5,000 for the first ten employees they hire in their first year of business. The aim of the NICs holiday is to encourage the creation of private sector jobs in regions reliant on public sector employment by reducing the cost to new business of employing staff. We see the use of the NICs holiday as a useful policy tool.

5.4.10 We believe that the UK Government should consider whether there is more scope for such measures within state aid rules. There may be a case for the Welsh Government being able to fund extra such payments to pay for reduced employer NICs in Wales, perhaps in respect of particular parts of Wales, in much the same way as we have already recommended in respect of capital allowances under corporation tax, although it would need to be considered whether this would be compatible with state aid rules and the principle that NICs funds GB-wide social security payments.
5.4.11 Finally we are aware that consideration is being given to reform of the funding of care for the elderly. This is a complex subject involving both non-devolved sources of funding such as Attendance Allowances within the social security system and devolved sources such as local authority social care budgets. In taking reform forward it will be important for the UK and Welsh Governments to ensure that effective and equitable systems are in place.

**Recommendation**

R.15. We do not recommend that NICs in their current form should be devolved. There is an intrinsic link between contributions and the National Insurance Fund which funds social security benefits.

We recommend that the UK Government give further consideration to geographically differentiated adjustments, such as the employer NICs holiday, to support the labour market within state aid rules. The Welsh Government should be able to fund extra such regionally-differentiated adjustments within Wales if compatible with EU commitments and the UK social security system.

5.5 INCOME TAX

5.5.1 Income tax is an annual tax on an individual’s income\(^\text{77}\) for a tax year (6th April to 5th April). Income tax is levied on a residence basis and not where the individual works.\(^\text{78}\) We discuss how residency would be determined under a devolved system of income tax later in this chapter.

5.5.2 Income tax is the largest single source of tax revenue in Wales and the United Kingdom as a whole. In Wales income tax accounts for approximately 30 per cent of total tax revenue. This compares to around 34 per cent for the United Kingdom as a whole. This lower share is due to average earnings in Wales being below the average for the United Kingdom and hence a smaller number of higher rate income tax payers, as well as the fact that the employment rate in Wales is below that of the United Kingdom (Annex D provides further details).

5.5.3 There are some sources of income that are not liable for income tax and will not contribute towards an individual’s taxable income. These sources include some social security benefits and income from some tax efficient savings products (such as Individual Savings Accounts and some National Savings and Investment products). Tax reliefs are available for contributions to pension schemes and donations to charities.

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\(^\text{77}\) This includes earnings from employment, earnings from self-employment, most pensions income (state, company and personal pensions), interest on most savings, income from shares (dividends), rental income, and income paid from a trust.

\(^\text{78}\) HMRC have detailed residency guidance including residency for those with second homes. Further details are available at: [http://www.hmrc.gov.uk/cnr/hmrc6.pdf](http://www.hmrc.gov.uk/cnr/hmrc6.pdf)
5.5.4 The international evidence\textsuperscript{79} shows that, along with property taxation, income taxation is the most common form of taxation that is devolved. Sub-national governments typically have a fairly high degree of autonomy over personal income taxation, though this is usually restricted to setting the rates. Internationally, evidence shows that the setting of the structure\textsuperscript{80} of income tax is usually deemed to be a function of the central government. This evidence also shows that there are various ways that income tax could be devolved.

5.5.5 One approach is to share the tax base between the central and sub-national government. When a tax base is shared, some part of the revenues raised by income tax would contribute towards the budget of the sub-national government with the remainder contributing to the budget of the central government. In this way both the central and sub-national government would share the accountability provided by income tax. This is the approach taken in Canada and also for Scotland in the Scotland Act 2012.

\textbf{Box 5.5: Income tax evidence}

We have received a considerable amount of evidence on whether to devolve income tax to Wales.

Our ICM opinion poll found that 64 per cent favoured income tax devolution, with 33 per cent against. One of the main findings from the poll was that a majority believed that the Welsh Government would ‘work harder’ to help the Welsh economy grow and therefore increase tax revenues if powers over taxation were devolved.

Our analysis of questionnaires found that more people favoured income tax devolution than any other of the current UK-wide taxes.

The Welsh Local Government Association told us that “the WLGA supports in principle the view from the Holtham Commission that there is a case for devolving some share of income tax”.

Of all the UK-wide taxes that could be devolved to the Welsh Government to increase accountability, PricewaterhouseCoopers told us that “it is only income tax that may offer scope for further investigation”.

Some members of the business community expressed caution. The CBI submission stated they “do not know of any robust evidence about the potential cost of devolving income tax to Wales, either in terms of the administrative cost of facilitating the change or the potential effect on the tax base in terms of people relocating between England and Wales due to tax differentials”.

A common concern during our evidence gathering was that Wales has a weaker tax base than the United Kingdom as a whole so the devolution of tax powers would result in the Welsh Government having a smaller budget. We heard that, “We do not have the resource base”, “the transfer of some income tax is highly undesirable due to the lower average wage in Wales”.

We also heard concerns regarding the possibility of different income tax rates impacting on cross-border flows. This is neatly summarised by the submission from the Institute of Chartered Accountants in England and Wales: “Given the proximity of much of the Welsh population to


\textsuperscript{80} This includes the level of the tax free personal allowance and the income thresholds that the tax rates are then applied to.
the border with England and the intensity of cross-border links, the potential for differences in the tax codes in the two countries to have unintended consequences must be considerable”.

However, we received evidence stating that “The Welsh Government should have complete freedom to alter its income tax – the economic realities will in any event inhibit too much divergence”.

We also received concerns regarding the administration of income tax in Wales. One of the submissions of evidence on this issue stated that “Differential taxation of income to be effective would involve a separate Welsh revenue collection mechanism which is inherently inefficient, costly and illogical”.

The Welsh Government told us that “the Welsh Government has not sought devolution of powers to vary income tax rates... That said, we are not ruling out income tax as a potential source of revenue for Wales over the longer term”. The devolution of income tax was supported by all the other major political parties (Welsh Conservatives, Welsh Liberal Democrats and Plaid Cymru) in Wales that submitted evidence to us.

Size of income tax base in Wales

5.5.6 In total we estimate that income tax raised £4.85 billion in 2010-11 from 1.42 million taxpayers in Wales.

5.5.7 HMRC estimates that in 2010-11 there were 89,000 higher rate taxpayers in Wales. While only representing 7 per cent of all taxpayers, we estimate that the higher rate taxpayers were responsible for approximately 33 per cent of all income tax revenue in Wales. Further details on trends and analysis of income tax revenues in Wales, including comparisons with the United Kingdom as a whole, are available in Annex D.

Assessing income tax against our principles

5.5.8 We believe that if the power to control aspects of income tax were transferred to the Welsh Government this would significantly enhance its ability to make decisions and its financial accountability. Income tax raises the most of all UK-wide taxes in Wales. Changes in income tax in Wales could, therefore, have a large influence on the size of the budget for the Welsh Government. The devolution of income tax would also enable the Welsh political parties to offer voters, at the time of elections, a choice between levels of taxation and corresponding levels of public expenditure. This would entail a real increase in empowerment.

5.5.9 Income tax also has a number of other desirable characteristics as a potential candidate for devolution. Income tax is a relatively visible tax as the amount paid is clearly displayed on payslips, for example. Income tax is also paid by most people at some stage in their life and is broadly well understood by taxpayers.

5.5.10 Since the tax is paid on the income of those that reside in Wales, the higher the total income of the residents of Wales, the higher the revenue from income tax. A clear link to the performance of the Welsh economy and the size of the budget for the Welsh Government would be established. If the tax were devolved, we believe this would further enhance the incentives of the Welsh Government to encourage economic growth in Wales and so increase tax revenues.
5.5.11 We believe, therefore, that there are strong reasons in principle to devolve income tax to the Welsh Government. As we will explain later we favour the model of sharing the tax base between the UK Government and Welsh Government, which the Calman Commission recommended in Scotland and the Holtham Commission recommended in Wales. However, we need to address the evidence we received about the potential negative consequences of income tax devolution.

Managing the risks of income tax devolution

5.5.12 We have considered very carefully the evidence we have received about the risks associated with the devolution of income tax. In particular, we received evidence on how income tax devolution would interact with the block grant. This interaction is key in managing risk.

5.5.13 The Holtham Commission provided detailed analysis on how the devolution of income tax should interact with the block grant. The UK Government has decided to adopt the indexed deduction method for Scotland. We agree that this is the best method and recommend it for Wales, with the additional proviso that changes to the block grant off-set mechanism should only be undertaken by joint agreement between the UK and Welsh Governments. As we discuss in Chapter 3, the indexed deduction method protects the budget of the Welsh Government from risks that are best managed at the UK level while exposing this budget to the risk and benefits of tax decisions made by the Welsh Government.

5.5.14 The Commission has heard evidence suggesting that as a consequence of a relatively weaker tax base in Wales the budget of the Welsh Government would be much reduced if this budget was dependent on tax revenues raised in Wales. This risk is considered in detail in Annex E. The main points are summarised in the following paragraphs.

5.5.15 The key advantage of adopting the indexed deduction method for the block grant off-set is that it is not the actual level of tax revenue that is raised in Wales that would determine whether the budget of the Welsh Government would be more or less than in a wholly block grant funded scenario. The important determinant is the relative growth in tax revenues in Wales compared to the rest of the United Kingdom.

5.5.16 Between 2000-01 and 2009-10, on average, income tax revenues excluding savings and dividend income in Wales have grown faster than across the United Kingdom as a whole as shown in Figure 5.1. If Welsh income tax revenues grow at a faster rate than across the United Kingdom as a whole, the budget of the Welsh Government would be higher than if it were wholly dependent on the block grant.

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81 See Chapter 5 and Annex 7 of its final report.

82 We have excluded income tax from savings and dividend income, as set out below. We agree with the Holtham and Calman Commission in not recommending that this source of income tax be devolved.
Figure 5.1: Growth in income tax revenues excluding revenue from savings and dividend income, 2000-01 = 100 (a)

Source: Commission calculations

(a) We have excluded income tax from savings and dividend income as we agree with the Holtham and Calman Commissions and do not recommend that this source of income tax be devolved (set out below).

(b) HMRC has not yet published data for 2008-09 due to methodological issues. We have used the mid point of the data for 2007-08 and 2009-10.

(c) UK figure includes Wales. In practice it makes little difference to the trends if we exclude Wales from the UK to compare growth in Wales to the “rest of the UK” as income tax revenues in Wales account for such a small proportion of total UK income tax revenues.

5.5.17 The main reason for the trends shown in Figure 5.1 is the relative change in the employment rate. In 2000, the employment rate in Wales was 5 percentage points below the average for the United Kingdom as a whole. This gap has now narrowed to 2.6 percentage points.\(^3\) Figure 5.2 shows the trends in the employment rates for Wales and the United Kingdom as a whole over this period. Figure 5.2 shows that between 2002 and 2008 the employment rate in Wales was a lot higher than at the start of the decade. Across the United Kingdom as a whole, the growth in the employment rate was more modest. While the employment rate fell in Wales at a faster rate than across the United Kingdom as a whole during 2009 and 2010, since then the employment rate in Wales has increased at a faster rate than across the United Kingdom as a whole.\(^4\) Our research paper “Economic Context in Wales”, published on our website, discusses these economic trends in Wales in more detail.

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\(^3\) The employment rate in Wales was 67.6 per cent for those aged 16-64 during May to July 2000; this compares to 72.6 per cent for the United Kingdom as a whole. During May to July 2012 the employment rate for those aged 16-64 in Wales was 68.6 per cent compared to 71.2 per cent for the United Kingdom as a whole.

\(^4\) The latest figures show that the employment rate in Wales during May to July 2012 increased by 1 percentage point compared to the year earlier. This compares to an increase of 0.8 percentage points for the United Kingdom as a whole over the same period.
5.5.18 While there are indeed risks that in the future Welsh income tax revenues grow at a slower rate than across the United Kingdom as a whole, our analysis shows that unless the income tax base in Wales grows at a much slower rate than the rest of the United Kingdom then the financial impact is relatively modest. A pessimistic outlook for Wales in comparison with the rest of the United Kingdom is in no way inevitable (see Annex E for a full analysis).

Impact on cross-border flows

5.5.19 We have also heard concerns that the porous border may make the devolution of income tax unattractive (nearly half of the population in Wales and nearly 10 per cent of the population of England live within 25 miles of the border). Some have suggested to us that individuals would move across the border if there were differences in income tax rates between Wales and England.

5.5.20 These are legitimate concerns as the economy in Wales is highly integrated with the economy in England and this high level of integration could influence behaviour if personal income tax rates were significantly different in Wales from England. This risk is considered in detail in Annex F. The main points are summarised in the following paragraphs.

5.5.21 We have reviewed the available international evidence as to whether different tax rates between neighbouring regions have resulted in tax-induced migration.

5.5.22 The very fact that neighbouring regions within countries like the USA, Switzerland and many others have such differing tax burdens suggests *prima facie* that significant behavioural responses do not materialise. This is corroborated by a report by HM Treasury quoted by the Holtham Commission. This concluded that in the context of the USA “even with a high degree of factor mobility, there is still some freedom for states to vary tax
It is also clear from the international evidence we have reviewed that a range of factors impact on the attractiveness of living in one region compared to neighbouring regions. It is not just a question of the relative tax burden. Many areas within Switzerland, for example, which have a lower tax burden also have relatively high housing costs and higher costs for public services. These act to reduce the financial benefit from moving to a low tax area.

5.5.23 Taxation funds public services and the evidence shows that individuals value those public services and make their location decisions based on the relative tax burden and the value they place on the public services that are provided. In addition, individuals and households also consider a wide range of other factors when deciding where to live. Many of those factors are difficult to quantify in a financial sense as they include quality of life, social networks and leisure amenities.

5.5.24 There is already a differential in the availability of public services between Wales and England as a result of devolution including in areas like prescription charges and funding for university tuition fees.

5.5.25 At the local level there are also significant differentials in taxation within the United Kingdom due to differences in council tax levels. The recent policy in England to freeze increases in council tax has not been replicated in Wales, resulting in a change in the council tax burden between border areas in England and Wales in a relatively short time period. This has not led to large tax-induced migratory flows.

5.5.26 Even within Wales there are large differences in council tax levels between bordering areas without this resulting in a large number of people moving between local authority areas as a result. The current difference between the Band I council tax level between Blaenau Gwent and Caerphilly for example is £846. We recognise that few people in those areas will be paying in Band I, but even at Band D the present difference is £353. Similar differences currently exist between Pembrokeshire and Carmarthenshire (£271 difference at Band D) and Denbighshire and Conwy (£175 difference at Band D) and many other local authority areas within Wales.

5.5.27 Although we take the view that cross-border movement is unlikely to result from relatively small differences in income tax rates, we also need to bear in mind one important conclusion from the Holtham report, where this cross-border issue was considered extensively. This was that only a small migration response to cross-border tax differences by those who pay high amounts of income tax would be required for there to be a negative impact on the budget for the Welsh Government. This has the implication for the design of a Welsh devolved income tax system as we will discuss later.

5.5.28 On the basis of the evidence, we conclude that differences in income tax levels between Wales and England would not induce significant changes to the behaviour of individuals and businesses unless the Welsh Government were to make large changes in income tax rates – something it is unlikely in practice to be in a budgetary position to do. Other highly integrated regions of other countries can operate differential personal income tax regimes, and we see no reason why Wales could not do so within the United Kingdom.

Financial Powers to Strengthen Wales

Administering a devolved income tax system

5.5.29 We have received evidence expressing concern about the potential administrative costs and the associated compliance costs if income tax were devolved. We summarise our views below.

5.5.30 An important factor to highlight is that any devolved income tax system for Wales would be based on the residence of an individual and not where that individual works. As a result, an individual who lives in Wales but works in England would pay income tax as decided by the Welsh Government. Box 5.6 summarises how this would operate in Wales.

Box 5.6: How a Welsh taxpayer would be defined

The Scottish devolved income tax system provides a precedent for how a Welsh taxpayer would be defined.

The Scottish rate of income tax will apply to UK resident taxpayers who are defined as Scottish taxpayers. This definition was set out for the purposes of the Scottish Variable Rate in the Scotland Act 1998. The Scotland Act 2012 refines these definitions while simplifying the presentation to make it clear that a Scottish taxpayer is a UK taxpayer either resident in Scotland or where the closest connection is with Scotland. HMRC is working closely with members of technical groups to ensure the definition can be applied efficiently.

5.5.31 With a devolved income tax system the first stage of the work is to identify all Welsh taxpayers. As income tax is being devolved in Scotland, HMRC has been working to identify all Scottish taxpayers and aims to add the prefix “S” to the relevant tax codes. HMRC has also established a number of technical stakeholder groups to look at implementation design issues. The same work would need to be undertaken for Wales. One of the advantages of the development work and implementation of the Scotland Act 2012 is that the Welsh and UK Governments can learn lessons to minimise implementation costs. As that development work takes place, we would suggest that the possibility that Wales may in the future be in the same position as Scotland should be fully taken into account to minimise the likelihood of duplicating work.

5.5.32 While detailed costs are not currently available for Scotland, an early provisional estimate of the likely changes needed to HMRC’s main IT systems and the operational processes to support those are in the region of £40-45 million, including an estimated £10 million to make the necessary changes to the IT systems and £30 million for administration and processing those changes. After the set-up the annual running costs would be around £4 million.

5.5.33 We recognise that it is very difficult to estimate the cost for introducing a similar system in Wales. The IT development costs will be affected by whether it will be possible for HMRC to adapt the system used for the Scottish rate for these purposes – this will depend on the final design of the Scottish system and on the nature of any proposals relating to Wales. While the non-IT and running costs could be smaller than Scotland, given Wales’s smaller population, the greater amount of economic activity along the England-Wales border could mean there are more enquiries from Welsh taxpayers and a greater role for HMRC, which could increase costs. As a first approximation cost estimates for Wales could be along the lines of a relative population share. This is an area where HMRC would need to carry out work in consultation with the Welsh Government before our proposals are implemented.
5.5.34 The compliance burden for businesses will be mainly associated with changes to the payroll software. However, with the devolution of income tax in Scotland, there is already the requirement for those UK businesses who employ employees resident in Scotland to alter their payroll systems to reflect that change. In addition, following each UK Budget changes to payroll software may need to be made to reflect changes in income tax decisions by the UK Government. Changes to the payroll software are a matter of routine and are already required on an annual basis to reflect changes in UK Government taxation policies. We do not, therefore, envisage significant increases in compliance costs to businesses.

**Our assessment on the desirability of income tax devolution**

5.5.35 To conclude, we believe that the benefits associated with devolving powers over income tax to Wales would outweigh the associated costs. As income tax raises the most of all UK-wide taxes, if it were devolved, then a material part of the budget available to the Welsh Government would be determined from tax revenue raised in Wales. The Welsh Government would become responsible for raising some of the money that it spends. The Welsh Government would also have greater incentives to strengthen the economy in Wales as a stronger economy would increase income tax revenues increasing the available budget of the Welsh Government.

5.5.36 There would also be a significant increase in the empowerment of the Welsh Government. The Welsh Government would have the fiscal powers to be able to implement income tax policies, which may be different from the UK Government’s, to reflect preferences in Wales. The devolution of powers over income tax could also allow for greater policy differentiation in the National Assembly for Wales as political parties, at the time of elections, may offer voters a real choice between the amount of tax they will pay and the corresponding levels of public spending in Wales.

5.5.37 Wales does have a porous border with England and we have considered the cross-border implications. There are already significant differences in the council tax burden between Wales and England and devolution has already resulted in differences in the provision of public services without noticeable migratory flows as a result. Highly integrated regions of other countries can operate differential personal income tax regimes, and we see no reason why Wales cannot do so within the United Kingdom.

5.5.38 We have considered the potential implications on the budget available for the Welsh Government and we see no systemic down-side risk. Indeed, historic trends over the last decade shows that, if the budget for the Welsh Government had been dependent during that period on income tax revenues in Wales along the lines that we recommend in this chapter, then the budget available to the Welsh Government would have been higher than it in fact was under the block grant funded system.

5.5.39 We now turn to some important matters of detail as to how income tax should be devolved.

**Should the tax structure be devolved?**

5.5.40 When we discuss the structure of a tax we are referring to the allowances and thresholds to which the tax rates are then applied. For income tax, individuals have a tax-free personal allowance of £8,105 (for 2012-13) meaning that no tax is paid on income up to this allowance. The amount of tax paid is calculated using different tax rates and a series of tax bands or thresholds. In the United Kingdom there are currently three rates of income tax and these different rates are applied once an individual’s income reaches certain thresholds.
5.5.41 Throughout our evidence gathering process concerns have been raised about the potential complexity and costs associated with any devolution of tax powers to the Welsh Government. Complexity and cost are particularly pertinent when considering whether the power over the structure of income tax should be devolved to the Welsh Government.

5.5.42 While we believe that it is technically feasible to operate a separate tax structure for income tax payers in Wales, we are not convinced that the additional complexity for businesses and individuals and the associated administrative costs for the collection agency would outweigh any gains that could be made as a result of changes to the design of income tax in Wales.

5.5.43 In addition, the international evidence that we have reviewed in Chapter 3 highlights that the redistributive function of the tax and benefit system should mainly be done at the central Government level. Wales as a relatively poor region of the United Kingdom benefits considerably from the redistributive aspects of taxation. As the structure of the income tax system plays a key role in those redistributive functions, we are not recommending that the powers over the structure of income tax should be devolved to the Welsh Government.

Should taxation of savings and dividends be devolved?

5.5.44 Most sources of income are liable for income tax and adding all these sources together will give an individual’s total income assessable for tax for the tax year. One of these sources is income from savings and dividends. Neither Calman nor Holtham recommended that income tax from savings and dividend income should be devolved and it is not devolved in the Scotland Act 2012. The Holtham Commission noted that:

“Unearned income, unlike most employment, does not require the recipient to be anywhere in particular so location is harder to pin down. It has also been suggested that devolution of powers to vary the income tax charged on unearned income would run into technical collection difficulties”.

5.5.45 An additional factor is that the tax base for savings income is much more dependent on the rates of interest which are not determined by the decisions of the Welsh Government. It is also unlikely that the policies of the Welsh Government could materially impact on the amount of dividend income in Wales. This means that there is no significant link between the policy decisions of the Welsh Government and any income raised by taxes on savings and dividends. As a result, we are not recommending that the Welsh Government should have the power to vary the rate of income tax levied on savings and dividend income.

5.5.46 The Calman Commission recommended that half of the yield from income tax on savings and dividend income should be assigned to the Scottish Government. This has not been incorporated in the Scotland Act 2012. While there may be some merits in this approach, as it would increase the size of the Welsh budget that is dependent on tax revenue generated in Wales (we estimate by just over £400 million), we do not believe this would improve the financial accountability of the Welsh Government and it would only transfer risk to the Welsh budget without the policy levers to manage this risk.

How much of the income tax base to devolve?

5.5.47 As we discuss earlier in this section, the concept of sharing the income tax base is a common approach to the devolution of powers over income tax at the sub-national level. The Scotland Act 2012 proposes that 10p of each income tax band should be devolved to Scotland. The Holtham Commission proposed that half of each tax rate should be devolved to the Welsh Government.
5.5.48 The Holtham Commission gave some valid reasons for devolving half of each rate to Wales. While our analysis above shows that income tax revenues in Wales have grown at a faster rate than across the United Kingdom as a whole, devolving half of the tax base would also expose the budget of the Welsh Government to greater risk if income tax revenues in Wales did not grow at a faster rate than across the rest of the United Kingdom. We do not see a compelling case for a greater transfer of risk in Wales than Scotland and are recommending that 10p of each band should be devolved to Wales. In our view, devolving 10p (which is half of the current basic rate) would represent a material part of the Welsh income tax base as this represents £2 billion, compared to the annual budget of the Welsh Government in the region of £15 billion.

5.5.49 However, the amount of the income tax base devolved to Wales could increase over time to reflect maturing tax devolution in Wales. Any change in the future along those lines would, of course, require political consensus at that time.

How should income tax rate setting powers be devolved?

5.5.50 Key issues in relation to rate setting powers are whether the Welsh Government should be able to set both basic and higher rates of income tax, whether it should be able to vary these independently and whether this should be restricted in any way.

5.5.51 There is established research evidence that highlights the influence that income tax rates can have on individuals. The tax rate for low earners is very important since it affects the decisions that individuals make in entering work and the incentives they have to earn more income from working.86

5.5.52 There is also research evidence87 that shows that the responsiveness of taxable income, and hence tax receipts, to tax rates may be higher at the top end of the earnings distribution. The response from higher earners to changes in tax rates is certainly very different from the response of lower earners. This higher responsiveness is not because higher earners’ employment decisions or hours of work are particularly responsive, but because they can find other ways to minimise the amount of tax that they pay. This can be by changing the form of remuneration, contributing more to a pension, converting income into capital gains or taking measures to avoid tax.

5.5.53 Further evidence is available from the Mirrlees review which noted that “tax rates at the very top of the distribution are particularly important to get right because of the very large amount of revenue being extracted from a very small number of people”.88

5.5.54 For there to be a real change in the financial accountability, autonomy and empowerment of the Welsh Government, it needs freedom to be able to vary each of the income tax rates separately in Wales. This would allow the Welsh Government to make changes to rates in a way that it considers will best meet preferences in Wales. Our view is that this is an essential component of the design of the devolved income tax system in Wales.

5.5.55 In addition, we do not believe that the Welsh Government should be restricted as to the extent that rates can vary in Wales above the reduced 10p “UK” rate. Devolved income tax revenues would become an important part of the budget for the Welsh Government and it would have to consider carefully the impact that changes to income tax in Wales would make to the amount of income tax revenue generated in Wales, as well as the impact on England. As a result there are unlikely to be very wide differences between Welsh and English tax rates.

5.5.56 We recommend that each year the Welsh Government should propose the rates for each rate of income tax in Wales above the reduced UK rate. The National Assembly for Wales would then vote to decide the level of Welsh income tax for each rate. A worked example of how the new system would operate is set out in Box 5.7 below.

**Box 5.7: Worked example of new income tax system**

The approach can be summarised in the following steps.

**Step 1** – At present the UK rates for income tax are 20p, 40p and 50p (the UK Government has announced that this will be reduced to 45p from April 2013). In Step 1 those are all reduced in Wales by 10p. The UK rates for income tax in Wales would therefore be 10p, 30p and 40p.

**Step 2** – The Welsh Government would put proposals before the National Assembly for Wales to vote on the level of Welsh income tax rates. This could restore the 10p that was deducted (to restore the status quo) or different rates could be applied to each rate (for example this could be 9p to the basic rate, 11p to the higher rate and 10p to the additional rate).

**Step 3** – The block grant is deducted using the indexed deduction outlined in Chapter 3 and discussed further in Annex E.

**Step 4** – Devolved tax receipts in Wales are added to the reduced block grant to give overall devolved resources.

The net effect on the Welsh block as a result of adding receipts from the Welsh rate of income tax and subtracting the block grant adjustment depends on the growth in the Welsh rate tax base in Wales (reflected in the growth in receipts) relative to the growth of the income tax base in the rest of the UK (reflected in the indexing of the block grant adjustment).

**How our proposals differ from those in Scotland**

5.5.57 Our proposals for the devolution of income tax powers to Wales do differ from those for Scotland as provided in the Scotland Act 2012. There are good reasons for this and we discuss those below with further discussion in Annex G.

5.5.58 The Scotland Act 2012 proposal would see the basic, higher and additional (currently the 50p rate) rates of income tax levied by the UK Government reduced by 10 pence in the pound for those defined as Scottish taxpayers. This is also what we are recommending. However, the Scottish Government would not have the power to propose each rate of income tax individually. Instead, the Scottish Parliament will have to levy a new Scottish rate of income tax which would be an equal amount to all of the main UK rates. For example, if the Scottish Parliament set the Scottish rate at 12p then this would apply to each rate. Similarly, if the Scottish Parliament set the Scottish rate at 8p then this would...
apply to each rate. The Scottish Parliament could not set a different rate for the basic, higher and additional rate of income tax. This was the recommendation from the Calman Commission. This is the main difference between our recommendations and the powers over income tax contained in the Scotland Act 2012. Box 5.8 shows how this would operate for Scotland. We refer to this requirement to set the Scottish rate equally to all rates of income tax as the Scottish ‘lockstep’ method.

Box 5.8: The Scottish ‘lockstep’

From April 2016 the main UK rates of income tax will be reduced by 10p for those defined as Scottish taxpayers, and the Scottish Parliament will be able to set a single new Scottish rate of income tax, which will apply equally to all of the main UK rates (basic, higher and additional rates). Figure 5.3 summarises how this would work.

From next year the UK rates for income tax will be 20p, 40p and 45p. Each year those rates would be reduced by 10p for Scottish income tax payers. So, the UK rate applied in Scotland would be 10p, 30p and 35p respectively as shown in the first panel in Figure 5.3.

The Scottish Parliament would then vote to decide the level of Scottish income tax. The key to the ‘lockstep’ approach is that whatever rate the Scottish Parliament decided must be applied equally to each rate. In the example in figure 5.3, if the Scottish Parliament decided to set the Scottish rate at 12p then this 12p is added to each of the UK rates meaning that the income tax rates applied to Scottish income tax payers would be 22p (10p + 12p), 42p (30p + 12p) and 47p (35p + 12p). This is shown in panel 2 in Figure 5.3. The Scottish Government could not, for example, set the Scottish rate for the basic rate at 10p, 9p for the higher rate and 11p for the additional rate.

Figure 5.3 The Scottish ‘lockstep’
5.5.59 Analysis from the Holtham Commission suggested that the proposal recommended by the Calman Commission and adopted in the Scotland Act 2012 would be unattractive for Wales. This is because the Scotland/England border is not so densely populated as the Wales/England border is: only 3.7 per cent of the population in Scotland and 0.5 per cent of the population in England live within 25 miles of the England/Scotland border. The figures for Wales are startlingly different: 48 per cent of the population of Wales and around 10 per cent of the population of England live within 25 miles of the England/Wales border. Moreover, people do not just live near the Wales/England border, but large numbers commute daily across it. Here the Holtham Commission analysis is even more pertinent currently than it was when that Commission reported - the number of people who commute daily between Wales and England has increased to 130,000 at the latest count compared with 100,000 at the time of the Holtham report (see Annex F for more details on commuting flows).

5.5.60 Due to the porous border between Wales and England, the Holtham Commission argued that the likelihood of higher rate taxpayers moving across the border purely in response to changes in the higher rate of income tax is high, and is greater than in the case of basic rate payers. They argued that the system as proposed for Scotland, where all the rates for income tax have to be increased or reduced by the same amount above or below the UK rate, would deter significant changes to income tax rates. This would be because of concerns that any Welsh Government would have about the potential adverse consequences on its revenues as a result of an outflow of taxpayers if rates were to increase in Wales. Similarly if rates were reduced, the impact for higher rate taxpayers would tend to cause a bigger outflow from England, weakening the English tax base. This would we suggest make the ‘lockstep’ effect potentially equally unappealing to the UK Government.

5.5.61 While we accept that the porous border is an important consideration in the design of our income tax recommendations, we believe that the power to vary the rates of income tax in Wales independently is essential to meet the principles of the devolution of powers over taxation that we have outlined in Chapter 3. This power will provide the Welsh Government with important policy flexibility that also addresses the cross-border issues that the Holtham Commission highlighted.

5.5.62 Some have argued that the Scottish ‘lockstep’ mechanism preserves the progressivity of the UK income tax system.\(^{89}\) We understand the argument that the main responsibility for determining the progressivity of the tax system should rest with central government, as international evidence suggests. But our analysis shows that even with the Scottish ‘lockstep’ system, progressivity would be affected and that under our proposals progressivity is unlikely to be affected markedly more than under the Scottish ‘lockstep’ system. This point is illustrated in Table 5.1.

5.5.63 Table 5.1 shows how the ratio between the basic rate of 20p and the higher rate of 40p is altered as changes are made under the ‘lockstep’ and under a system where rates can be varied separately. With the rates set as they are at present (40p and 20p) the ratio is

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\(^{89}\) A progressive tax system is one where the tax rate increases as the taxable base increases. For income tax, as the income of an individuals increases then, in a progressive tax system, so does the rate of tax applied to that income. In the UK there are three rates of income tax that are applied as income reaches certain thresholds. Those tax rates increase at the higher income thresholds.
0.5 (20/40). If under the ‘lockstep’ approach both rates were reduced by 2p then the ratio would be 0.47 (18/38). Conversely, if both rates were increased by 2p then the ratio would be 0.52 (22/42). Table 5.1 shows that under the ‘lockstep’ proposal the progressivity of the income tax system would change if the Welsh Government set the Welsh rate at anything other than restoring the previous UK rates of 20p and 40p.

5.5.64 The power to vary income tax rates independently could also change the progressivity of the income tax system. If, for example, the Welsh Government were to reduce the basic rate by 2p and increase the higher rate by 3p then the ratio would fall to 0.42 (18/43). Table 5.1 shows that, even under the extreme scenarios where the differences between the basic and higher rate would be as wide as 30 pence in the pound and as narrow as 10 pence in the pound, the progressivity of the tax system would be broadly similar to the ‘lockstep’ approach.

Table 5.1 Income tax progressivity

<table>
<thead>
<tr>
<th>Scottish “Lockstep” Approach</th>
<th>Power to vary rates independently</th>
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</thead>
<tbody>
<tr>
<td>Basic rate</td>
<td>Higher rate</td>
</tr>
<tr>
<td>10</td>
<td>30</td>
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<tr>
<td>15</td>
<td>35</td>
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<tr>
<td>18</td>
<td>38</td>
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<td>25</td>
<td>45</td>
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<td>30</td>
<td>50</td>
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</tbody>
</table>

5.5.65 Some have also argued that if Wales had a different system from that for Scotland then this would increase the administrative costs of income tax devolution. While there may be some minor administrative implications, we are not persuaded by that argument since income tax rates could be quite different in Wales and Scotland even under the Scottish ‘lockstep’ approach (Wales could set the Welsh rate at 11p and Scotland theirs at 9p for example). Once the administrative work to identify Welsh taxpayers has been undertaken, the administrative implications of then setting the tax rate to apply to those taxpayers is likely to be small.

5.5.66 We believe that there is a convincing case for the Welsh Government to be able to vary the rates for each band of income tax independently.
Transitional arrangements

5.5.67 We are conscious that our recommendations represent a major change to devolution in Wales in an area where public knowledge is fairly low. We discuss in Chapter 8 mechanisms for ensuring that there is both political and public consent to the devolution of so fundamental a tax, and whether a referendum would be desirable prior to devolution.

5.5.68 To help increase awareness and to provide sufficient time to enable the Welsh and UK Governments to implement successfully a devolved income tax system in Wales we propose that income tax receipts should be initially assigned to Wales with the UK Government bearing any risk of any deviation of outturn from forecast tax receipts. This is in line with the model proposed for Scotland. This could happen as soon as the OBR are able to produce Welsh income tax forecasts.

5.5.69 In addition, following the necessary legislation, we think that, as in Scotland, there should be a transitional period when income tax devolution is based on forecast, not outturn receipts. We discuss the issue of timing and other implementation issues in Chapter 8.

Implementing our recommendation on income tax

5.5.70 There is, however, a condition that we need to recognise as necessary before our income tax recommendations are likely to be able to proceed. In Chapter 2 we referred to the intergovernmental talks on fair funding in Wales. While we did not seek evidence on the fair funding issues, a large number of the submissions we have received highlighted the case for changing the existing determination of the block grant, currently the Barnett formula. This was to ensure that the devolution of income tax had the “right starting point”. We also note the international evidence that the success of tax devolution is likely to depend on a well functioning equalisation system. We do not believe that our income tax recommendations will have a wide degree of support in Wales unless both the Welsh and UK Government are seen to be making progress on this issue, in the spirit of consent and co-operation that we believe is a fundamental principle of tax devolution. We recommend that the transfer of income tax powers to the Welsh Government should be conditional upon resolving the issues of fair funding in a way that is agreed by both the Welsh and UK Governments.

Recommendations

R.16. We recommend that the UK and Welsh Governments should share the yield of income tax. The Welsh Government should have responsibility for setting income tax rates in Wales and we recommend the following package:

a. income tax on savings and distributions should not be devolved to the Welsh Government;

b. there should be new Welsh rates of income tax, collected by HMRC, which should apply to the basic, higher and additional rates of income tax;

c. the basic, higher and additional rates of income tax levied by the UK Government in Wales should be reduced initially by 10 pence in the pound. Over time the Welsh Government’s share could increase if there is political consensus;

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30 This included the evidence submitted by the Finance Working group of the Wales in a Changing Union, The Welsh Local Government Association, The Institute of Directors, the oral session with tax experts from Grant Thornton and the written and oral evidence from the Welsh Government.
d. the Welsh Government should be able to vary the basic, higher and additional rates of tax independently;

e. the Welsh Government should not be restricted in its rate setting above the reduced UK rates;

f. the block grant adjustment mechanism should be based on the indexed deduction method as advocated by the Holtham Commission and being implemented in Scotland that automatically incorporates the principle of ‘no detriment’; and

g. there should be transitional arrangements following the introduction of income tax devolution, in particular to help manage the transfer of risk.

R. 17. We recommend that the Office for Budget Responsibility should produce Welsh income tax forecasts in a similar way to Scotland and the amounts forecast should be assigned to the Welsh Government prior to the introduction of legislation, without any impact on the Welsh Government’s spending power.

R.18. We recommend that the transfer of income tax powers to the Welsh Government should be conditional upon resolving the issue of fair funding in a way that is agreed by both the Welsh and UK Governments.

5.5.71 Bringing these recommendations together, Box 5.9 summarises the potential revenue implications from our income tax recommendations.

**Box 5.9: Potential revenue implications of our recommendations.**

Table 5.2 shows the number of taxpayers and the amount of income tax revenue that will determine the budget for the Welsh Government under our income tax recommendations. In total, £2 billion of income tax revenue will be devolved to the Welsh Government; the majority originating from the 10p of revenue from basic rate taxpayers in Wales.

<table>
<thead>
<tr>
<th>Number of taxpayers (000s)</th>
<th>Tax revenue from 10p from each rate (£ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic rate</td>
<td>1,288</td>
</tr>
<tr>
<td>Higher rate</td>
<td>89</td>
</tr>
<tr>
<td>Additional rate</td>
<td>4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,381</strong></td>
</tr>
</tbody>
</table>

Source: Commission calculations

If income tax were devolved it would be open to the Welsh Government to choose a higher or lower rate of income tax than in the rest of the United Kingdom.

Table 5.3 summarises our estimates of the potential revenue impact if the Welsh Government decided to change the main rates for income tax by 1p. The first column in Table 5.3 shows the gross impact which is the impact assuming that taxpayers do not change their behaviour in response to a change in the marginal rate of income tax that they pay. This shows that if the Welsh Government increased/reduced the basic rate by 1p the revenue raised from basic rate taxpayers in Wales would be £180 million higher/lower.
Research\(^9\) shows that taxpayers do respond to a change in their marginal rate of income tax. This research shows that individuals tend to increase their pre tax income following a reduction in their marginal rate of income tax as individuals choose to work more as the net return from work is higher by a reduction in the amount of tax they will have to pay. In the example of the 1p reduction in the basic rate the impact of the behavioural response is to reduce the net loss to the Welsh Government to £-170 million. So while a reduction in income tax rates would generate less tax revenue for the Welsh Government there would be a partially offsetting effect on tax revenue as a result of these behavioural effects.

As Table 5.3 shows the gross impact of changes to the higher and additional rates is modest in Wales. A 1p change could result in a change in income tax revenue for the Welsh Government of +/-£16 million and +/-£4 million respectively. The possible behavioural responses would change this gross impact to +/-£12 million for the higher rate and +/-£3 million for the additional rate respectively.

**Table 5.3: Potential revenue implications by changing the rates of income tax in Wales, £ million**

<table>
<thead>
<tr>
<th>Tax change (+/-) 1p</th>
<th>Gross impact (+/-)</th>
<th>Behavioural response (+/-) (a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic rate</td>
<td>180</td>
<td>170</td>
</tr>
<tr>
<td>Higher rate</td>
<td>16</td>
<td>12</td>
</tr>
<tr>
<td>Additional rate</td>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,381</strong></td>
<td><strong>2,000</strong></td>
</tr>
</tbody>
</table>

Source: Commission calculations

(a) If the tax change were positive, the behavioural response would be negative and vice versa. The parameters to calculate the possible behavioural response are taken from Saez et al (2009) using the same methodology as applied by the Holtham Commission (see Chapter 6 and Annex 5 of their final report for further details).

The above analysis does not include a migratory response. The Holtham Commission estimated that a 1p income tax increase in the higher rate of income tax could reduce income tax yields by £39 million.\(^9\) These cross-border effects are analysed further in Annex F.

It is important to note that these are broad estimates, and are subject to a lot of uncertainty. If income tax were devolved, the Welsh Government would no doubt wish to make its own estimates to inform its tax setting decisions.


\(^9\) The behavioural (both income and substitution) and migration effects are not expected to be identified separately in Welsh income tax forecasts and outturn figures. However they will be part of outturn revenue figures and will therefore be taken into account as in Scotland without any specific adjustments to the block grant being necessary.
5.6 CONCLUSIONS

5.6.1 For the financial accountability and empowerment of the National Assembly for Wales and Welsh Government to be improved sufficiently, they should be responsible for raising a substantial proportion of devolved spending. They should also be responsible for a tax that most people pay and are conscious of, so that decisions made by the National Assembly are ones in which most people have a stake. Of the four larger taxes (corporation tax, Value Added Tax, National Insurance Contributions and income tax), we consider that income tax would be appropriate for partial devolution. The taxation of income on savings and dividends should not be devolved.

5.6.2 We consider that the Welsh Government should share responsibility for income tax at all rates with the UK Government. The most straightforward way for this to happen is for the UK Government to decide the structure of income tax and then reduce the rate of income tax applying in Wales, at all rates, by ten pence in the pound, and also reduce the grant to the Welsh Government by an equivalent amount.

5.6.3 The National Assembly for Wales would decide on levels of income tax for each rate (basic, higher and additional) individually by accepting or amending proposals set before it by the Welsh Government. This could restore the 10p that was deducted (to restore the status quo) or different rates could be applied to each rate. The power to vary individually income tax rates that are applied to each band in Wales is essential to the design of the devolved income tax system in Wales. In setting basic and higher tax rates the Welsh Government would need to consider carefully the possible impact of tax changes on cross-border household movements.

5.6.4 While we do not recommend that corporation tax is devolved unless it is devolved in both Scotland and Northern Ireland, we recommend that the Welsh Government should be able to introduce more Enterprise Zones in Wales benefiting from increased capital allowances, provided the Welsh Government bears the cost.

5.6.5 ‘Fair funding’ for Wales is outside our terms of reference, but we consider that resolving the issues of fair funding in a way that is agreed by the Welsh and UK Governments is necessary for our income tax proposals to be taken forward.

5.6.6 The next chapter considers whether borrowing powers ought to be devolved.
Chapter 6 – Borrowing

6.1 OVERVIEW

6.1.1 This chapter examines the case for devolving borrowing powers to the Welsh Government. We consider whether limits should be put in place; what sources of borrowing may be available; and the possible scope for other innovative ways of increasing public investment in Wales.

6.1.2 We have also received a substantial amount of evidence supporting the Welsh Government gaining powers to borrow for capital purposes. This would allow the Welsh Government to pursue larger capital projects more flexibly than restrictions currently allow.

6.1.3 Our recommendations for tax devolution will introduce a certain amount of volatility into the Welsh budget. To manage this volatility we assess the case for the Welsh Government to have additional revenue borrowing powers.

6.1.4 Borrowing powers would also fit well against our core principles:

- they would increase empowerment and accountability, in addition to the tax powers we are recommending, by providing the Welsh Government with increased flexibility to pursue longer term capital projects than restrictions currently permit. There would, however, be responsibility on the Welsh Government to use these borrowing powers prudently;
- they would promote efficiency and growth through the potential for increased investment in high value projects; and
- they would promote equity for Welsh citizens with those of Scotland and Northern Ireland, whose governments already have relevant borrowing powers.

6.2 BORROWING

Existing United Kingdom arrangements

6.2.1 In the United Kingdom public sector borrowing is controlled by HM Treasury within the UK fiscal framework, the aim of which is currently to deliver the UK Government’s two fiscal targets of balancing the cyclically adjusted current budget by 2016-17 and seeing public sector net debt falling in 2015-16. Any new borrowing by the Welsh Government would need to be accommodated within this framework. Control of borrowing is central to the United Kingdom’s fiscal credibility.

6.2.2 Box 6.1 describes the UK borrowing arrangements.

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93 Our principles are discussed further in Chapter 3.
Box 6.1: UK Government Borrowing

Borrowing by the UK Government is undertaken by the Debt Management Office (DMO) which is part of HM Treasury but operates at arm’s length from Ministers. The DMO’s remit is to carry out the Government’s debt management policy of minimising financing costs over the long term, taking account of risk, and to minimise the cost of offsetting the Government’s net cash flows over time, while operating a risk appetite approved by Ministers in both cases. The DMO’s main debt management activity is the issue of bonds on behalf of the National Loans Fund.

The Public Works Loan Board (PWLB) is a statutory body operating within the Debt Management Office. The PWLB’s function is to lend money from the National Loans Fund to local authorities and other prescribed bodies, and to collect the repayments.

Current situation in Wales: the Welsh Government’s existing powers

6.2.3 The Welsh Government currently has borrowing powers to manage temporary shortfalls in its budget. Under Section 121 of the Government of Wales Act 2006, Welsh Ministers may borrow from the Secretary of State sums that are deemed required to meet a temporary excess in expenditure over income or to provide a working balance. HM Treasury may then issue funds to the Secretary of State out of the National Loans Fund. In total, borrowing as set out under Section 121 must not at any time exceed £500 million. In practice it has not been necessary to use these powers.

6.2.4 Legally, Welsh Ministers also have extensive borrowing powers following the transfer of functions from the Welsh Development Agency to the Welsh Government. These powers arose from the fact that the WDA had extensive borrowing powers to undertake both its economic and social functions in Wales under the Welsh Development Agency Act 1975. However, in the event that these Welsh Government powers were exercised, the borrowing has been regarded by HM Treasury as counting towards the Welsh Government DEL and would therefore require offsetting savings to be made by the Welsh Government. Borrowing funds by this route would not represent any additional resources to the Welsh Government, so these powers have not been used.

6.2.5 The use of the Welsh Government’s existing WDA borrowing powers is being examined in current intergovernmental talks and was specifically excluded from the Commission’s terms of reference. We look forward to a mutually satisfactory outcome to these talks.

Box 6.2: Summary of WDA Powers

In 1999 an Order in Council (the National Assembly for Wales (Transfer of Functions) Order 1999) duly transferred most of the Minister of the Crown functions under the 1975 Act to the National Assembly for Wales. This transfer included the powers to permit Agency borrowing. The Government of Wales Act 1998 gave power to the National Assembly for Wales (by order) to abolish the Agency, transfer its functions to itself and to make any appropriate consequential, incidental, supplementary etc provisions (including amending or repealing enactments). The Agency was duly abolished and its functions transferred to the National Assembly for Wales in April 2006, by the Welsh Development Agency (Transfer of Functions to the National Assembly for Wales and Abolition) Order 2005.

The National Loans Fund is the account that brings together all the UK Government’s lending and borrowing.
The Government of Wales Act 2006 established the Welsh Government (of which the Welsh Ministers are the main legal part) as an executive, and reconstituted the National Assembly for Wales as a legislature and body to scrutinise the Welsh Government. The Government of Wales Act 2006 also transferred to the Welsh Ministers most of the functions of the “old” National Assembly for Wales, including those functions which the National Assembly for Wales had acquired from the Agency in 2006. These included the borrowing powers.

6.2.6 At present the Welsh block DEL budget is separated into revenue (known as “resource”) and capital. Welsh Ministers have the ability to transfer funds from resource into capital but not from capital to resource without the permission of HM Treasury. Alterations in the size of each are determined via the Barnett formula. This means that the size of the Welsh capital budget is based on changes in capital spending planned for England. There is occasionally a lack of clarity whether major infrastructure projects sited in England are to the general benefit of the United Kingdom, which would not generate Barnett consequentials (for example funding for the Olympic Games).

6.2.7 Capital projects must be financed within the capital budget, which the Welsh Government typically plans for the three year UK spending review period. This is the period over which the Welsh Government can have the maximum certainty over the size of its capital budget.

Borrowing powers of devolved and local governments in the United Kingdom

6.2.8 Local authorities in England, Scotland and Wales can borrow under the prudential borrowing framework, also known as unsupported borrowing. This framework is largely self-regulating with local authorities deciding the amount to borrow based on a general assessment of affordability. Guidance is provided for local authorities by the Chartered Institute of Public Finance and Accountancy (CIPFA) and borrowing must be undertaken with regard to CIPFA’s “Prudential Code”.95

6.2.9 The level of local authority prudential borrowing in Wales has increased from £30 million in 2004-05 to a forecast level of £256 million in 2011-12, representing 24 per cent of total local authority capital expenditure. In 2010-11, local authorities in Wales spent £340 million on the servicing of existing borrowing (representing 4.7 per cent of net revenue expenditure).

6.2.10 Local authorities can also borrow supported by grant from the Welsh Government, known as supported borrowing.

6.2.11 Local authorities in Wales have a range of sources for borrowing. The majority (76 per cent in 2011) of borrowing is from the Public Works Loan Board (PWLB). Local authorities can also borrow from commercial banks and this represented 17 per cent of local authority borrowing in 2011. Local authorities can issue their own debt by way of a bond issue.

6.2.12 The Welsh Government has launched the Local Authority Borrowing Initiative, wherein local authorities utilise their borrowing powers in order to fund highways infrastructure with the Welsh Government funding repayment costs.

95 Further details regarding CIPFA’s Prudential Code and local authority borrowing are available at: http://www.cipfa.org.uk/pt/prudential_framework.cfm
6.2.13 In Northern Ireland local authorities have fewer responsibilities; the Northern Ireland Executive has an equivalent borrowing power to reflect this under the 2002 Reinvestment and Reform Initiative.\textsuperscript{96}

6.2.14 The Scotland Act 2012 provides a range of new borrowing powers to the Scottish Government which will be able to borrow up to a stock of £2.2 billion for capital purposes, with an annual limit of 10 per cent of the Scottish annual capital DEL budget (approximately £230 million in 2014-15), and up to £500 million to manage any budget shortfalls including those as a result of volatility in tax receipts. The Act currently allows the Scottish Government to borrow by way of a loan from either the National Loans Fund (that is, from the UK Government) or from commercial banks, but it does not allow Scotland to issue its own bonds.

6.2.15 However the UK Government introduced a power in the Scotland Act 2012 which enables the UK Government to amend, in future, the way in which Scottish Ministers can borrow to include bond issuance, without the need for further primary legislation. On 30 September 2011 the Chief Secretary to the Treasury announced that a public consultation would be launched to seek views on this issue: “later this year we will begin a final public consultation on Scottish bond issuance. This is a complex area, with a range of impacts to be considered, but one where it is right to take forward the debate”.

**International evidence**

6.2.16 The international evidence suggests that borrowing may be the most economic and equitable way to finance sub-national\textsuperscript{97} government capital outlays on the grounds that borrowing can improve the allocation of resources over time. Sub-national governments also require access to borrowing to finance lumpy capital spending, whose benefits span a large number of years. International experience also demonstrates that the design of the regulatory framework under which borrowing powers are devolved is central to ensuring that sub-national borrowing does not jeopardise the national Government’s fiscal objectives.\textsuperscript{98}

6.2.17 Countries have relied upon a wide range of methods to limit the risk of imprudent borrowing by sub-national governments. The most common approach to constraining sub-national borrowing is through the use of fiscal rules with limits placed on the total amount of borrowing than can be undertaken by sub-national governments. Our research paper on International Fiscal Systems published on our website sets out further details on the international evidence.

\textsuperscript{96} Further details are available at: www.official-documents.gov.uk/document/hc0607/hc00/0079/0079.pdf

\textsuperscript{97} As set out in Chapter 3, the term generally for governments such as devolved administrations, provinces, states or länder though some, such as Wales or Catalonia actually are governments of separate nations within a larger state

\textsuperscript{98} Ahmad, J (1999) *Decentralising borrowing powers* World Bank.
Box 6.3: Evidence on welsh borrowing powers

We have received a substantial amount of evidence on whether the Welsh Government should be granted additional borrowing powers.

The opinion poll conducted by ICM found as many as 80 per cent of the Welsh public believe that the Welsh Government should have the power to borrow. The poll also found that 67 per cent considered that the amount of borrowing permitted should be jointly decided by the Welsh and UK Governments. Our own questionnaire found similar support, with 62 per cent supporting the Welsh Government having powers to borrow and repay money to support projects such as roads, hospitals and schools.

The Welsh Government submission called for the devolution of borrowing powers irrespective of whether tax varying powers were devolved. It considered that the “borrowing powers would need to operate within a well-defined framework that included limits to ensure sustainability of debt repayments”. The Welsh Government also believed that it would require revenue borrowing powers to manage budget volatility in the event of tax devolution.

The four main political parties in the National Assembly agreed that the Welsh Government should be granted powers over borrowing.

The WLGA considered that borrowing should be permitted within a prudential framework, in line with the borrowing powers of Local Authorities, but that the “UK Government would have a reserve power to cap the level of borrowing”. Caerphilly County Borough Council also considered that any safeguards to ensure affordability should “ultimately be the responsibility of the Welsh Government”.

There was, however, some caution in the evidence over the dangers of excessive borrowing. This emphasised the need for any Welsh Government borrowing to be set within a strict framework of limits. CBI Wales recognised the merits for the devolution of borrowing powers, in order to allow the Welsh Government to pursue large capital investment projects, whilst highlighting that “a clear ceiling must be placed on the permitted level of borrowing, based on negotiations with HM Treasury and following the Scottish precedent”.

Support for giving the Welsh Government borrowing powers was not universal. The ICM poll found that some 18 per cent of the Welsh public thought that the Welsh Government should not be able to borrow to fund investment.

We observed a similar pattern of views during our public engagements across Wales. Overall the views we heard were largely in favour of the Welsh Government having powers to borrow with many considering it an anomaly that the Welsh Government cannot borrow whilst local government can. Views were largely positive over the Welsh Government borrowing both to manage any variation in income from tax receipts and to allow it to pursue large capital projects, which should benefit the Welsh economy. This was by no means a unanimous view however; there was also a large degree of caution amongst the Welsh public who were concerned that Wales could accumulate large amounts of debt, highlighting the need for strict limits to be put in place.
6.3 ASSESSMENT

6.3.1 The majority of evidence that we have received has been supportive of the Welsh Government gaining powers to borrow for capital purposes. Submissions have often noted the anomalous nature of the existing funding regime in that local authorities in Wales can borrow, under the prudential regime, but the Welsh Government has no access to borrowing. Evidence has also supported borrowing for current or revenue spending to manage volatility in tax revenues. The National Assembly for Wales Finance Committee’s report on borrowing in July 2012 also recommended that the Welsh Government should be granted the power to borrow.

6.3.2 The Holtham Commission believed that the present restrictions on the Welsh capital budget are also unjustifiable. It argued that the three year horizon of capital budgets offered by the current system is an impediment to effective management of capital expenditure. Devolution of limited borrowing powers for capital purposes would enable planning horizons to be extended, and would enable larger projects to be entertained than current constraints readily permit. It would therefore make it easier to align capital expenditures with Welsh priorities.

6.3.3 Taking into account all the evidence we have received, our view is that the Welsh Government should have the power to borrow to fund capital projects. It is not for us to specify how the Welsh Government may wish to use such a power although possible examples have been highlighted to us, including further investment in ICT infrastructure or improving transport infrastructure. The evidence we have received has emphasised the importance of investment which achieves economic growth, as well as the principle of value for money.

6.3.4 Our recommendations for the devolution of tax powers will introduce some volatility into the budget of the Welsh Government (see Annex D Welsh tax receipts for details on this volatility). To manage this volatility, we believe that the Welsh Government will also require additional revenue borrowing powers.

6.3.5 A common theme amongst submissions was recognition of the dangers of excessive borrowing. As we have outlined earlier in this chapter recent events have highlighted the need for appropriate limits to be set for any borrowing powers granted.

Limits to revenue borrowing

6.3.6 The international evidence and the evidence submitted to us support the principle that any new borrowing powers should be set within a framework that places limits on the amount of borrowing that can be undertaken. We agree.

6.3.7 We have given thought to the limits for borrowing. On revenue borrowing, the £500 million limit that the Welsh Government currently has to manage potential temporary shortfalls should be developed into a power to borrow similar to the Scottish Government. This would allow it to deal with variations between forecast and outturn receipts as we describe below. This overall limit should be sufficient to manage the expected volatility in receipts from the taxes that we recommend should be devolved to the Welsh Government.

6.3.8 Within an overall limit of £500 million, Welsh Ministers should be provided with powers to borrow to finance current expenditure up to the Welsh proportionate equivalent (which might be about £100 million) of the Scottish £200 million in any one year. This would apply
when there is either a temporary mismatch between tax and spend during the course of a year or where the difference between tax receipts forecast from the Spending Review and outturn is negative and above 0.5 per cent of the Welsh Resource budget in the relevant year. The total current debt should be £500 million in line with the existing limit. This borrowing limit should be reviewed at each UK spending review and revised if necessary to reflect economic conditions.

**Limits to capital borrowing**

6.3.9 On borrowing for capital purposes, the limits set for Scotland provide a natural starting point for our recommendations for Wales. The Scotland Act 2012 provides for Scottish Ministers to borrow to fund capital projects. Scottish Ministers will be permitted to borrow to up to 10 per cent of the Scottish capital budget (approximately £230 million in 2014/15) in any year to fund capital expenditure, subject to UK Government constraints. The Scottish Government also has an overall capital stock limit of £2.2 billion.

6.3.10 A number of additional factors should be taken into account when assessing the future limits for Wales relative to Scotland. First we note the limited use of Private Finance Initiatives (PFI) in Wales compared with Scotland. The total capital value of the Welsh Government’s projects is £544 million with annual unitary charge payments peaking at £110m in 2028-29. The total capital value of the Scottish Government’s PFI projects is £5,700m with unitary charge payments peaking at £1,093m in 2025-26. The Welsh Government therefore has about 10 per cent of Scotland’s exposure (and around 1 per cent of the UK total). The Welsh Government therefore has a smaller PFI liability which should be fully taken into account when assessing borrowing limits.

6.3.11 Evidence from the Wales in Changing Union Project suggests that the Welsh Government may be able to service higher debt prudently. They propose that a limit could be set on the proportion of the Welsh budget that could be devoted to servicing debt. An example might be a limit set at 5 per cent of the block grant. This would imply that Wales could carry a total debt of £3 billion.

6.3.12 There are counter arguments. The UK Government at present has to borrow to cover the Welsh fiscal deficit; this is higher as a percentage of GDP than the comparable borrowing for Scotland. In addition, as we discuss later, our proposals for devolving tax powers to Wales would mean that the Welsh Government raises a smaller proportion of its revenue relative to its spending than in Scotland. As such the Welsh Government would have less control over the size of its future budgets compared to Scotland.

6.3.13 We do not believe that Wales should get a proportionally lower capital limit than is in place for Scotland. This would mean for Wales a limit of £130 million a year based on 2011-12 spending, around 10 per cent of the Welsh Government’s current annual capital DEL, and an overall capital stock limit of £1.3 billion. We make no firm recommendations on the upper borrowing limits but we do recommend that the annual and stock borrowing limits be reviewed at each UK spending review. The limit set should be agreed mutually between the Welsh and UK Governments taking due consideration of economic conditions and the other factors we have discussed, including recognition of Wales’s lower PFI exposure. We also recommend that there should be some flexibility to vary the annual profile between years over the spending review period to meet Welsh circumstances.
Sources of borrowing

6.3.14 We now turn to the source of borrowing. These sources potentially include direct borrowing from the central government, borrowing from a financial intermediary and direct access to the capital markets (that is, issuing bonds).

6.3.15 The Holtham Commission noted that borrowing from the UK Government is likely to be cheaper than the Welsh Government issuing its own bonds, citing the example of Transport for London where bonds issued in 2006 were 0.38 percentage points above the UK Government gilt rate. It recommended borrowing from the National Loans Fund.

6.3.16 The Calman Commission took the same view for Scotland, and no power to issue bonds was contained in the Scotland Act 2012. However, the UK Government announced that it would undertake a review of the possibility of the Scottish Government being given power to issue bonds. HM Treasury’s consultation paper of June 2012 assesses the benefits and costs. It notes that bond finance by Network Rail, Transport for London and Greater London Authority provides some insight into the premiums on bonds currently issued by UK sub-sovereign authorities (0.4 percentage points, 1.5 percentage points and 0.9 percentage points respectively).

6.3.17 We believe that borrowing sourced from the direct issue of Welsh bonds is likely to be more expensive than borrowing from the UK Government. The costs involved in setting up and administering a Welsh bond, as well as the higher risk, make it probable that this would not be the cheapest source of borrowing.

6.3.18 We note, however, that there might be some benefits in exposing the Welsh Government to the bond market to allow it to gain valuable experience in its operation. Moreover, while bonds may be more expensive at present, a possible future scenario where they may be cheaper or more attractive to the Welsh Government cannot be ruled out. We therefore see no reason in principle for preventing the Welsh Government from being able to issue its own bonds in addition to borrowing from the National Loans Fund and other sources such as commercial banks.99

6.3.19 Of course, any new borrowing will have to be repaid. We note HM Treasury’s view, in relation to the Scotland Act 2012 and expressed directly to us, that new borrowing must be accompanied by new taxation powers. HM Treasury considers that such powers should be in place to provide an independent source of revenue which can be adjusted if necessary to support borrowing. This logic has been questioned by some of the evidence we have heard and was highlighted to us as an area for further consideration by the Assembly Finance Committee. We have heard that there is no necessary connection between taxation powers and borrowing powers – a block grant is as secure a source of income for the repayment of debt as a capacity to generate income.

6.3.20 In the Scottish context HM Treasury has accepted that borrowing may be repaid either by increased revenue from Scottish taxation or a reduction in Scottish public spending. This means that they accept that there is no necessity to increase tax to allow borrowing, providing that tax powers exist.

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99 We are aware of the UK Government’s current review of the possibility of the Scottish Government being able to issue bonds. HM Treasury (2012): The Scotland Act 2012: a consultation on bond issuance by the Scottish Government.
6.3.21 Our view is that the case for borrowing powers to be devolved to the Welsh Government is stronger where the Welsh Government has powers to vary the size of its budget through taxation in order to help meet repayments. Any capital borrowing in Wales will in any case need to be financed - either through increased revenue from devolved taxation or from other new sources of revenue, or from readjustments in public spending. The Welsh Government will need to describe in its budget how it will intend to meet the repayments. This report recommends that the Welsh Government should have taxation powers. This means that HM Treasury’s requirement for borrowing to be accompanied by taxation powers would in any event be met. The taxation powers that we recommend would allow the Welsh Government to meet any repayments if there were unforeseen budgetary restrictions caused by a reduction in the block grant beyond the Welsh Government’s control.

6.3.22 As we noted earlier, the Welsh Government can already borrow under the powers transferred from the WDA. The issue of whether the Welsh Government can exercise those powers to increase the available resources in Wales is being considered in the intergovernmental talks and is not part of our remit. The WDA powers present an opportunity for the Welsh Government to gain borrowing powers prior to our recommendations on tax varying powers coming into force. This borrowing would have to be repaid from within its existing budget.

6.4 **WELSH CASH RESERVE**

6.4.1 The WGLA advocated a Welsh reserve. As in Scotland we support the introduction of a Welsh cash reserve to smooth the effects when receipts are lower or higher than forecast. In years when receipts are higher than forecast, any additional revenues beyond those used to service existing debt should be paid into the Welsh cash reserve. Monies contained in the reserve provide flexibility for years in which outturns in tax receipts are lower than forecast. As is the case with the Scottish cash reserve, we suggest that, when outturn receipts from taxes are lower than forecast by more than 0.5 per cent of the Welsh revenue budget, any accrued cash reserve, and subsequently borrowing, would be drawn upon. The Welsh cash reserve would operate in the same manner as the Scottish cash reserve which is held within the UK Government public spending system. It would be independent of the separate end year flexibility system and would not be clawed back by the Treasury.

6.5 **OTHER CAPITAL FUNDING OPTIONS**

6.5.1 While the increased borrowing powers which we have recommended above are significant, we have received evidence in support of other funding mechanisms to promote increased public and private sector investment in Wales.
Box 6.4: Evidence on other funding mechanisms to promote investment in Wales

Evidence highlighted the potential for the Welsh Government to utilise local government borrowing to pursue capital spending. The CBI noted that it “would like to see progress in utilising local authority borrowing powers to secure additional spending on important capital projects”. The South East Wales Economic Forum’s Innovative Financing Working Group had also “discussed the potential for utilising local government’s prudential borrowing powers to deliver scope for capital expenditure to the Welsh Government, which would use a portion of its revenue budget to repay local government for both the capital and the interest”.

The National Assembly’s Finance Committee has also advocated a range of innovative funding models and drawn attention to the importance of improved public sector asset management in its report ‘Borrowing Powers and Innovative Approaches to Capital Funding’.

6.5.2 These other innovative approaches are discussed in detail at Annex H and have also been considered by the Assembly Finance Committee in its report ‘Borrowing Powers and Innovative Approaches to Capital Funding’.

6.5.3 There is a considerable amount of investment in Wales, in addition to the additional borrowing which we recommend above. The main points to note are as follows:

- the Welsh Government has announced a capital investment strategy of some £15 billion over the next decade.\(^{100}\) The Welsh Government published a first iteration of its Wales Infrastructure Investment Plan in the spring. A more detailed version will be published in the autumn of 2012 following a consultation process. This is expected to include a number of innovative methods for funding capital projects;
- in addition to capital funding financed from the Welsh Government’s DEL budget, local authority prudential borrowing has provided almost £1 billion since 2004-05;
- major investment to improve Welsh connectivity has been announced including broadband and rail investment;
- there is potential for major increased energy investment in Wales including nuclear and renewable sources, including possibly in the longer term a Severn barrage;
- the Haywood review\(^{101}\) of city regions has highlighted the potential of EU funds to support investment, where Wales receives more than any other UK region. Wales has benefitted from around £1.9 billion in capital funding from EU structural funds in 2007-13. The Haywood review also highlighted the scope for new sources such as the borrowing which we are recommending;
- the private sector has a key role to play including not for profit companies, and better models emerging from the UK Government’s review of PFI. We welcome the priority being given to strengthening private sector investment in Wales in the Welsh Government’s infrastructure plan;
- there is scope for increased investment in housing in Wales, including possible mechanism such as land auctions, more flexible approaches to planning obligations, the role of registered social landlords including through housing stock transfers and loan guarantees, and reform of the Housing Revenue Account as in England;

\(^{100}\) Welsh Government (2012) *Wales Infrastructure Investment Plan*.

• the UK Government announced in July 2012 that it is making available innovative new guarantees for major infrastructure projects that have stalled because of lack of available finance; and a new temporary lending programme will provide support to public private partnerships that are struggling to get financing. It announced in September 2012 that it is taking forward the necessary UK legislation; and it announced changes in the housing and planning system, which is a devolved matter. The Welsh Government is taking forward its own reforms to the planning system.

6.5.4 Our view is that, while innovative approaches such as these are very important, new Welsh Government financial powers are not necessary in these areas, although we are reviewing the boundary between devolved and non-devolved policy areas in Part II of our work. These innovative funding mechanisms are essentially devolved matters for the Welsh Government to consider further in consultation with HM Treasury where appropriate, and we encourage the Welsh and UK Governments to work together to promote increased investment in Wales through the variety of funding mechanisms available.

**Recommendations**

R.19. We recommend that Welsh Ministers should be given an additional power to borrow to increase capital investment above the Welsh Government DEL budget. There should be an overall limit to such borrowing, at least proportionate to that in Scotland, whilst taking into consideration the relative lack of exposure to PFI in Wales. The agreed annual profile should provide some flexibility and be subject to review in each spending review. Borrowing should be from the National Loans Fund and commercial sources. We also believe that the Welsh Government should be able to issue its own bonds.

R.20. We recommend that new powers for Welsh Ministers to borrow for short term purposes should be introduced to manage cash flow and volatility in taxes when devolved taxes are in place, similar to those in the Scotland Act 2012.

R.21. We recommend that the Welsh and UK Governments should work together to promote increased investment in Wales through the variety of funding mechanisms available.

**6.6 CONCLUSIONS**

6.6.1 The tax powers we recommend will give the Welsh Government some control over its total spending, but to be fully accountable for its spending decisions it should be able to influence the total of its capital spending in any one year as well. So we recommend that the Welsh Government have the capacity to borrow for capital investment according to prudential annual and overall limits agreed with the UK Government. Borrowing provides useful flexibility for the Welsh Government to manage major capital investment projects and, like the Scottish Government’s borrowing powers, can be managed within the United Kingdom’s overall macro-economic framework.

6.6.2 In addition the Welsh Government should be given powers over borrowing for current spending to manage the volatility of tax receipts under the new funding system.

6.6.3 There are a range of other mechanisms for increasing investment in Wales, but these do not require new powers for the Welsh Government.

6.6.4 The next chapter assesses other ways in which financial accountability could be improved.
Chapter 7 – Further improving financial accountability

7.1 OVERVIEW

7.1.1 This chapter sets out ways of improving financial accountability other than through devolving tax and borrowing powers. We cover in this chapter: improving information; improving intergovernmental arrangements; changes in the devolved public spending framework; and the Crown Estate.

7.1.2 It is clear from the evidence that we have received that devolving tax and borrowing powers are not the only ways of improving financial accountability in Wales. For example, evidence pointed to the need to provide better information; to the desirability of strengthening institutional arrangements in relation to devolved funding; and to possible improvements to the way in which public spending is planned and controlled in Wales under the UK public spending system. We have assessed these proposals against our devolved funding principles, including increasing accountability and responsibility, cooperation and transparency.

Box 7.1: Evidence on other ways of improving financial accountability

We have received a number of ideas on ways of improving financial accountability other than through tax devolution and borrowing.

The need to make more information about Welsh public finances and outcomes available to improve public understanding and accountability was raised quite often in our public meetings.

Dr Andrew Crawley and Professor Max Munday (Cardiff Business School, Cardiff University) noted the importance of modeling the effects of tax changes statistically, the need for improved data on Wales and improved policy advice.

The case for improving intergovernmental relations was also raised. The Welsh Government said “the Statement of Funding Policy should as far as possible become a jointly owned document of the UK Government and the devolved administrations... Technical aspects of the funding regime should be administered by an independent body”. The Welsh Government made the case for changes to the funding system to improve transparency and to better allocate resources including “freedom to move funds between capital and resource... unrestricted ability to save and spend unspent funds”.

The issue of the ownership and control over the Crown Estates in Wales being transferred to the Welsh Government was also raised in the evidence we received.
7.2 IMPROVING INFORMATION

7.2.1 Some of the evidence put to the Commission suggests that there is an urgent need to improve the availability of financial information about Wales so as to increase accountability and transparency.

7.2.2 Improving regional and country economic data is not a new subject. For example, in 2004 a report to the UK Government\(^\text{102}\) made recommendations for improving regional and country data. Since then there have been some improvements, for example in the quality of data in HM Treasury’s Public Expenditure Statistical Analyses.

7.2.3 In light of the evidence we have received we think there is scope to improve the availability of data in Wales in a number of areas that we outline below, although in each case decisions will need to be made following a detailed assessment of the costs and benefits involved.

7.2.4 Clear reporting to individual citizens on taxes raised or money borrowed would enable them to better question government decision-making. We note that local councils routinely provide information in council tax bills on how they spend their budget and how they are financed. In addition, we welcome the announcement in the last UK Budget that more information will be provided to taxpayers at the UK level. It has been put to us, for example in some of the public meetings which we have held around Wales, that taxation and borrowing may become more acceptable the more that citizens can see how they are used beneficially. Welsh citizens should therefore understand what they get from increased borrowing or increases and reductions in Welsh taxation. This would facilitate the presentation of clear policy choices to the electorate.

7.2.5 Beyond information, the idea of hypothecation has many attractions – taxpayers could be told that a particular tax was being used for a particular purpose. If they saw the merit in that purpose, they might be more inclined to understand the case for the tax. We note that hypothecation of fuel duties to support sustainable transport was advocated by Sustrans in evidence to the Commission. We acknowledge, however, that there are problems in hypothecating spending to taxation, especially the fact that money is fungible (in other words, hypothecated spending on a service may simply replace money that would have been spent on that service in any case, so allowing that money to be spent elsewhere). Hypothecated tax may therefore merely replace what would have been spent on the same service anyway, thus allowing more to be spent on non-hypothecated services. While we do not therefore advocate full hypothecation, there may be scope for some hypothecation, for example the introduction of levies to build local flood defences. This would allow the taxpayer to have a clear understanding of the rationale for government decisions.

7.2.6 At present it is difficult to compare the Welsh Government’s spending with the equivalent spending in England. Better information is required for expenditure by Whitehall departments on services in England that are devolved to Wales. HM Treasury does not currently publish this information other than indirectly through the Barnett comparability factors. There are genuine difficulties in making exact like-for-like comparisons between England and the devolved administrations given differences in policy. For example, water spending is in the public sector in Scotland and Northern Ireland but not in England and

Wales. However the Holtham Commission made estimates of spending in England in devolved areas and such estimates are necessary to inform the debate on devolved public finances in Wales.

7.2.7 There may be a case for modifying the Office for National Statistics (ONS) United Kingdom accounts to include a ‘sub-national’ tier of government spending. This was recommended by the Holtham Commission and would amplify the information already published in Public Expenditure Statistical Analyses. The UK Government should consider with the ONS and the devolved administrations whether this is feasible and desirable. In the longer term consideration should be given as to whether to develop Welsh, Scottish and Northern Ireland national accounts.

7.2.8 Better information is required on the amount of tax collected in Wales. HM Treasury does not produce this information for all taxes, and there are difficulties in producing estimates for some taxes such as corporation tax, as we have explained earlier. Nevertheless we have ourselves produced estimates for Welsh tax receipts, as the Scottish Government does for Scotland. It would be helpful to inform the UK fiscal debate if HM Treasury were to produce figures on a consistent basis across the United Kingdom.

7.2.9 Similarly HM Treasury does not produce figures on country and regional fiscal balances (that is, tax revenues minus government spending), although the Scottish Government does produce estimates for Scotland and Oxford Economics does for the United Kingdom’s regions. It is striking that more data tend to be available for Scotland than for Wales, particularly through the Scottish Government’s Government Expenditure and Revenues in Scotland annual report. Such estimates have to be treated with a great deal of caution, given the necessary number of assumptions. However again we believe that figures on a consistent basis across the United Kingdom would be helpful.

7.2.10 Better information on improving public service delivery in Wales is desirable. While policy in devolved areas is a matter for the Welsh Government, and the Welsh Government has published a wide set of delivery indicators, some of the evidence we have received suggests there are concerns that public service delivery outputs and outcomes cannot be compared on a consistent basis. Useful information is published by the ONS in Regional Trends. It would be helpful if the UK Government and the devolved administrations were to publish annually key comparative statistics by country and possibly region in devolved and non-devolved areas. This might be based on existing data sources to avoid additional costs and would complement the figures already published by HM Treasury on expenditure inputs in Public Expenditure Statistical Analyses. We recognise however that this would require the agreement of the devolved administrations.

7.2.11 Particularly in the context of possible increased fiscal powers, the Welsh Government may wish to consider whether more information should be developed about the Welsh economy subject to cost, feasibility and value for money considerations, for example on GVA or other income measures, and Welsh economic modelling and forecasting. This might build on what is already planned by the Welsh Government in their work programme on improving economic statistics.

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103 See Chapter 5.


Recommendation

R.22. There is opportunity for improving the availability of information to increase financial accountability, public understanding and transparency, and we recommend the following, subject to a detailed assessment of the costs and benefits involved by the UK Government and Welsh Government, as appropriate:

a. estimates of spending in England on services which are devolved in the case of Wales should be made available to help inform the debate on public finances in Wales;

b. consideration should be given to whether the ONS United Kingdom accounts should include a ‘sub-national’ tier of government spending;

c. figures on the amount of tax collected in Wales should be produced. Such figures should also include estimates of the Welsh fiscal balance. This country and regional analysis should be done on a consistent basis across the United Kingdom;

d. we encourage the UK Government and the devolved administrations to publish annually key comparative statistics in devolved and non-devolved areas; and

e. the Welsh Government should consider whether more information could be published on the economy in Wales including on Welsh GVA or other income measures, as well as on economic forecasting.

7.3 IMPROVING INTERGOVERNMENTAL ARRANGEMENTS

7.3.1 Evidence has suggested possible improvements to intergovernmental arrangements on funding. Our view is that the UK and Welsh Governments should work together collaboratively in a spirit of mutual respect and consent. This collaborative working should recognise their shared objectives of creating a successful Welsh economy and high quality public services within a common UK fiscal framework.

7.3.2 One suggestion was for an independent body to oversee devolved funding. While we do not think it would be appropriate to ask an unelected body to make policy decisions on devolved funding matters, we think there may be scope to build on the Office for Budget Responsibility’s (OBR) new role in relation to forecasting Scottish tax receipts. This could involve inviting them, in consultation with HM Treasury, the Welsh Government and the other devolved administrations, and ONS, to publish the economic and financial information in relation to Wales and the other parts of the United Kingdom that we suggested earlier. The OBR’s existing role could also be expanded to include reviewing and auditing technical aspects of the funding regime where HM Treasury, the devolved administrations and the OBR consider appropriate. Alternatively, another body such as the ONS or NAO could be considered more appropriate.

7.3.3 HM Treasury’s Statement of Funding Policy, which sets out the devolved funding principles, should as far as possible be jointly owned by the UK Government and the devolved administrations. We recognise the argument that this is a HM Treasury document because the funding arrangements are a non-devolved matter under the devolution settlement. However, the devolved administrations are consulted about changes and, bearing in mind the evidence we have received on the importance of agreeing changes between HM Treasury and the devolved administrations, we recommend that the Statement should be agreed transparently in a spirit of mutual consent wherever possible.
7.3.4 There has been a suggestion that there should be a separate Joint Ministerial Committee (JMC) between the UK Government and the devolved administrations on devolved finance, rather than the current more informal finance ministers’ meetings and distinct from discussions of economic matters held at the JMC (Domestic). We believe that rather than set up another committee, the current finance ministers’ meetings should be formalised by holding regular meetings at least every six months and more transparent reporting of the outcomes.

7.3.5 Disputes between the devolved administrations and HM Treasury are resolved through a JMC process independent of HM Treasury. If appropriate, we believe the JMC might benefit from on occasion asking to be informed by an independent assessment, if there are appropriate external experts. The OBR might be able to perform this role where appropriate. However we accept that, ultimately, responsibility for the UK public expenditure system rests with the UK Government.

7.3.6 The present arrangement whereby the Chief Secretary to the Treasury has attended the National Assembly’s Finance Committee to answer questions on the UK Budget is welcome. This should be formalised through an agreement between HM Treasury and the National Assembly for Wales, in line with the arrangements for the Secretary of State’s presentation of the Queen’s Speech.

7.3.7 The current formal accountability arrangements set out in Chapter 2 should be made more publicly transparent to increase awareness and scrutiny. At present the Wales Office is accountable to the UK Parliament for the payment of the block grant to the Welsh Government, is audited by the NAO and reports to the Welsh Affairs Committee. The Welsh Government is accountable to the National Assembly for Wales, is audited by the Welsh Audit Office (including periodic value for money assessments) and reports to the Assembly’s Finance Committee. While these lines of accountability are clear and appear to be fundamentally sound, there is a case for giving more publicity to the information which is already available to counter any impression that there is a lack of sufficient scrutiny of public spending in Wales, given the apparent lack of awareness in Wales about the current scrutiny arrangements.

**Recommendation**

R.23. The following institutional changes should be made to improve financial accountability:

a. consideration should be given to the Office of Budget Responsibility or another body having a wider role in either producing or validating information on public finances and the economies of Wales, Scotland and Northern Ireland; and reviewing and auditing technical aspects of the devolved funding system where appropriate;

b. changes to the Statement of Funding Policy should be agreed between the UK Government and devolved administrations wherever possible and transparently recorded;

c. the current finance ministers’ meetings should be formalised;

d. the present arrangement whereby the Chief Secretary to the Treasury has attended the National Assembly’s Finance Committee to answer questions on the UK Budget should be formalised; and

e. more information should be made available on the current scrutiny and accountability of public spending in Wales.
7.4 PUBLIC EXPENDITURE MATTERS

7.4.1 We have received some evidence, particularly from the Welsh Government, on possible improvements to the Welsh funding system to increase transparency and enable Welsh Ministers to allocate resources in line with Welsh circumstances. Given that the United Kingdom public spending system is UK-wide, any changes for Wales may have implications for the other devolved administrations, so changes in this area would need to be considered in this wider context.

7.4.2 Evidence has suggested that there should be flexibility for the Welsh Government to move funds between capital and resource budgets. Flexibility already exists to move funds from resource into capital budgets but flexibility in the opposite direction is not normally allowed. Our view is that, if in the future the Welsh Government were to make a justified case for such a switch, the UK Government should have a presumption of agreeing such requests within an agreed concordat, provided the UK Government’s fiscal targets were not put at risk. This would naturally be dependent on the Welsh Government’s record on prudent budget management.

7.4.3 On the issue of greater end year flexibility for carrying forward unspent budgets from one year to the next, the Welsh Government and UK Government have agreed a devolved Budget Exchange scheme governing flexibility for the current spending review period to 2015. The Welsh Government has noted there is a case for greater flexibility to allow it to roll forward more unspent resources within agreed constraints. We believe that the UK and Welsh Governments should review experience of the current scheme in the next spending review and agree appropriate flexibility, provided that the UK Government’s fiscal targets are not put at risk.

**Recommendations**

R.24. The Welsh Government should be allowed to switch spending from capital to resource spending within the terms of a concordat agreed with HM Treasury, in the light of the Welsh Government’s record on budget management and provided the UK Government’s fiscal targets are not put at risk.

R.25. The UK and Welsh Governments and other devolved administrations should review experience of the devolved budget exchange scheme in the next spending review and agree appropriate flexibility provided the UK Government’s fiscal targets are not put at risk.

7.5 CROWN ESTATE

7.5.1 The Crown Estate is the body which manages land owned by the Crown. We have received evidence that the revenues of the Crown Estate in Wales are likely to be increasingly important especially in the context of its role in developing renewable energy, and that the option of devolving the Crown Estate should be considered.

7.5.2 We welcome the recent announcement by the UK Government establishing the Coastal Communities Fund, which will increase investment in Wales based on a share of Crown Estate revenues above the existing Barnett formula allocation.\(^{107}\)

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\(^{106}\) Announced by the Chief Secretary in July 2011. The scheme allows the carry forward of planned underspends subject to certain limits.

\(^{107}\) HM Treasury 22 July 2011.
7.5.3 Our view is that the question of devolving the Crown Estate or introducing powers similar to the Scotland Act 2012 is more for Part II of our work as it would involve issues including governance that go beyond financial accountability. Financial aspects will be taken into account in any such work in Part II.

7.6 CONCLUSIONS

7.6.1 We make a number of recommendations about how financial accountability can be improved through ways other than devolving tax and borrowing powers. These include publishing improved financial and economic data for Wales; a possible wider role for the Office for Budget Responsibility on the public finances and economy of Wales; strengthened consultation and working arrangements between institutions; and improvements in the public expenditure system as it applies to Wales.

7.6.2 In the next chapter we set out how the changes we recommend in this report should be implemented.
Chapter 8 – Implementation

8.1 OVERVIEW

8.1.1 In this chapter we set out a timetable for the implementation of our recommendations. We also discuss what institutional arrangements might underpin the devolution of tax and borrowing powers. First we discuss whether a referendum would be necessary before the introduction of devolved taxation powers.

Box 8.1: Evidence on implementation arrangements

We received evidence on various aspects of the implementation of reforms.

Some evidence stressed the urgency of reform, particularly to tackle the economy. For example, the Changing Union Partnership said “borrowing powers would allow Wales to increase its competitiveness more quickly, by transparent means... To respond to the devolution of these powers the Welsh Government should take urgent steps to transform its current Finance department into a robust Treasury function”. Some Assembly Members also felt there would be a need for a stronger Assembly scrutiny function.

But some evidence also favoured a staged approach. For example, the Welsh Government said ”tax assignment may have merit as a staging post to full devolution in certain circumstances”. The need to build a consensus was frequently mentioned, for example “it is imperative that any changes that occur achieve a consensus among Welsh people”.

While we did not receive a lot of evidence on the details of implementation, we were impressed by the consideration which is being given to implementing financial devolution in Scotland and the potential to draw on this work in building the capacity to implement financial devolution in Wales.

8.2 IS A REFERENDUM NECESSARY?

8.2.1 We received evidence that argued in favour and against the holding of a referendum before any tax-varying powers are transferred to Wales. In light of this evidence, we believe that it is incumbent on us to make a recommendation on an issue that divides opinion. First, we set out the main arguments on each side.

8.2.2 There are arguments against a referendum. Some arguments are a general opposition to any use of referendums because they are seen as an abdication of political responsibility. Others believe that if referendums are used, they ought to be reserved for ‘fundamental constitutional issues’. In this context, it was argued to us that “the devolution of taxation powers to a democratic body whose existence has itself been endorsed in a referendum, and whose powers have been further extended in a second referendum” did not qualify as a

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108 The arguments are made by Professors Richard Wyn Jones and Roger Scully in the Summer 2012 edition of Agenda. They have made much the same arguments to us directly.
fundamental constitutional issue, but was more the “remedying of a constitutional defect”\textsuperscript{110}

8.2.3 In the particular case of taxation, the arguments in favour and against the devolution of an individual tax are complex: it may be difficult to understand readily the kind of complexities with which this report deals. It would be unjustified to have a referendum on each minor piece of tax law change. No referendum was held on the 2012 Scotland Act taxation powers, and no referendum is being considered in Northern Ireland for the change to APD there.

8.2.4 Turnout in a referendum on a technical tax issue could be so small as to make the outcome both risible and contestable. Our online debates discussed “referendum fatigue” in Wales, and we were asked to consider whether the substantial public expenditure cost would be justifiable in an age of austerity.

8.2.5 It could, however, be regarded as elitist to bypass what Jefferson called the “latent wisdom” of the people as a whole. The principal argument in favour of a referendum is that a potential change in the body that has power to levy tax is so major an issue that the people have a right to decide it. This argument is bolstered by a number of precedents. First, there was a second question asked in the 1997 Scottish referendum (“I agree that a Scottish Parliament should have tax-varying powers”). There was barely any debate about whether the taxation powers in the Scotland Act 2012 should require a referendum because the issue had been settled in 1997.\textsuperscript{111} Secondly, Wales itself expects referendums on devolution issues – the referendums of 1979 and 1997, and especially that of 2011, show this.

8.2.6 A further argument relates to the 2011 referendum: the preamble to the question in that referendum (“The Assembly cannot make laws on subject areas such as defence, tax or welfare benefits, whatever the result of this vote”) appeared to rule out tax devolution without a further referendum. It may be considered disingenuous to not now hold a referendum when it was implied in 2011 that devolution of taxation powers would require popular endorsement.

**Box 8.2: Evidence on a Referendum**

There was strong support in the ICM Public Opinion survey for a referendum: 81 per cent of those polled favoured a referendum in case of the devolution of income tax, and 62 per cent believed that a referendum was necessary in the case of minor taxes. Our questionnaire responses were more evenly divided.

Research undertaken in April 2012 by YouGov and the Wales Governance Centre at Cardiff University found that a small plurality believed that a decision on introducing a power for varying the basic rate of income tax by 3p could be left to elected politicians.

The Finance Working Group for the Wales in a Changing Union project suggested that a referendum should be held only if 500,000 electors requested it.

For the Welsh Government “there would need to be another referendum before [income tax] powers could be transferred to Wales”. The Assembly Conservative Group told us that they “believe that [in the context of income tax] any alteration in the fiscal governance of the Assembly should be achieved through a referendum”.

\textsuperscript{110} Second submission to the Silk Commission from the Changing Union Partnership Finance and Funding Working Group - page 9.

\textsuperscript{111} RW Jones’s and Scully’s argument that the 2012 Act provides a precedent for not holding a referendum does not fully address the view that the 1997 decision obviated a need for another Scottish referendum.
Alternatives to a referendum

8.2.7 Popular support for a proposition could be expressed by other means than through a referendum. Perhaps the most regularly used method in the United Kingdom is through endorsement of a policy by voting for a party that includes a commitment in its election manifesto. However, even if all parties were to endorse our proposals in their next manifestos, the electorate is unlikely to regard this issue as the principal determinant of how they cast their vote. The Finance Working Group for the Wales in a Changing Union project also suggested a popular ‘trigger’ for a referendum. Though this is an interesting idea, we think there would be practical difficulties. This is because the trigger would have real legal consequences. It would therefore need to be provided for in legislation that would fix issues like eligibility to vote in terms of age and residency. The task of verifying signatories would be enormous – it could not be done informally as it is with electronic petitions. There would be a campaign to activate the trigger and issues about public support for the campaigns in favour and against the trigger would need to be determined. If the trigger were activated, there would have been two campaigns – one to activate the trigger, the other on the referendum itself. This would lead to even more voter fatigue.

Our view

8.2.8 For us, the views expressed in favour of a referendum by the Welsh Government and by the largest opposition party in the National Assembly for Wales, the high level of popular support demonstrated in our ICM poll and the preamble to the question in the 2011 referendum are of particular importance. This is because we have a mandate to come forward with proposals that will command broad support in Wales. To propose a course that was contrary to those political parties’ evidence, or contrary to a majority opinion, would undermine our duty to secure broad support. We believe that a referendum should be held in Wales before any fundamental shift in tax-varying powers from London to Cardiff occurs.

8.2.9 We believe that such a fundamental shift would occur if the Welsh Government and Assembly were to have any responsibility for income tax. There is a special nature to income tax: constitutionally, it has always been a ‘temporary’ tax that expires each year on 5 April. The UK Parliament has then to reapply it by an annual Finance Act. This special nature of income tax was recognised by the Holtham report which argued that income tax devolution would be different from devolution of other taxes or the giving of powers to introduce new taxes and that it “would represent a major shift in the relationship between the citizen and the devolved administration”, although we recognise that it is quite difficult to define precisely what constitutes a major shift. We note also that the 1997 Scottish referendum was clearly in context of income tax since the right to vary income tax by 3p in each band was the only taxation proposal.

8.2.10 If the result of the referendum were in favour, Wales would have endorsed the devolution of executive, legislative and fiscal powers – three of the most important powers of government.

When should the referendum take place?

8.2.11 Ideally a referendum would take place before any tax varying powers were devolved and the matter would be settled. But it seems to us logically coherent to implement our recommendations in respect of stamp duty land tax, aggregates levy, landfill tax, Air Passenger Duty, innovative taxes and borrowing powers before a referendum since these taxes are related to Welsh Government responsibilities, while at the same time the revenue they raise is relatively small. What we therefore envisage is a parliamentary Bill in the 2014-
15 session that would give these taxation powers to the National Assembly for Wales, but which also would provide for a referendum before any income taxation powers were granted.

8.2.12 The model in the Government of Wales Act 2006\textsuperscript{112} worked well with the referendum on legislative powers. This would mean that the referendum would only be triggered by Welsh Government support, a two-thirds majority vote in the National Assembly for Wales, UK Government agreement and the agreement of both Houses of Parliament. This, of course, means that either Government could apply a brake to the devolution of income tax, but even assuming that they do not do so, it would be unlikely that a referendum could be held before 2017 at the earliest.

8.2.13 The advantage that this passage of time would bring would be that the electorate could judge from evidence how the Welsh Government had dealt with the assignment of income tax prior to the referendum (assignment could then be ended if the referendum outcome was against devolution of income tax) and how they had used minor taxation powers. It would also mean that the Welsh electorate could make their decision with the evidence of what the consequences of Scottish income tax devolution had been.

**Recommendation**

R.26. Devolution of income tax should be subject to a referendum in Wales. Provision for such a referendum should be contained in the Act which introduces tax and borrowing powers.

8.3 WHAT LEGISLATION WOULD BE REQUIRED AND WHAT MIGHT BE THE TIMETABLE?

8.3.1 We make two sorts of recommendations in this report - those which do not require a new Westminster Bill and those which require implementation through a Westminster Bill comparable to the Scotland Act 2012.

8.3.2 We envisage that our recommendations would be implemented in three tranches: a first tranche which does not require a new Bill; a second tranche which would require a new Bill but would not require a referendum; and a third block which we believe would require a referendum (as discussed earlier).

**Recommendations which do not require a new Wales Bill**

8.3.3 A substantial number of our recommendations could be introduced without any change to the current Government of Wales Acts. Such recommendations include:

- the options for improving accountability set out in Chapter 7 could be introduced administratively without legislation;
- the change to the planning and control of business rates described in Chapter 4 could be introduced administratively without legislation;
- the recommendation in Chapter 5 for more capital allowance Enterprise Zones in Wales could be introduced through orders under UK Finance Act powers;
- income tax assignment discussed in Chapter 5 could be introduced administratively without legislation;

\textsuperscript{112} Set out in sections 103 and 104.
the devolution of rates on long haul flights for Air Passenger Duty discussed in Chapter 4 could be implemented in Wales through a UK Finance Act;

regional variations in UK taxes discussed in Chapter 4, such as NICs holidays, could be introduced through a UK Finance Act; and

the use of existing borrowing powers, if agreed by the UK and Welsh Governments in their intergovernmental talks.

8.3.4 All these reforms, if agreed by the UK and Welsh Governments, could be introduced before the next UK General Election. It is our strong view that the benefit they would bring to Wales and to the United Kingdom as a whole means that they should be implemented as soon as possible.

Recommendations which do require a new Wales Bill

8.3.5 The question whether the devolution of tax and borrowing powers could be achieved through Orders in Council under the existing Government of Wales Act, or whether it would require a new Government of Wales Bill, raises both legal and political issues. Ultimately these issues are a matter for the UK Government to determine in consultation with the Welsh Government. But our understanding is that while the section 109 Order in Council power could conceivably be construed as allowing tax devolution, use of a Statutory Instrument for these purposes would be unusual and might be open to legal challenge. Giving taxation powers to Wales would be regarded as altering the scope of devolution rather than amending tax law. On this basis the following recommendations would require a new Government of Wales Bill:

- income tax devolution;
- devolution of stamp duty, landfill tax and aggregates levy;
- a power to introduce innovative Welsh taxes; and
- new borrowing powers – although the use of the Welsh Government’s existing borrowing powers would not require new legislation and is being considered separately in the intergovernmental talks on fair funding.

8.3.6 There may be a temptation to argue that any legislation should wait until after we have reported on Part II of our remit. We obviously cannot yet say whether any of our recommendations from that part of our work will require primary legislation. But whether or not Westminster primary legislation is necessary for Part II, we believe that our recommendations in Part I should be taken forward separately in their own right during the current Parliament.

Recommendation

R.27. A new Wales Bill should be introduced in this Parliament to devolve tax and borrowing powers. A bill to devolve tax and borrowing powers should not wait until the completion of Part II of our work. Changes which do not require legislation should be introduced as soon as possible.
8.4 INSTITUTIONAL ISSUES RELATING TO DEVOLUTION OF TAX AND BORROWING POWERS

8.4.1 This section sets out what changes might be made to the institutional framework governing the financial relationship between the UK Government and Welsh Government as a result of devolving tax and borrowing powers, building on the proposed Scottish arrangements set out in the Scotland Office’s paper Strengthening Scotland’s Future. While these arrangements should reflect Welsh circumstances, the model being developed in Scotland can usefully be drawn on where appropriate.

**Intergovernmental Bilateral Committee on Welsh Fiscal Devolution**

8.4.2 In Scotland, a joint UK Government/Scottish Government committee is being established which will meet twice a year following the OBR’s biannual forecasts to discuss taxation and macroeconomic policy. A similar committee should be established for Wales if tax and borrowing powers are devolved.

**Relationship between the Welsh Government and HMRC**

8.4.3 In line with our devolved funding principle of cooperation and constructive engagement, the relationship between HMRC, the Department for Work and Pensions, and the Welsh Government on income tax should be set out in a Memorandum of Understanding, which should be published in advance of implementation.

8.4.4 The Scottish Government has announced that it intends to set up a new body called Revenue Scotland to administer and collect devolved Scottish taxes. Revenue Scotland would work alongside Registers of Scotland on the replacement for stamp duty land tax and with the Scottish Environmental Protection Agency on disposals to landfill. In Wales it would be for the Welsh Government to decide whether it wished to set up a similar Revenue Wales body taking into account the need for value for money.

8.4.5 For the National Assembly for Wales and Welsh Government, the lines of accountability of HMRC in relation to the Welsh rate of income tax should be similar to those of HMRC to the UK Parliament and Government. The Assembly should receive a report on the administration of the Welsh income tax receipts, as part of the National Audit Office (NAO)’s annual report on HMRC’s overall performance. Assembly Committees should be able to request that HMRC Accounting Officers give evidence to them. An HMRC Additional Accounting Officer should be made specifically accountable for the collection of the Welsh rate of income tax.

8.4.6 The UK Government should also inform Welsh Ministers in writing of HMRC Commissioner appointments. The Welsh Bill should enable the Welsh Government to compensate HMRC for the additional costs associated with implementing and maintaining the Welsh rate of income tax, net of any savings that HMRC might make. Estimates of these costs should be drawn up for discussion at the Bilateral Committee at the appropriate time.

8.4.7 It would be for the Welsh Government to decide whether it would wish to use HMRC (assuming HMRC was willing) or establish a new body for administration of taxes that are wholly devolved and any new taxes. But in any case, the Welsh Government would need to agree formal arrangements, for example a contract or accompanying service level agreement, with the body it wishes to administer the taxes.
Tax avoidance and evasion

8.4.8 At present the UK Government is responsible for policy and administration in respect of closing tax loopholes and reducing tax evasion for central government taxes, and the Welsh Government and Welsh local authorities have responsibility in respect of local taxes. If taxes are devolved, such as stamp duty land tax, then the Welsh Government would become responsible for these issues. Where the tax base is shared as for income tax, HMRC would be responsible for administering the UK income tax system as a whole, but it would need to agree in its memorandum of understanding with the Welsh Government how to close any tax loopholes or tax evasion issues arising from the Welsh income tax system.

Setting annual Welsh tax rates

8.4.9 Where taxes are devolved, the Welsh Government would set tax rates annually in its Welsh budget including forecasts of revenue raised. Where the tax base is shared such as for income tax, the Welsh Government would announce annually in its budget what the Welsh income tax rates would be for the forthcoming year relative to the announced UK rates for the forthcoming year, and the Welsh budget would include Welsh income tax forecasts based on these rates. The details, including in relation to the operation of the annual UK Finance Bill, would be for the UK and Welsh Governments to agree, building on the Scotland Act precedent in Scotland.

Impact on other UK Government departments

8.4.10 If the Welsh Government chooses to vary one of its rates of income tax so that the combined rates in Wales differed from the rates in the rest of the United Kingdom, this could have an impact on wider UK Government policies where the needs of individuals are calculated net of income tax; examples are income-related benefits, including the new Universal Credit. A fuller picture of the possible impacts should be developed with the departments concerned, in the lead up to implementation and as policy is developed. Where a varying tax rate could lead to an increase or decrease in liabilities for the UK Government, the principle which is set out in the Statement of Funding policy that ‘the body whose decision leads to the additional cost will meet that cost’ should be adhered to. HMRC and other relevant departments should consult the Welsh Government over the size and implications of these costs as more information becomes available.

Transparency and independence

8.4.11 One of the key principles of tax devolution and borrowing set out in Chapter 3 is the need to ensure transparency, and this principle has been emphasised in the evidence which we have received.

8.4.12 The UK Government and Welsh Government should therefore make sure that the system is as transparent as possible with the key components either verified independently or dependent on independent sources. The OBR should be responsible for forecasting Welsh tax receipts, based on data that would include information provided by the Welsh Government. A memorandum of understanding between the OBR, HMRC and HM Treasury should be published in the lead up to implementation alongside more detail on the forecasting methodology. The Finance Committee of the National Assembly for Wales would need to develop a relationship with the OBR.
8.4.13 If the Welsh Government decides to approach HMRC to administer the smaller taxes, and HMRC agree, then it would be up to the Welsh Government to decide how any audit arrangement should work, though they would, of course, involve scrutiny by the Assembly.

8.4.14 The financing system would be crucially dependent on how adjustments to the block grant are calculated. The initial reductions made in respect of the reduced receipts to the UK Exchequer should be based on both outturn tax receipt data and forecasts by the OBR. The final judgments and assumptions regarding the forecast and forecast methodology should remain those of the OBR. These calculations should be conducted in a transparent way, available for public audit.

8.4.15 Transparency to citizens is also important, and the new powers would give the Welsh Government an opportunity to involve stakeholders and citizens more generally in the development of taxation and spending policies that are in the interests of Wales.

8.4.16 We also agree with the ‘no detriment’ principle set out in Strengthening Scotland’s Future, meaning that any policy changes to the UK tax base that impact upon the Welsh budget would be compensated by an appropriate adjustment to the block grant. These adjustments should be transparent, and should include appropriate adjustments where the UK Government provides additional resources funded from UK wide provision to reduce taxes in England which are devolved in Wales.

**A Welsh Treasury function**

8.4.17 The package we recommend would entail a fundamental change to the nature of the Welsh Government and its responsibilities. Some of the evidence we have received has expressed concern about the capacity of the Welsh Government and National Assembly for Wales to take on tax and borrowing powers, and the need to avoid diverting their attention from the more immediate tasks of improving public services in Wales and strengthening the Welsh economy.

8.4.18 Part of our response to these concerns is to recommend a staged approach to implementation as we have set out above. However, in addition, if tax and borrowing powers were devolved, the Welsh Government should take this opportunity to develop its existing finance department into a strong Welsh Treasury. This should have high calibre staff with the appropriate skills and experience, responsible for planning and controlling public spending, developing and implementing a Welsh fiscal policy and creating a stronger Welsh tax base.

8.4.19 In addition, the Welsh Treasury would be responsible for drafting the annual Welsh Finance Bill, and the Welsh Government would need to ensure that it had sufficient policy, administrative and legal skills, drawing on existing and new sources of expertise.

8.4.20 Managing any new borrowing powers would also require new expertise, although if borrowing were in the first place from the National Loans Fund rather than issuing Welsh bonds, staffing requirements would be more simple.

8.4.21 The Welsh Government would need to ensure that any administrative costs were kept to the minimum necessary and contained within its overall budget. But we are also mindful that the sort of high quality Welsh Treasury we have in mind could achieve efficiencies and economies that would more than pay for its administrative costs.
8.4.22 The Welsh Treasury should implement international best practice. The development of an effective Welsh fiscal policy would require a culture of challenge and ambition across the Welsh Government. The Welsh Treasury, under the direction of the Finance Minister, should have the central role in the Welsh Government that Finance Ministers and Finance Ministries have elsewhere.

**Recommendation**

R.28. The Welsh Government should set up a Welsh Treasury to manage the new powers we are recommending.

**Strengthening the Welsh tax base and managing volatility**

8.4.23 The Welsh Government and UK Government, and their respective Treasuries, should use both devolved and non-devolved economic powers to strengthen the Welsh tax base. The Bilateral Committee on Welsh Fiscal Devolution referred to above would provide a forum for creating a stronger bilateral focus on improving the Welsh economy.

8.4.24 In addition, much of the evidence we have received has registered concerns about the importance of strengthening the capacity to manage the increased risk which tax devolution and borrowing potentially poses for the Welsh budget. As set out in this chapter these changes in funding should be introduced in a phased way to manage the risks of instability in public finances and of windfall gains or adverse shocks to the Welsh Budget. The Committee on Welsh Fiscal Devolution would have an important role in providing bilateral oversight of the implementation of this phased process.

**National Assembly for Wales budget procedures**

8.4.25 In this report we have referred to taxes being devolved to the Welsh Government, or the Welsh Government using certain taxation powers. This has been convenient shorthand that recognises the fact that it is the executive government that must run the economy of any modern nation, and that it is therefore responsible for fiscal policy. But as in Westminster, where the UK Government must secure the agreement of Parliament to its taxation proposals, so in Wales the exercise of the powers that we have proposed to be transferred to Wales would be subject to the democratic endorsement and scrutiny of the National Assembly for Wales. The Welsh Government’s powers are always contingent on their acceptability to the directly elected body.

8.4.26 The present National Assembly procedures for the consideration of the budget are set out in the Government of Wales Act 2006. They centre on an annual Assembly budget motion which authorises the allocation of resources provided by HM Treasury. These procedures will no longer be fit for purpose once the Assembly is given legislative responsibility for borrowing and tax-raising. Where now the Welsh budget process just involves authorising the allocation of spending to programmes, if our recommendations are accepted, the Welsh Government would also need to propose tax rates and borrowing for the forthcoming year and these would therefore need to be considered and authorised by the Assembly.

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113 See sections 124 to 130. The present procedure is an improvement on the non-statutory budgetary procedures under the corporate body model of the 1998 Act.
8.4.27 In the Westminster system, the Finance Bill provides statutory authorisation for revenue raising and taxation measures. A separate Supply and Appropriation Bill procedure authorises the allocation of government expenditure. Given that some argue that Supply expenditure is subject to insufficient oversight or control by the House of Commons, the National Assembly may wish to consider international best practice in integrating the parliamentary consideration of taxation and spending when developing new procedures.

8.4.28 In accordance with our principle of transparency, we believe that the Assembly’s procedures for the consideration of taxation, borrowing and spending should reflect international best practice. This would mean the integration of revenue raising and borrowing with spending into a single Finance (or Budget) Bill; a Bill process for Wales that involved enough time for proper scrutiny by the Finance Committee and other subject committees (a classic procedure is for each subject committee to feed in its views on the budget to the Finance Committee); and the full involvement of stakeholders outside the Assembly in the process of consideration of the Bill.

8.4.29 In Scotland, the Scottish Parliament has, since inception, had the power to develop its own financial and budgetary procedures. The Scotland Act 1998 simply provided for the establishment of a Scottish Consolidated Fund and a few basic finance and accountability requirements. Scottish procedures are governed by the Public Finance and Accountability (Scotland) Act 2000, an Act of the Scottish Parliament. In Wales, procedures are prescribed by the Government of Wales Act 2006 and cannot be altered by the Assembly.

8.4.30 A mature fiscal settlement requires the Assembly to take more responsibility for procedural matters. Passing control over budgetary procedure to Cardiff would require Westminster legislation, but we understand that this could be done by Order in Council under section 109 of the Government of Wales Act – such an Order could allow an Assembly Act to repeal or modify the parts of the Government of Wales Act 2006 that deal with budgetary procedures (though there would remain a need for Westminster legislation to make general provisions about the Welsh Consolidated Fund and some other basic financial safeguards as in Scotland). We believe that the National Assembly for Wales should have legislative control of its own budgetary procedures.

8.4.31 Having new financial responsibilities would require Assembly Members to take on a new and complex responsibility if the Assembly is to discharge its proper role of holding the Welsh Government to account. It would be important for them to meet this challenge. Though there have been excellent examples of financial scrutiny carried out under existing procedures by the Assembly Finance Committee,114 we received some representations from Assembly Members that they were already stretched and would find difficulty in scrutinising important financial legislation adequately. It is not part of our remit to consider the number of Assembly Members but, just as it would be necessary for the Welsh Government to have adequate backing at official level for the new financial responsibilities we believe it should have, the National Assembly Commission may wish to consider building up capacity and expertise for financial scrutiny through the training of Members and through the research and committee support that Members receive. Good scrutiny means good legislation, and good legislation pays for itself.

114 We have already referred to the recent report by the Finance Committee on Borrowing Powers and Innovative Approaches to Capital Funding of July 2012. Another example from the Third Assembly was the Report on the 2009-10 Draft Budget.
Recommendations

R.29. The new funding system will require a strengthening of the institutional arrangements to deal with finance:

a. a joint Intergovernmental Bilateral Committee on Welsh Fiscal Devolution should be established to meet at least twice a year following the OBR's biannual forecasts to discuss taxation and macroeconomic policy;

b. the relationship between HMRC, the Department for Work and Pensions, and the Welsh Government on income tax should be set out in a Memorandum of Understanding, which should be published in advance of implementation;

c. for the National Assembly for Wales and Welsh Government, the lines of accountability of HMRC in relation to the Welsh rate of income tax should be similar to those of HMRC to the UK Parliament and Government. An HMRC Additional Accounting Officer should be made specifically accountable for the collection of the Welsh rate of income tax;

d. the Wales Bill should enable the National Assembly for Wales to compensate HMRC for the net additional costs associated with implementing and maintaining the Welsh rate of income tax. For the taxes that are to be wholly devolved (SDLT and Landfill Tax) and any new taxes, the Assembly will need to agree formal arrangements, for example a contract or accompanying service level agreement, with the body, either new or existing, which they decide to administer the taxes;

e. where a varying tax rate could lead to an increase or decrease in liabilities for the UK Government, the principle which is set out in the Statement of Funding policy that ‘the body whose decision leads to the additional cost will meet that cost’ should be adhered to;

f. the UK Government should make sure that the Welsh funding system is as transparent as possible with the key components either verified independently or dependent on independent sources. The OBR should be responsible for forecasting Welsh tax receipts, based on data that will include information provided by the Welsh Government. A memorandum of understanding between the OBR, HMRC and HM Treasury should be published in the lead up to implementation alongside more detail on the forecasting methodology. The ‘no detriment’ principle should apply as in Scotland; and

g. the UK Government should invite the Comptroller and Auditor General as head of the NAO to prepare a report to the National Assembly for Wales on HMRC’s administration of the Welsh rate of income tax. If the Welsh Government decides to approach HMRC to administer the smaller taxes, and HMRC agree, then it will be up to the Welsh Government to decide how any audit arrangement should work.

R.30. The Welsh Government and UK Government should work closely together to use both devolved and non-devolved economic powers to strengthen the Welsh tax base.

R.31. These changes should be introduced in a phased way to manage the risks of instability in public finances and of windfall gains or adverse shocks to the Welsh Budget.

R.32. The National Assembly for Wales should have legislative control of its own budgetary procedures.

R.33. The National Assembly Commission may need to consider modest building-up of capacity for financial scrutiny.
8.5 A POSSIBLE TIMETABLE FOR INTRODUCING A NEW WALES BILL

8.5.1 A possible timetable is set out below for the implementation of our recommendations, although we recognise that this timetable would in practice be matter for the UK Government to decide in consultation with the Welsh Government and National Assembly for Wales.

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>November 2012</td>
<td>First Commission report published</td>
</tr>
<tr>
<td>Spring 2013</td>
<td>UK Government and Welsh Government responses published</td>
</tr>
<tr>
<td>Summer 2013</td>
<td>First opportunity for devolution of APD long haul rate in a Finance Bill</td>
</tr>
<tr>
<td>Autumn 2013</td>
<td>HMG White Paper on Wales Bill and first OBR Welsh tax forecasts published – forecast tax assignment introduced</td>
</tr>
<tr>
<td>Summer 2014</td>
<td>Wales Bill published following first Commission report</td>
</tr>
<tr>
<td>Spring 2015</td>
<td>National Assembly gives assent and Bill enacted</td>
</tr>
<tr>
<td>Spring 2015</td>
<td>UK party manifesto commitments on implementation of second Commission report and response to possible future referendum request</td>
</tr>
<tr>
<td>Autumn 2015</td>
<td>Welsh Budget for 2016-17 presented to Assembly, featuring new tax powers</td>
</tr>
<tr>
<td>April 2016</td>
<td>Welsh Government’s stamp duty, aggregates levy and landfill tax introduced; and new borrowing powers used (if agreed by the UK Government, existing borrowing powers might be used earlier than this)</td>
</tr>
<tr>
<td>May 2016</td>
<td>Welsh General Election, manifestos reflect policies on new taxation and borrowing powers and referendum</td>
</tr>
</tbody>
</table>

8.5.2 The newly elected National Assembly for Wales would then decide if and when to ask the UK Government to trigger the referendum power in the new Act. A possible timetable might be:

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017</td>
<td>National Assembly votes to ask UK Government to introduce secondary legislation for a referendum; referendum held</td>
</tr>
<tr>
<td>April 2018</td>
<td>if passed, transitional income tax devolution introduced (based on forecast taxes)</td>
</tr>
<tr>
<td>April 2020</td>
<td>income tax devolution fully operational</td>
</tr>
</tbody>
</table>

8.6 CONCLUSIONS

8.6.1 Our recommendations represent significant changes and will therefore need to be introduced on a phased basis.

8.6.2 We believe a new Wales Bill should be introduced in this Parliament to take forward the recommendations we make which require legislation. Changes which do not require legislation should be introduced as soon as possible.
8.6.3 The devolution of income tax represents a fundamental constitutional shift in powers from London to Cardiff. We believe that the devolution of income tax should be subject to a referendum, triggered by a two-thirds majority vote in the National Assembly for Wales and with the agreement of the UK Parliament. The provision for this referendum should be contained in the Act which devolves tax and borrowing powers.

8.6.4 Institutional arrangements will need to be strengthened. We recommend a number of possible ways of achieving this including setting up a Welsh Treasury function and building the National Assembly for Wales’s capacity for financial scrutiny.

8.6.5 In the next chapter we assess the overall impact of our package of recommendations, and possible future developments.
Chapter 9 – Overall impact and looking to the future

9.1 OVERVIEW

9.1.1 This chapter assesses the overall impact of our package of recommendations in a number of areas, particularly in terms of their impact on public finances, on households and individuals in Wales, and on the Welsh economy and businesses. We also consider here whether the package meets our original remit and discuss how the package might take account of possible future developments in devolution in both the UK and EU contexts.

9.1.2 This impact assessment is inevitably high-level. If the UK and Welsh Governments decide to implement our recommendations, as we believe they should, we would expect them to carry out more detailed impact assessments of their specific proposals in accordance with their normal practices.

9.2 IMPACTS OF OUR PACKAGE

Box 9.1: Evidence on the impacts of our recommendations

The evidence we have received emphasised the importance of considering the impacts of our recommendations on Wales.

The Welsh TUC urged the Commission to “consider their conclusions within the context of the impacts of any changes they propose upon the workforce in Wales, particularly those on low pay”.

We heard a considerable amount of evidence on the particular circumstances of different parts of Wales. For example, one individual referred to “a centralist Cardiff Bay... is further away from North Wales than Westminster” and another noted that “within Flintshire, a handful of international companies represent a significant proportion of the ‘Welsh economy’”.

Concern was also expressed about the possible impact on tax levels in Wales. For example, in our ICM poll 25 per cent wanted higher spending and higher taxes, and 44 per cent thought that the Welsh Government would put up taxes. True Wales were concerned that under devolution-max\(^{115}\) taxes would have “to double overnight”.

The Welsh CBI emphasised the importance of evaluating the impact on business: “Welsh business is concerned, first and foremost, with the effective operation of government policies and their ability to grow the economy”.

\(^{115}\) Devolution-max is a devolution funding option where most taxes and spending are devolved. As discussed in Chapter 3 we do not recommend this model for Wales.
Fiscal Impacts

9.2.1 Some have expressed views not just about the principles of tax devolution but also about what the practical impact would be. For example, Lord Rowlands said in the Lords debate "We remember the great cry of the American colonies: 'No taxation without representation'. We have representation without taxation. There are very few legislative bodies in the world that have full legislative power but do not have any form of tax powers. There is a compelling constitutional logic in place that some kind of tax power should accompany legislative power. The questions that arise the moment that we say that are: what and how? ...I could not say yes to the granting of such powers unless I knew what impact I was making".

9.2.2 We have received evidence that our proposals should be affordable, and should not carry unacceptable fiscal risks to either the UK Government or the Welsh Government. A number of possible fiscal impacts are assessed below.

9.2.3 If the income tax base were devolved as we propose and the Welsh Government were to set the same rates of income tax as the rest of the United Kingdom, then, under the terms of our recommended block grant adjustment mechanism, public spending in Wales could be higher or lower than under the Barnett formula depending on whether the Welsh income tax base grows faster or slower than the rest of United Kingdom.

9.2.4 We have assessed what the impact might be in the future by drawing on what it might have been in past years. Over the period 2000-2010, income tax revenues excluding savings and dividend income increased on average by 4.1 per cent a year in Wales compared to 3.8 per cent for the United Kingdom as a whole, excluding Wales. This relatively high growth in Wales was a result of the relatively favourable labour market conditions seen in Wales over the last decade resulting in the narrowing of the historical gap in the employment rate in Wales compared to the average for the United Kingdom as a whole. If this recent historical trend were to continue in the future then the budget of the Welsh Government would be greater than if fully funded by the block grant by just over £6 million per year (which cumulatively would result in an additional £27 million by year five). It may seem paradoxical that income tax receipts rose proportionately more in Wales than the rest of the United Kingdom in 2000 to 2010 since this was a period when GVA per head in Wales tended to fall relative to the UK average. However this fall is mainly explained by falling profits in Wales rather than falling income from employment sources.

9.2.5 This is, of course, not the only possible scenario and we acknowledge that there is a risk that, if Welsh tax revenue growth were lower than that of the United Kingdom as a whole, then Welsh public spending could be lower under income tax devolution than under the current block grant arrangements. This is explored further in Annex E on risks and scenarios. However even this analysis indicates that the impact would be unlikely to be very large in either direction, and that there is no systematic downside risk.

116 In practice it makes little difference to the trends if we exclude Wales from the United Kingdom to compare growth in Wales to the “rest of the UK” as income tax revenues in Wales account for such a small proportion of total UK income tax revenues.

117 The employment rate in Wales was 67.6 per cent for those aged 16-64 during May to July 2000; this compares to 72.6 per cent for the United Kingdom as a whole. During May to July 2012 the employment rate for those aged 16-64 in Wales was 68.6 per cent compared to 71.2 per cent for the United Kingdom as a whole.

118 This GVA trend is explored further in our Economic Context Research paper available on our web-site as well as in Plaid Cymru’s recent Economic Commission Report "Offa’s Gap", which also emphasises the importance of export-led growth and improved connectivity to improve Welsh economic performance.
9.2.6 As the analysis illustrates, a key issue is what the long term trend of Welsh income would be relative to the rest of the United Kingdom. It is difficult to know what the future path of the Welsh income tax base would be. Much would depend on the relative performance of the Welsh economy. The Welsh Government said in its recent annual report on its Programme for Government that, while the lack of economic levers available to it limits its short term influence over GVA per head, devolved policy areas for which it is responsible are nevertheless crucially important for economic growth over the longer term. Wales’s future prosperity, and the tax revenues that result, are thus to a significant extent in Welsh hands.

9.2.7 We see no reason in principle why the Welsh income tax base should not grow as quickly, if not more quickly, than the rest of the United Kingdom over the longer term, although we also note the downside risks and the need for appropriate economic policies. We therefore suggest transitional arrangements which would avoid risks to the Welsh budget in the shorter term. But we also believe that our proposals themselves would further incentivise the Welsh Government to improve economic growth, as well as giving the Welsh Government extra economic levers. This would be reflected in the Welsh income tax base.

9.2.8 So far in this section we have assumed that the Welsh Government keeps income tax rates at the UK level. There are different risks if, instead of keeping income tax rates at the UK level, the Welsh Government changes income tax rates. If these were altered downwards, then there would be less revenue at least initially (and a commensurate reduction in the Welsh block grant). If they were increased, then there would be more revenue. However, it is not easy to estimate what any given change might mean in terms of revenue foregone or gained and thus what its overall effect on the finances available to the Welsh Government might be. This is because of the possible behavioural and migration effects that we discussed earlier when we argued for the importance of not introducing the Scottish ‘lockstep’ mechanism in Wales.

9.2.9 Under our proposals the Welsh Government could change the basic and higher rates by different amounts, so mitigating any behavioural and migration effects. It would certainly need to assess very carefully the balance of risks and opportunities involved in introducing different income tax rates in Wales from England. But if it assesses those risks and decides that they are acceptable, it would be an accountable decision of the sort that we believe a devolved government should be empowered to take.

9.2.10 In the case of the smaller-yielding taxes we recommend for devolution, the fiscal impact depends on how the Welsh Government decides to use the new powers, but the impact is unlikely in any case to be major in relation to the Welsh Government’s overall budget (because the amount of tax revenue at stake is not very large). There may also be positive economic effects.

9.2.11 The Welsh Government would need to bear the net administrative costs associated with tax devolution. For devolved taxes, the administration costs would depend on Welsh Government decisions about the design of devolved taxes. Some additional costs may also be incurred by the Welsh budget through strengthening Welsh Government policy capacity and legislative drafting capacity; and strengthening the scrutiny capacity in the National Assembly for Wales. It would be crucial for the Welsh Government to keep these administrative costs as tightly controlled as possible, though we accept that good administration costs money – and is in itself a wise form of investment.
9.2.12 If the Welsh Government were set a limit on capital borrowing at least on a pro rata basis to Scotland as discussed in Chapter 6, this might be up to around £130 million a year or 10 per cent on top of existing Welsh Government capital budget. Repayment of loans would be funded either by increased Welsh Government taxes or from within the Welsh budget and would need to be affordable.

9.2.13 Borrowing for current purposes would depend on the volatility of tax receipts, but would be limited.

9.2.14 Devolving business rates as we are proposing would reduce the Welsh Government DEL budget but increase its AME budget. It would not make the Welsh Government systematically better off or worse off. The detailed impact would depend on a number of factors including the relative buoyancy of business rates in England and Wales and would need to be assessed by the Welsh and UK Government before implementing any changes to those financial arrangements for business rates.

**Overall fiscal impact**

9.2.15 In overall terms our assessment is that the fiscal impacts of our package would be likely to be manageable without unacceptable risks to the Welsh and UK public finances. So far as there are risks, we believe that those are outweighed by the accountability and empowerment gains that follow from the responsibility for tax and borrowing.

9.2.16 It might be asked, if the fiscal impacts are expected to be fairly modest, whether there is a case for these reforms in the first place. However, taken together the reforms do involve a major transfer of financial power from the UK Government to the Welsh Government, as we set out below.

9.2.17 Details of the revenue yield in Wales of central government taxes that would be devolved to the Welsh Government under our recommendations are shown in Table 9.1.

**Table 9.1: Revenue yield from taxes devolved to Wales**

<table>
<thead>
<tr>
<th>Tax</th>
<th>Revenue yield (£ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax</td>
<td></td>
</tr>
<tr>
<td>10p of each band</td>
<td>2,000</td>
</tr>
<tr>
<td>Stamp duty land tax</td>
<td>115</td>
</tr>
<tr>
<td>Landfill tax</td>
<td>62</td>
</tr>
<tr>
<td>Aggregates levy</td>
<td>21</td>
</tr>
<tr>
<td>Air Passenger Duty – long haul flights</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>2,199</strong></td>
</tr>
</tbody>
</table>

9.2.18 The package would result in changes that are significant, rational and practical. In aggregate, total devolved central government taxes under the control of the Welsh Government would be £2.2 billion – a figure that represents just under 15 per cent of the budget of the Welsh Government. If we include council tax and business rates (which would become fully devolved under our proposals), the total would come to about £4.4 billion out of total Welsh devolved spending of about £18 billion (Welsh Government and Welsh local
This represents about 25 per cent of the total. It is somewhat higher than council tax as a percentage of local authority spending, which is around 18 per cent. This would be historic - the first time that Wales would have its own tax system.

**Impact on the size of the public sector**

9.2.19 The Welsh Government could use its powers either to reduce tax and spending, or to increase tax and spending: this is the essence of political choice and accountability. The political parties in Wales might well take different views on this. For us, this is one of the aspects of the devolution of taxation powers that brings greatest accountability and transparency – the requirement that there would be for political parties to set out their stalls on what they would propose to do with the taxation powers they would have and to be held to account on what has been achieved. But we do not think there is an inherent reason why tax devolution and borrowing should lead to a larger or smaller public sector.

**Impact on Welsh individuals and households**

9.2.20 A main objective of devolving tax and borrowing powers is to improve financial accountability. We have received a good deal of evidence in favour of this. Our proposals would impact on Welsh individuals and households, first of all in the general sense of making the Welsh Government more financially accountable to the people of Wales. Welsh people will be better informed and better able to hold the Welsh Government to account on the tax and borrowing decisions it makes. In particular, they would be enabled to make choices at a Welsh General Election on the commitments on taxation and borrowing made by Welsh political parties in their manifestos.

9.2.21 There are more specific effects that Welsh citizens would notice:

- all income tax payers would pay part of their income tax to the Welsh Government. In addition, the rate of income tax which they pay would be determined by the Welsh Government. So Welsh income tax payers could see a link between tax and spending in Wales. Furthermore, the differential between basic and higher rates of tax would be determined by the Welsh Government so the Welsh Government could make the tax system more or less progressive than in the rest of the United Kingdom in accordance to the preferences of citizens in Wales;

- the results from our opinion poll shows that 59 per cent of respondents said that public services in Wales will only ever improve if the Welsh Government can make its own decisions about taxation and spending;

- houses bought would be subject to a Welsh stamp duty or whatever replacement tax the Welsh Government might introduce once stamp duty is devolved;

- people making long haul flights from a Welsh airport would pay a Welsh rate of APD, which could be higher or lower than in England; and

- innovative Welsh taxes, for example to improve the environment or public health, would potentially impact on individuals and households, and the proceeds could be used to improve Welsh public services or reduce other taxes. Imaginative proposals that would result in a clear – and popular – public good might result.

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119 Including spending financed by council tax and business rates.
9.2.22 It is also in the interest of individuals and households in Wales if Welsh businesses prosper. We later describe the benefits to business of the package we propose. Those benefits should also be felt by the people who are employed by the businesses or who use their services.

9.2.23 Of course, there would only be benefits if the powers are used wisely – and not every decision would benefit all Welsh citizens equally. But there would be the potential for real and tangible benefits for individuals and households in Wales, and the opportunity through the ballot box to have a much greater say in the decision-making process.

Impact on different parts of Wales and on poorer households in Wales

9.2.24 We have received evidence expressing concerns about whether devolving tax and borrowing powers would benefit all parts of Wales, for example North Wales and rural Wales; and whether it would benefit poorer households.

9.2.25 The devolution of powers does not itself differentiate between different parts of Wales or different parts of the population. However, devolution of taxation and borrowing would provide opportunities for any future Welsh Government to use its new powers for the benefit of all parts of Wales, and to benefit poorer households in Wales.

9.2.26 It would be important for any future Welsh Government to ensure that increased investment from the use of new borrowing powers did not benefit just one part of Wales. Similarly, the Welsh Government would need to ensure that it took account of cross-border effects (for example in North East Wales) in making its tax decisions and that changes to devolved taxes benefited all parts of Wales. While our view is that the overall progressivity of the tax system is mainly a matter for the UK Government, the devolved tax and borrowing powers would potentially provide any future Welsh Government with further levers for helping low income households.

Impact on the Welsh economy and business

9.2.27 We have received a good deal of evidence in support of the view that devolving tax and borrowing powers would provide the Welsh Government with more instruments to increase economic growth in Wales, particularly given the current economic difficulties. Results from our opinion poll shows that 60 per cent of respondents thought that the Welsh economy would be stronger if the Welsh Government could decide levels of taxation and spending in Wales.

9.2.28 In our view the two objectives of increasing financial accountability and increasing growth are complementary. Increasing financial accountability by devolving tax and borrowing powers would give the Welsh Government mechanisms it could use to make Wales more prosperous. This would be in the interests of both Wales and the United Kingdom more generally.

9.2.29 Elsewhere in this report we make a large number of recommendations, many of which have a bearing on increasing economic growth. Of course the devolution of powers does not by itself increase growth but depends on how the Welsh Government chooses to use these powers. The potential impacts could include those set out in the box below.
Box 9.2: Impact of our proposals on the welsh economy and business

Our proposals would enable Welsh political parties and any future Welsh Government to develop a Welsh fiscal policy to promote the Welsh economy and Welsh business, working alongside the UK Government.

Our income tax proposals would further incentivise growth, even if the Welsh Government decided not to vary the rate of income tax from the United Kingdom’s rate. If income tax revenues grow in Wales above those for the rest of the United Kingdom then the Welsh Government could increase public spending or reduce taxation elsewhere.

If the Welsh Government chose to reduce income tax rates, this could improve work incentives and make Wales a more attractive place to live and work; or alternatively if it chose to increase income tax rates, this could provide resources to increase public sector economic investment in Wales.

Our corporation tax proposals would facilitate enhanced capital allowances in more Enterprise Zones, leading to increased investment in Wales.

Our proposals on business rates would give the Welsh Government complete control of business rates, providing greater flexibility to change rates and spending in Wales to meet Welsh economic circumstances.

If the Welsh Government incentivised local growth and investment by (for example) use of Tax Increment Funding, Business Improvement Districts and by use of the Community Infrastructure Levy or a Welsh variant, this could foster growth of the local economy.

Our proposals on stamp duty land tax would enable the Welsh Government to intervene to stimulate the housing market in Wales.

Furthermore, if the Welsh Government carried out a more comprehensive review of residential and commercial property taxation, this could create a better functioning land and property market.

The Welsh Government could chose to introduce innovative taxes to improve the functioning of the economy, for example, by reducing undesirable environmental or health risks; and it could use the proceeds to reduce taxes on business.

If the Welsh Government were given the power to vary APD on long haul flights, it could use this as part of a Welsh airport development strategy.

While the scope for taxing Welsh natural resources is limited at present, Wales has potentially a strong resource base in terms of water, renewable energy, aggregates, coal and gas and it would be important to ensure appropriate levies are kept under review to promote well functioning markets.

Our proposals to devolve borrowing powers would enable the Welsh Government to increase investment in high return economic infrastructure projects.

In addition, we recommend that the Welsh and UK Governments work together to promote increased investment in Wales.
9.3  POSSIBLE FUTURE DEVELOPMENTS

9.3.1 Our proposals would involve a gradual transfer of powers to Wales as described in the timetable in Chapter 8. However, it is important also to try to assess our proposals against future developments over a longer timescale if the appetite for further tax devolution increases in Wales or if external circumstances change.

9.3.2 There are three taxes where we indicate possible scope to go further. On income tax, we recommend a gradualist approach building up over time from devolving 10p in each band to devolving larger slices if there is political consensus. On corporation tax, we recommend that if the tax is devolved to Scotland and Northern Ireland, then it should also be devolved to Wales. In addition, the greater flexibility which we recommend on the number of Enterprise Zones should be kept under review if there are changes to the Enterprise Zone policy in England. On APD, we recommend moving first to devolution of rates for direct long haul flights and then consideration of full devolution in the light of wider UK aviation policy developments.

9.3.3 In addition, if SDLT is devolved and if the Welsh Government is given powers to introduce innovative Welsh taxes and full control of business rates, the Welsh Government could take the opportunity to rationalise property and land taxation in Wales, perhaps along the lines recommended by the Mirrlees Review for the United Kingdom as a whole.\textsuperscript{120}

9.3.4 We have also made recommendations that will ensure that devolution is always considered when changes are made to UK tax system, and that the Welsh Government is enabled to use taxes and levies to respond to Welsh needs.\textsuperscript{121}

Scottish referendum on independence

9.3.5 One future constitutional event may have profound consequences for Wales and the United Kingdom more generally - the Scottish referendum. The extent of the possible consequences is something to which the First Minister of Wales has drawn attention recently. The Welsh devolution settlement will need to be kept under review in the light of developments in Scotland, including any implications for the future of the Barnett formula and of possible further tax powers in Scotland.

EU and UK fiscal and monetary Unions

9.3.6 Everyone is aware of the current EU fiscal and monetary crisis and we were encouraged by several witnesses to learn lessons from those events. We are also aware of the current discussion on the harmonisation of taxation across the EU.

9.3.7 In particular, some evidence we have heard has raised questions whether fiscal devolution within the United Kingdom would weaken the UK Union; and whether it would be compatible with lessons learned in the Eurozone that fiscal and monetary union should go hand in hand.

\textsuperscript{120} IFS (2011), Tax by Design Chapter 16: 

"The taxation of property in the UK is currently something of a mess. As we have seen when considering the practicalities involved in implementing an ideal system, up to a point this is understandable. But it remains both desirable and feasible to clear up much of the mess."

\textsuperscript{121} Discussed in Chapter 4.
9.3.8 Our proposals will not weaken the UK union, as they are designed carefully to prevent excessive borrowing and excessive loss of the risk pooling benefits, which are a positive feature of the present devolution funding arrangements.

9.3.9 Welsh fiscal devolution is compatible with the possible emergence of fiscal and monetary union in the Eurozone area. EU fiscal and monetary union go hand in hand but involve big adjustment costs for the weaker economies in the Eurozone. Wales avoids those adjustment costs by being outside the Eurozone and inside the UK fiscal and monetary union.

9.3.10 Some degree of devolution of fiscal powers from the UK Government to the Welsh Government is entirely compatible with maintaining the benefits of UK fiscal and monetary union, as the international evidence demonstrates.

Part II of our remit

9.3.11 A view we heard was that we should have examined Part II of our remit before Part I, as Part II may have fiscal implications which we may need to take into account. We are, of course, not ourselves able to alter our terms of reference, but we believe that it has been perfectly logical to deal with the matters covered in this report before going on to the second part of our remit. However, we recognise that recommendations in Part II of our work might lead to transfers of functions from the UK Government to the Welsh Government (or vice versa), with associated transfers of funding as appropriate. We will ensure that any financial issues that arise are addressed in our second report.

9.4 DOES OUR PROPOSED PACKAGE MEET OUR REMIT AND FISCAL PRINCIPLES?

9.4.1 At the beginning of this report, we referred to the logic of financial powers following legislative powers. We have been able to contribute to that process, and are grateful to all who have helped us to do so. We have carefully considered the views of all, including those who have expressed scepticism about the benefits of devolution, and we have addressed the concerns which many people have expressed.

9.4.2 We are satisfied our package of recommendations meets the Commission’s remit. It is also consistent with the broad thrust of the Holtham report, which has been widely welcomed in Wales, and meets the fiscal principles that we have adopted:

• it would strengthen accountability by empowering the National Assembly for Wales and Welsh Government to set its own budget, so linking taxation and representation at the Welsh level as well as the UK level;

• it would promote efficiency and growth by providing additional levers and incentives to strengthen the Welsh economy and other devolved policies;

• it would promote equity and fairness by ensuring Welsh spending is related in some measure to Welsh taxation, by enabling the National Assembly for Wales to develop a Welsh tax system that accords with the Assembly’s democratic mandate, and by providing Wales with borrowing powers following those in Scotland and Northern Ireland;

• it would promote a funding settlement based on the principles of agreement and mutual consent;
• it would promote the principle of fiscal discipline by maintaining fiscal credibility at the United Kingdom and Welsh levels, and would maintain a stable and predictable funding system;
• it would promote the principle of transparency in the operation of the new system; and
• It would promote the principle of simplicity by avoiding devolution in more complex areas of the tax system while offering the opportunity for the Welsh Government to introduce more simple devolved taxes.

9.4.3 Our package is thus far-reaching. At the same time, we have recognised the widely held view that change should be introduced incrementally over a period of years to ensure risks are fully assessed and addressed, and that the necessary capacity and experience are built up over time, while maintaining focus on delivering improved performance in existing devolved policy areas.

9.4.4 In assessing amendments to the Scotland Bill in 2011, the UK Government set out three criteria: amendments needed to be based on evidence, to maintain the cross-party consensus, and to benefit the devolved nation without detriment to the rest of the United Kingdom. We can say that these are precisely the criteria we have adopted in the case of Wales.

9.4.5 We have ensured that our recommendations are firmly based on the available evidence, and we have drawn extensively on the wide range of views presented to us through all the methods we used to garner opinion. We have also relied on international experience.

9.4.6 We have considered the impact of our recommendations on Wales and other parts of the United Kingdom. We believe they will benefit Wales and the whole of the United Kingdom.

9.4.7 Central to all our work has been a desire to generate proposals with a wide degree of support based on evidence, with a view to finding consensus around recommendations that will make a real difference.

9.4.8 We have produced a report on which we have all agreed and which we commend for speedy implementation.
**Annually Managed Expenditure (AME)** is spending included in TME that does not fall within DELs. Expenditure in AME is generally less predictable and more difficult to control than expenditure in DEL. AME is split into departmental AME and other AME.

**Central government** is a sector in National Accounts. It comprises Parliament; government departments and their executive agencies; the devolved assemblies of Scotland, Wales and Northern Ireland; government funds such as the National Loans Fund; the foreign exchange official reserves; most Non-Departmental Public Bodies; and various other non-market public bodies that are controlled by central government.

**Departmental Expenditure Limits (DELS)** are firm plans for three years for a specific part of a department’s expenditure. DEL covers all administration costs and programme expenditure except where some programme spending cannot reasonably be subject to close control over a three-year period; or spending relates to non-cash costs other than depreciation and impairments. Departmental spending not in DEL is included in departmental AME. Both resource and capital budgets are divided into DEL and departmental AME.

**Fiscal balance** is the government’s tax revenues minus government spending.

**Fiscal policy** is the use of government revenue collection (taxation) and expenditure (spending) to influence the economy. The two main instruments of fiscal policy are government taxation and expenditure.

**Gross Value Added (GVA)** is linked as a measurement to gross domestic product (GDP), as both are measures of output. The relationship is defined as: GVA + taxes on products - subsidies on products = GDP.

**Her Majesty’s Revenue and Customs (HMRC)** collects and administers central government taxes.

**Identifiable expenditure** is expenditure that can be recognised as having been incurred for the benefit of individuals, enterprises or communities within a particular country or region. Examples are most health and education services, and spending on social security and pensions. See Chapter 9 for further details.

**National Audit Office (NAO)** audits UK Government spending and carries out value for money studies. **The Wales Audit Office (WAO)** carries out similar functions in respect of devolved Welsh Government spending in Wales.

**National Insurance Contributions (NICs)** are paid by employers and employees and fund social security spending through the National Insurance Fund (NIF).

**National Loans Fund (NLF)** – the NLF is a government account with the Bank of England set up under the National Loans Fund Act 1968. All government borrowing transactions are handled through this fund.
Non identifiable expenditure is expenditure that cannot be recognised as benefiting a particular country or region, so is deemed to be incurred on behalf of the United Kingdom as a whole, for example, most defence expenditure, overseas representation and tax collection.

Office for Budget Responsibility (OBR) was created in 2010 to provide independent and authoritative analysis of the UK’s public finances.

Office for National Statistics (ONS) collects and publishes national statistics.

Private Finance Initiative (PFI) is a system for purchasing capital intensive services for the public sector. Typically, the private sector designs, finances, builds, and maintains infrastructure, and other fixed capital assets, and then operates those assets to sell services to the public sector. In a proportion of cases the capital assets are accounted for on the balance sheet of the private sector operator; in other cases they are on the public sector’s books.

Public sector net borrowing (PSNB) is the difference between public sector receipts and expenditure as measured by National Accounts. It also equals the net balance of the public sector’s acquisition of financial liabilities less its acquisition of financial assets.

Public sector net debt (PSND) is the sum of the public sector’s financial liabilities at nominal value, less its liquid financial assets.

Public Works Loans Board (PWLB) is a UK Government agency which lends to local authorities on a prudential basis.

Resource budget is the budget for current expenditure on an accruals basis. It is divided into resource DEL (which is a control total) and resource departmental AME (a planning total).

Capital budget is the budget for capital expenditure and is split similarly into DEL and AME.

Spending Reviews set DELs for the following three or four years. The first was the Comprehensive Spending Review in 1998 with further SRs held every two years until 2004. A second Comprehensive Spending Review reported in autumn 2007 and set budgets for 2008-09 to 2010-11. A further Spending Review in autumn 2010 set budgets for 2011-12 to 2014-15.

Sub-National Government is the technical term used for governments below the nation-state level, such as devolved administrations, provinces, states or länder to enable international comparisons.

Supply expenditure is expenditure that is voted by Parliament either in the annual Main Estimates or in Supplementary Estimates.

Total Managed Expenditure (TME) is a definition of aggregate public spending derived from National Accounts. It is the consolidated sum of current and capital expenditure of central and local government, and public corporations. TME can also be presented as the sum of DEL and AME.

Value Added Tax (VAT) is a tax on consumption levied on the value added at each stage of production of goods and services.

Welsh Consolidated Fund is the account managed by the Welsh Government through which revenues and expenditures for the devolved Welsh budget flow. The UK Consolidated Fund is the equivalent fund at the UK level managed by the UK Government.
Annex A: Commissioners’ Biographies and members of the Secretariat

Paul Silk was named as chair of the Commission by the Secretary of State for Wales on 11 October 2011. He is a former Clerk to the National Assembly for Wales, serving from March 2001 until December 2006. During this period he was the most senior official in the Assembly and acted as the principal advisor to the Presiding Officer and was responsible for all the services that are delivered to Assembly Members through the Assembly Parliamentary Service.

He was a Clerk in the House of Commons from 1975-1977 and 1979-2001 clerking at different times three different departmental select committees - the Foreign Affairs (1998-2001), Home Affairs (1989-1993) and Energy (1984-1989) Committees. He is also a former Clerk of the Welsh Grand Committee, the Clerk in charge of the Government of Wales Bill and contributed to drafting the first standing orders of the National Assembly for Wales. He was Director of Strategic Projects in the House of Commons from 2007 to 2010.

He has also worked as Presidential Adviser in the Parliamentary Assembly of the Council of Europe and has written and lectured extensively on Parliament and the constitution. He is an honorary...
Professor at the Wales Governance Centre at Cardiff University, and works regularly for the Westminster Foundation for Democracy. He was born in Crickhowell and lives near there now.

**Professor Nick Bourne** was nominated by the Welsh Conservative Party. He served as the Leader of the Welsh Conservative Party and as a member of the National Assembly for Wales for the Mid and West Wales electoral region from 1999 until 2011. He is a former Professor of Law and has also been Assistant Principal of Swansea Institute of Higher Education and Dean of Swansea Law School (now Swansea Metropolitan University).

First elected to the National Assembly for Wales in 1999, and re-elected in 2003 and 2007, Professor Bourne sat on the Assembly’s European and External Affairs committee and was the party’s spokesman on constitutional matters. He became leader of the Welsh Conservatives in August 1999, and Leader of the Opposition in the National Assembly in July 2007. Professor Bourne also became the Shadow Minister for Finance and Public Service Delivery in addition to his role as Leader of the Opposition in the National Assembly from June to October 2008. He was a member of the National Assembly Advisory Group, the body which set up the Assembly’s working arrangements.

Prior to his appointment in the Assembly he has also held high profile positions in a number of private companies including as Director of Holborn Group ltd (1988 – 1991) and Company Secretary and Director of Chart Foulks Lynch plc (1984 – 1988) both specialising in distance learning and oral tuition.

He has served on the British Council Welsh Advisory Committee from 2011 and from 2012 has been Chair of the Haven Enterprise Zone. He is a member of the External Advisory Board of the Wales Governance Centre.

**Sue Essex** was nominated by the Welsh Labour Party. Sue is a former Welsh Assembly member representing the Cardiff North Constituency (1999-2007). She was Minister for Environment, Planning and Transport in the first term of the Assembly and was Minister for Finance, Local Government and Public Services in the second term.

She is a qualified planner and worked for many years in local government and as a lecturer in planning at Cardiff University. She served as a local Councillor in Cardiff for sixteen years and became the first woman Leader of Cardiff City Council. She also served as a member of the Countryside Council for Wales. Since standing down from the Assembly in May 2007, she has led a review on behalf of the Assembly Minister on affordable housing in Wales and also advised UWIC and Bangor University on leadership and collaboration in postgraduate teaching.

She has been made an Honorary Member of The Chartered Institute of Housing, The Royal Society of Architects of Wales and an Honorary Fellow of the Chartered Institute of Waste Management. Sue has decided to stand down from the Commission at the end of Part I of its remit.

**Dr Eurfyl ap Gwilym** was nominated by Plaid Cymru. He is Deputy Chairman of Pure Wafer plc, chair of the Principality Building Society Pension Trustees and a director and trustee of the Institute of Welsh Affairs. He is a member of the audit committee of the National Museum of Wales and of the Investment Committee of the University of Wales.

Dr ap Gwilym recently stepped down from the board of the Principality Building Society where he was Deputy Chairman and from NCC Group plc where he was a non-executive director. He has also served as a non-executive director of iSOFT Group plc and Eqos Limited. In 1999, he was one
of a three man team responsible for floating the Terence Chapman Group on the London Stock Exchange and has since been involved in floating three other companies. Prior to that he was Chief Executive of BIS Banking Systems International, a subsidiary of Nynex Inc, and the Chief Executive of GE Information Services where he also served as UK National Executive for GE and as a member of the CBI President’s Council. His early career was spent with Unilever and Philips. He is the author of many articles on treasury matters and economic policy and has served as Director of Research and National Chairman of Plaid Cymru.

Rob Humphreys was nominated by the Welsh Liberal Democrats. He is the Director of the Open University in Wales, having held posts previously at Swansea University and as Director for Wales of the National Institute for Adult Continuing Education. During his time at Swansea he worked on the innovative and award-winning Community University of the Valleys project, and was awarded a Distinguished Teaching Award for his work with adult students. In 2005 he was a founder member and first chair of the Swansea Festival of Learning. He was appointed by the Minister of Education to the first and second ‘Rees Reviews’ of higher education funding, which led to significant changes to the funding of universities in Wales. In 2008 and 2009 he held the post of Specialist Adviser to the Welsh Affairs Committee of the House of Commons during its Inquiry into Cross-Border Services. He was later appointed to the Independent Review of Higher Education in Wales, which reported to the Welsh Government in May 2009. In 2008 he was appointed by the First Minister and Deputy First Minister to the All-Wales Convention. He was chair of the independent review of governance within the Further Education sector in Wales, which reported to the Minister for Education in 2011. He is a member of the BBC Audience Council for Wales, and the Student Experience Teaching & Quality Committee of the Higher Education Funding Council for Wales.

Originally from Montgomeryshire, he was an unskilled labourer for seven years on leaving school before becoming a mature student, winning a trade union scholarship to study at Ruskin College Oxford and then graduating from Cardiff University in 1989. He is married to broadcaster and film-maker Catrin Evans, and they live with their ten year old daughter in Swansea.

Dyfrig John CBE is currently Chair of Principality Building Society, a Trustee and Director of the Wales Millennium Centre (WMC) and President of the HSBC Pensioners’ Association. Prior to this, he was Deputy Chairman and Chief Executive of HSBC Bank plc, a position he has held from May 2008, adding to his previous role of Director and Chief Executive of HSBC Bank plc. He was previously Deputy Chief Executive of the bank (from May 2005) and an Executive Director since January 2003. Before this, he was an HSBC Group General Manager from August 2000, and a Group Managing Director from 6 March 2006.

Following several senior management appointments at Midland Bank’s London head office, he became Retail Banking Director for Wales and South West England. In January 1993, he was appointed General Manager for Wales. He also held appointments on the Board of Authority at S4C, and the Development Board for Rural Wales. In 1996, he was also Chairman of the Olympic Appeal in Wales.

Dyfrig John left the UK in May 1997 to become Chief Executive Officer of the Hong Kong and Shanghai Banking Corporation in India, where he was also a member of the Standing Committee on Money Markets at the Reserve Bank of India. In November 1999, he moved to Malaysia as Deputy Chairman and Chief Executive Officer of HSBC Bank Malaysia Berhad.

He was born on 14 May 1950 in West Wales, and was educated in Pembrokeshire and Cardiff. He is married with two sons. He is a Sloan Fellow from London Business School, a Fellow of the Institute
of Financial Services and was awarded an honorary doctorate from the University of Glamorgan in 2005. In 2007, he was honoured with membership to the Eisteddfod Gorsedd (White). He has also been recognised with a Fellowship by Trinity College Carmarthen, Bangor University, Aberystwyth University and an honorary doctorate from the University of Wales. He became a Commander of the British Empire in 2010. Dyfrig has decided to stand down from the Commission at the end of Part I of its remit.

**Professor Noel Lloyd CBE** was the Vice-Chancellor of Aberystwyth University from 2004 to his retirement in 2011, having previously been Registrar and Secretary, Pro Vice-Chancellor, Dean of Science and Head of the Department of Mathematics. He graduated in Mathematics from the University of Cambridge, completed his PhD there and was a Research Fellow at St John’s College. His research interests are in Nonlinear Analysis and Dynamical Systems. He is currently a Distinguished Research Professor in Mathematics at Aberystwyth University. He was awarded a CBE in the Birthday Honours List in 2010 for services to Higher Education in Wales, and is a Fellow of the Learned Society of Wales.

From 2008 to 2011, Professor Lloyd was chair of Higher Education Wales and a Vice-President of Universities UK. From 2005 to 2011, he was a member of the board of UCEA, chairing its Health and Safety Committee; he was also a member of the board of QAA and chaired its Access Regulation and Licensing Committee. He currently serves on the Judicial Appointments Commission, chairs HPC Wales (High Performance Computing Wales) and Fair Trade Wales, and is a member of the Shadow Board of JISC (the Joint Information Services Committee). He has served on various Research Council committees and a number of editorial boards. He has been a member of the HEFCW Quality Assurance Committee, and was a member of the board of the mid-Wales TEC and then of the mid-Wales ELWa Regional Committee.

He is an active member of Capel y Morfa, Aberystwyth, having been church secretary from 1989 to 2004. He has chaired the Church and Society board of the Presbyterian Church of Wales. Professor Lloyd is married, with two children in their thirties.

**Members of the Secretariat**

The Commission has been supported by a Secretariat consisting of officials seconded from the Wales Office, HM Treasury and the Welsh Government:

- Sian Oborne, Joint Secretary (until June 2012);
- Michael Kay, Joint Secretary (from June 2012);
- Mark Parkinson OBE, Joint Secretary;
- Edward Sherriff, Economic Adviser;
- David Harries, Research Officer;
- Sara Parry, Communications Officer;
- Linzi Perriman, Administrative Assistant (January 2012 to June 2012).
Annex B: List of sources of evidence

The Commission expresses its thanks to all those who contributed to its work. In addition to the list below of organisations and individuals from whom we received evidence, we made 28 visits, and held public meetings in every local authority area in Wales. We also met UK and Welsh Government Ministers and officials.

Further details of our evidence, visits and meetings are available on our website.

Written Evidence

John Ball
Madoc Batcup
Bristol Airport
Peter Briebach
John Broughton
W J Capper
Cardiff Airport
CBI Wales
Chartered Institute of Taxation
“CJ”
Coalition for Economic Justice
Michael Cossey-Edwards
Roger Cracknell
Professor Andrew Crawley and Professor Max Munday
Peter Crellin
Mike Cuddy
David Davies MP
Geraint Davies MP
James Davies
John Davies
Mark Drakeford AM
Gwyn Edwards
Federation of Small Businesses
J L Gardner
Lord Garel-Jones
Len Gibbs

Stephen Jones
Professor David King et al, Stirling University
Edgar Lloyd
Manchester Airport Group
Michael Matthews
Mid and West Wales Fire and Rescue Authority
David Melding AM
Paul Murphy MP
National Audit Office
National Farmers Union Cymru
Carol Norman
Lyn Owen
Parliament for Wales Campaign
Tom Peters
Plaid Cymru
PricewaterhouseCoopers
Clr Allan Pritchard
J Putyatin
Tracey Rihill
Medwyn Roberts
RWE
South East Wales Economic Forum
“Steve”
Sustrans Cymru
Dave Taylor
David Taylor
True Wales
Gwynedd County Council
Professor David Heald
Frank Harbud
Dennis Harkus
Institute of Chartered Accountants England and Wales
Institute of Directors Wales
Dr Ian Johnson
Glyndwr C Jones
Professor Richard Wyn Jones

Wales in a Changing Union Partnership
Wales Trades Union Congress
Robert Walker
Welsh Communist Party
Welsh Conservative Assembly Group
Welsh Conservative Party
The Welsh Government
Welsh Liberal Democrats
Welsh Local Government Association
Cllr Matt Wright

Oral Evidence

Bevan Foundation
Bristol Airport
Dr Gillian Bristow
Cardiff Airport
CBI Wales
Country Land and Business Association Wales
Deloitte
Federation of Small Businesses
Professor Jim Gallagher
Grant Thornton
Gwynedd County Council
Professor Gerald Holtham
Institute of Directors Wales
Institute of Public Policy Research
Professor Richard Wyn Jones
Professor David Miles
Mineral Products Association
National Farmers Union Cymru
Office of Budget Responsibility
PricewaterhouseCoopers
Professor Roger Scully
Professor Bernd Spahn
Alan Trench
True Wales
Wales in a Changing Union Partnership
Welsh Local Government Association
Annex C: Public Expenditure in Wales

C.1 This annex provides further details on public spending in Wales.

C.2 Table C1 shows the breakdown of the Welsh Government’s budget. As outlined in Chapter 2, this is the total of the Departmental Expenditure Limit (DEL) and the Annually Managed Expenditure (AME) which is known as Total Managed Expenditure (TME). In 2011-12 the Welsh DEL was £14.625 billion. This is expected to increase (in nominal terms) to £14.744 in 2014-15. As discussed in Chapter 2 there are a number of demand-led expenditure lines which are updated in the Budget and in the autumn and are included in the Welsh Government AME.

Table C1: Total Managed Expenditure, Wales £ million

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Resource DEL (a)</td>
<td>11,955</td>
<td>12,420</td>
<td>13,078</td>
<td>13,386</td>
<td>13,239</td>
<td>13,378</td>
<td>13,510</td>
<td>13,542</td>
</tr>
<tr>
<td>Capital DEL</td>
<td>1,462</td>
<td>1,627</td>
<td>1,932</td>
<td>1,751</td>
<td>1,386</td>
<td>1,233</td>
<td>1,149</td>
<td>1,202</td>
</tr>
<tr>
<td>Total DEL</td>
<td>13,417</td>
<td>14,047</td>
<td>15,010</td>
<td>15,138</td>
<td>14,625</td>
<td>14,611</td>
<td>14,659</td>
<td>14,744</td>
</tr>
<tr>
<td>Resource AME</td>
<td>-62</td>
<td>138</td>
<td>293</td>
<td>53</td>
<td>72</td>
<td>138</td>
<td>-9</td>
<td>122</td>
</tr>
<tr>
<td>Capital AME</td>
<td>165</td>
<td>168</td>
<td>202</td>
<td>209</td>
<td>244</td>
<td>267</td>
<td>289</td>
<td>313</td>
</tr>
<tr>
<td>Total Managed</td>
<td>13,520</td>
<td>14,353</td>
<td>15,505</td>
<td>15,400</td>
<td>14,941</td>
<td>15,016</td>
<td>14,939</td>
<td>15,179</td>
</tr>
</tbody>
</table>

Source: Public Expenditure Statistical Analyses 2012, HM Treasury

(a) As part of the Spending Review 2010, Resource DEL was presented less depreciation.

C.3 Table C2 shows the total amount of public expenditure that can be identified to be in Wales, including both devolved and non-devolved spending. In total, just over £30 billion of public expenditure was identified to be in Wales. As discussed in Chapter 2, the majority of public expenditure in Wales is the responsibility of the Welsh Government and Welsh local government. The remainder is the responsibility of the UK Government; the largest item is social security payments.
Table C2: Identifiable expenditure on services, departmental grouping 2010-11

<table>
<thead>
<tr>
<th>Department</th>
<th>Total Expenditure on Services (£ million)</th>
<th>As a per cent of total identifiable expenditure in Wales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Welsh Government</td>
<td>10,303</td>
<td>34.21%</td>
</tr>
<tr>
<td>Wales Office (a)</td>
<td>5</td>
<td>0.02%</td>
</tr>
<tr>
<td>Welsh local government (b)</td>
<td>8,198</td>
<td>27.22%</td>
</tr>
<tr>
<td>Local government public corporations</td>
<td>3</td>
<td>0.01%</td>
</tr>
<tr>
<td>UK government departments</td>
<td>11,605</td>
<td>38.54%</td>
</tr>
<tr>
<td>Total</td>
<td>30,115</td>
<td></td>
</tr>
</tbody>
</table>

Source: Public Expenditure Statistical Analyses 2012, HM Treasury

(a) This includes public corporations sponsored by central government departments.
(b) This includes the grant funding from the Welsh Government DEL of approximately £4.3 billion.

C.4 Table C3 shows the total identifiable expenditure on services per head of the population across the regions of England and the devolved countries of the United Kingdom. In Wales total identifiable public expenditure per head in 2010-11 was £10,017, which is above the average for England and the United Kingdom as a whole. However, this is below the other two devolved countries. Table C4 shows this figure as an index compared to the average for the United Kingdom as a whole (UK=100). Total identifiable expenditure in Wales in 2010-11 was 13 per cent above the average for the United Kingdom as a whole. This compares to 14 per cent above the average in Scotland and 20 per cent above the average in Northern Ireland.

Table C3: Total identifiable expenditure on services by country and region, £ per head

<table>
<thead>
<tr>
<th>Country</th>
<th>2006-07 outturn</th>
<th>2007-08 outturn</th>
<th>2008-09 outturn</th>
<th>2009-10 outturn</th>
<th>2010-11 outturn</th>
</tr>
</thead>
<tbody>
<tr>
<td>North East</td>
<td>7,833</td>
<td>8,235</td>
<td>8,889</td>
<td>9,459</td>
<td>9,501</td>
</tr>
<tr>
<td>North West</td>
<td>7,636</td>
<td>8,093</td>
<td>8,631</td>
<td>9,267</td>
<td>9,386</td>
</tr>
<tr>
<td>Yorkshire and the Humber</td>
<td>7,033</td>
<td>7,332</td>
<td>7,867</td>
<td>8,462</td>
<td>8,512</td>
</tr>
<tr>
<td>East Midlands</td>
<td>6,527</td>
<td>6,875</td>
<td>7,385</td>
<td>7,950</td>
<td>8,098</td>
</tr>
<tr>
<td>West Midlands</td>
<td>7,097</td>
<td>7,502</td>
<td>8,015</td>
<td>8,613</td>
<td>8,679</td>
</tr>
<tr>
<td>East</td>
<td>6,241</td>
<td>6,534</td>
<td>7,067</td>
<td>7,690</td>
<td>7,834</td>
</tr>
<tr>
<td>London</td>
<td>8,352</td>
<td>8,806</td>
<td>9,355</td>
<td>10,146</td>
<td>10,198</td>
</tr>
<tr>
<td>South East</td>
<td>6,208</td>
<td>6,524</td>
<td>7,091</td>
<td>7,513</td>
<td>7,529</td>
</tr>
<tr>
<td>South West</td>
<td>6,531</td>
<td>6,896</td>
<td>7,481</td>
<td>7,977</td>
<td>8,096</td>
</tr>
<tr>
<td>England</td>
<td>7,042</td>
<td>7,414</td>
<td>7,962</td>
<td>8,553</td>
<td>8,634</td>
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<tr>
<td>Scotland</td>
<td>8,588</td>
<td>9,045</td>
<td>9,424</td>
<td>9,945</td>
<td>10,165</td>
</tr>
<tr>
<td>Wales</td>
<td>8,260</td>
<td>8,609</td>
<td>9,144</td>
<td>9,726</td>
<td>10,017</td>
</tr>
<tr>
<td>Northern Ireland</td>
<td>8,963</td>
<td>9,540</td>
<td>10,044</td>
<td>10,550</td>
<td>10,668</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>7,288</td>
<td>7,671</td>
<td>8,203</td>
<td>8,785</td>
<td>8,888</td>
</tr>
</tbody>
</table>

Source: Public Expenditure Statistical Analyses 2012, HM Treasury
Table C4: Total identifiable expenditure on services by country and region, UK=100

<table>
<thead>
<tr>
<th>Region</th>
<th>2006-07 outturn</th>
<th>2007-08 outturn</th>
<th>2008-09 outturn</th>
<th>2009-10 outturn</th>
<th>2010-11 outturn</th>
</tr>
</thead>
<tbody>
<tr>
<td>North East</td>
<td>107</td>
<td>107</td>
<td>108</td>
<td>108</td>
<td>107</td>
</tr>
<tr>
<td>North West</td>
<td>105</td>
<td>106</td>
<td>105</td>
<td>105</td>
<td>106</td>
</tr>
<tr>
<td>Yorkshire and the Humber</td>
<td>97</td>
<td>96</td>
<td>96</td>
<td>96</td>
<td>96</td>
</tr>
<tr>
<td>East Midlands</td>
<td>90</td>
<td>90</td>
<td>90</td>
<td>90</td>
<td>91</td>
</tr>
<tr>
<td>West Midlands</td>
<td>97</td>
<td>98</td>
<td>98</td>
<td>98</td>
<td>98</td>
</tr>
<tr>
<td>East</td>
<td>86</td>
<td>85</td>
<td>86</td>
<td>88</td>
<td>88</td>
</tr>
<tr>
<td>London</td>
<td>115</td>
<td>115</td>
<td>114</td>
<td>115</td>
<td>115</td>
</tr>
<tr>
<td>South East</td>
<td>85</td>
<td>85</td>
<td>86</td>
<td>86</td>
<td>85</td>
</tr>
<tr>
<td>South West</td>
<td>90</td>
<td>90</td>
<td>91</td>
<td>91</td>
<td>91</td>
</tr>
<tr>
<td>England</td>
<td>97</td>
<td>97</td>
<td>97</td>
<td>97</td>
<td>97</td>
</tr>
<tr>
<td>Scotland</td>
<td>118</td>
<td>118</td>
<td>115</td>
<td>113</td>
<td>114</td>
</tr>
<tr>
<td>Wales</td>
<td>113</td>
<td>112</td>
<td>111</td>
<td>111</td>
<td>113</td>
</tr>
<tr>
<td>Northern Ireland</td>
<td>123</td>
<td>124</td>
<td>122</td>
<td>120</td>
<td>120</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Public Expenditure Statistical Analyses 2012, HM Treasury

C.5 The UK and Welsh Governments do not produce a breakdown of non identifiable expenditure by country and region of the UK, although the Scottish Government provides figures for Scotland in its Government Expenditure and Revenue in Scotland annual publication. However, one such estimate is provided in an article by Gerald Holtham in the Institute of Welsh Affairs Agenda publication (Summer 2012). This gives a figure of £2,064 per head in Wales\(^{122}\) in 2009-2010 (or around £6.2 billion), the majority of which is defence and public debt interest. This is additional to the spending described above.

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\(^{122}\) The methodology apportions non-identifiable expenditure on a per head basis so each country and region of the United Kingdom has the same per head figure.
Annex D: Welsh tax revenue estimates

D.1 This annex sets out further details about Welsh tax revenue estimates. HMRC does not provide estimates of revenues by region for the majority of UK-wide taxes as the current UK tax system does not identify location of taxable activity for all taxes. It is, however, possible to provide an estimate of those revenues. This Annex summarises those estimates and outlines the methodology we have used. The figures below do not include council tax revenue (about £1.3 billion) and business rate revenue (about £0.9 billion).

Headline estimates

D.2 Table D1 provides an estimate of the revenues raised in Wales by each of the taxes that are collected for the UK Exchequer. In aggregate, we estimate that just over £16 billion was raised in Wales in 2010-11, the most recent year for which robust data are available. Revenues raised in Wales are estimated to have fallen between 2007-08 and 2009-10, reflecting the decline in UK revenues more generally as a result of the recession which began in 2008. Income tax, VAT and Corporation tax are clearly highly cyclical with large absolute changes in revenues over the last few years. While Stamp Duty Land Tax and Capital Gains Tax are also relatively volatile, the absolute revenue changes are comparatively modest.

Table D1: Estimated revenues in Wales from UK-wide taxes, £ million

<table>
<thead>
<tr>
<th></th>
<th>2007-08</th>
<th>2008-09</th>
<th>2009-10</th>
<th>2010-11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax*</td>
<td>5,150</td>
<td>4,850</td>
<td>4,710</td>
<td>4,850</td>
</tr>
<tr>
<td>Value Added Tax*</td>
<td>3,585</td>
<td>3,275</td>
<td>2,930</td>
<td>3,485</td>
</tr>
<tr>
<td>NIC*</td>
<td>3,700</td>
<td>3,570</td>
<td>3,440</td>
<td>3,475</td>
</tr>
<tr>
<td>Fuel duty*</td>
<td>1,250</td>
<td>1,250</td>
<td>1,310</td>
<td>1,365</td>
</tr>
<tr>
<td>Corporation tax*</td>
<td>1,425</td>
<td>1,120</td>
<td>1,005</td>
<td>1,170</td>
</tr>
<tr>
<td>Alcohol and tobacco duty*</td>
<td>770</td>
<td>800</td>
<td>855</td>
<td>885</td>
</tr>
<tr>
<td>Vehicle Excise duty*</td>
<td>275</td>
<td>255</td>
<td>265</td>
<td>265</td>
</tr>
<tr>
<td>Stamp Duty Land Tax*</td>
<td>210</td>
<td>115</td>
<td>100</td>
<td>115</td>
</tr>
<tr>
<td>Capital gains tax*</td>
<td>170</td>
<td>250</td>
<td>80</td>
<td>110</td>
</tr>
<tr>
<td>Insurance premium tax*</td>
<td>105</td>
<td>95</td>
<td>90</td>
<td>100</td>
</tr>
<tr>
<td>Stamp duty tax on shares*</td>
<td>135</td>
<td>105</td>
<td>100</td>
<td>95</td>
</tr>
<tr>
<td>Betting and gaming duties*</td>
<td>70</td>
<td>60</td>
<td>60</td>
<td>60</td>
</tr>
<tr>
<td>Landfill tax*</td>
<td>50</td>
<td>55</td>
<td>50</td>
<td>60</td>
</tr>
<tr>
<td>Inheritance tax*</td>
<td>70</td>
<td>55</td>
<td>45</td>
<td>50</td>
</tr>
<tr>
<td>Climate change levy*</td>
<td>40</td>
<td>40</td>
<td>40</td>
<td>40</td>
</tr>
<tr>
<td>Aggregates levy*</td>
<td>30</td>
<td>25</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>Air passenger duty*</td>
<td>15</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Total</td>
<td>17,040</td>
<td>15,915</td>
<td>15,100</td>
<td>16,160</td>
</tr>
</tbody>
</table>

Source: HMRC (*) and Commission Calculations (+)

For VAT part of the change in revenues seen is the result of the changes to the headline rate.
D.3 Table D2 compares the estimated share of total tax revenues for each tax for Wales and the United Kingdom as a whole. For many of the main UK-wide taxes the share of total tax revenue that each tax raises in Wales is broadly in line with the share for the United Kingdom as a whole. There are, however, some notable differences. Estimated income tax revenues comprise a lower share of total tax revenue in Wales because Wales has lower income tax revenue per head than the United Kingdom as a whole. This is a result of lower average earnings in Wales, meaning that Wales has a lower proportion of higher rate taxpayers. Estimated VAT revenues in Wales comprise a larger share of total Welsh revenues than for the UK as a whole. This relatively larger share is more a reflection of Wales’s relatively lower tax revenues in total than VAT being a particularly buoyant tax in Wales in absolute terms. VAT revenues per head in Wales are below the average for the United Kingdom as a whole. Fuel duty represents a larger share of total revenues in Wales than the UK as a whole. Fuel consumption per head in Wales is broadly in line with the average for the United Kingdom as a whole while for most other taxes the revenue per head in Wales is below the average for the United Kingdom as a whole. Corporation tax revenues also represent a lower share of the total revenues in Wales. This is a reflection of the relative decline in gross operating surplus (a broad measure for profits generated in Wales) seen in Wales over the last 20 years due to the decline in capital-intensive industry in Wales.

Table D2: Share of total tax revenues, 2010-11

<table>
<thead>
<tr>
<th>Per cent of total tax revenue</th>
<th>Wales</th>
<th>UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax</td>
<td>30.00</td>
<td>34.10</td>
</tr>
<tr>
<td>Value Added Tax</td>
<td>21.60</td>
<td>18.55</td>
</tr>
<tr>
<td>NIC</td>
<td>21.50</td>
<td>21.45</td>
</tr>
<tr>
<td>Fuel duty</td>
<td>8.50</td>
<td>6.05</td>
</tr>
<tr>
<td>Corporation tax</td>
<td>7.25</td>
<td>9.35</td>
</tr>
<tr>
<td>Alcohol and tobacco duty</td>
<td>5.50</td>
<td>4.10</td>
</tr>
<tr>
<td>Vehicle Excise duty</td>
<td>1.65</td>
<td>1.25</td>
</tr>
<tr>
<td>Capital gains tax</td>
<td>0.70</td>
<td>0.80</td>
</tr>
<tr>
<td>Stamp duty land tax</td>
<td>0.70</td>
<td>1.30</td>
</tr>
<tr>
<td>Insurance premium tax</td>
<td>0.60</td>
<td>0.55</td>
</tr>
<tr>
<td>Stamp duty tax on shares</td>
<td>0.60</td>
<td>0.65</td>
</tr>
<tr>
<td>Betting and gaming duties</td>
<td>0.40</td>
<td>0.35</td>
</tr>
<tr>
<td>Landfill tax</td>
<td>0.40</td>
<td>0.25</td>
</tr>
<tr>
<td>Inheritance tax</td>
<td>0.30</td>
<td>0.60</td>
</tr>
<tr>
<td>Climate change levy</td>
<td>0.25</td>
<td>0.15</td>
</tr>
<tr>
<td>Aggregates levy</td>
<td>0.15</td>
<td>0.05</td>
</tr>
<tr>
<td>Air passenger duty</td>
<td>0.05</td>
<td>0.50</td>
</tr>
</tbody>
</table>

Source: HMRC and Commission calculations

124 Wales’s share of expenditure used to estimate VAT revenues is below its population share.
SUMMARY OF METHODOLOGY AND DESCRIPTION OF TRENDS

Income tax

D.4 Aggregate income tax estimates for Wales are published by HMRC. The most recent outturn estimate is for 2009-10. HMRC have delayed the publication of data for 2008-09 due to difficulties in obtaining a full set of data on individuals’ income and tax liabilities. We have made an estimate for 2008-09 by applying Wales’s share of UK income tax revenues in 2007-08 to the total UK income tax revenues for 2008-09. Our estimates for 2010-11 have been calculated using the economic assumptions published by the Office for Budgetary Responsibility in their Economic and Fiscal Outlook.125 Those assumptions are used by HMRC to estimate the number of taxpayers in Wales (and the rest of the United Kingdom) post 2009-10. In total we estimate that income tax raised £4.85 billion in 2010-11.

D.5 We are not recommending that income tax on savings and dividend income be devolved to Wales. In the figures below we have excluded the income tax revenue from savings and dividend income. We have also excluded those taxpayers that are liable for income tax based on savings and dividend income alone. Excluding income tax from savings and dividend income, income tax raised just over £4.4 billion in 2010-11. Figure D1 shows the relative growth in income tax revenues in Wales compared to the average for the United Kingdom as a whole.

Figure D1: Growth in income tax revenues excluding savings and dividend income, 2000-01 = 100 (a)

Source: Commission calculations
(a) We have excluded income tax from savings and dividend income as neither the Holtham or Calman Commission recommend that this source of income tax be devolved to Wales or Scotland respectively.
(b) HMRC has not yet published data for 2008-09 due to methodological issues. We have used the mid point of the data for 2007-08 and 2009-10.
(c) UK figure includes Wales. In practice it makes little difference to the trends if we exclude Wales from the UK to compare growth in Wales to the “rest of the UK” as income tax revenues in Wales account for such a small proportion of total UK income tax revenues.

125 Further details are available from the OBR: http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-march-2012/
D.6 HMRC also publishes the number of taxpayers by their marginal rate, together with their associated income. A more detailed distribution of income giving the number of taxpayers in smaller income bands was estimated by applying a cubic spline interpolation to create a smooth continuous income distribution function for Wales. HMRC estimates that in 2010-11 there were 89,000 higher rate and 4,000 additional rate taxpayers in Wales. While only representing 7 per cent of all taxpayers, we estimate that the higher and additional rate taxpayers were responsible for approximately 33 per cent of all income tax revenue in Wales. Table D3 summarises the number of income tax payers and tax revenue raised by each marginal rate in 2010-11.

Table D3: Number of income tax payers and revenue raised in Wales (excluding savings and dividend income), 2010-11

<table>
<thead>
<tr>
<th>Marginal rate of taxpayer</th>
<th>Taxpayers</th>
<th>Income tax revenue (£ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic rate – 20p</td>
<td>1,288,000</td>
<td>2,950</td>
</tr>
<tr>
<td>Higher rate – 40p</td>
<td>89,000</td>
<td>1,110</td>
</tr>
<tr>
<td>Additional rate – 50p</td>
<td>4,000</td>
<td>370</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,381,000</strong></td>
<td><strong>4,425</strong></td>
</tr>
</tbody>
</table>

Source: Commission Calculations

Value Added Tax

D.7 Wales’s estimated share of aggregate UK Value Added Tax revenues is based on Wales’s share of UK household expenditure (excluding food and housing) for 2008-2010, taken from the ONS publication Family Spending 2011. This is likely to provide a reasonable estimate. However, it is noted that around 30 per cent of UK VAT revenue comes from the exempt sector which mostly originates from the selling, leasing and letting of commercial land and buildings. As we do not know how much VAT revenue originates from the exempt sector we have not adjusted our estimate to reflect this. However, if we applied Wales’s share of turnover from real estate activities as a proxy for Wales’s share of the VAT revenue from the exempt sector then the estimate for Welsh VAT revenues in 2010-11 would be around £300 million lower at £3.1 billion.

National Insurance Contributions

D.8 There are no official estimates of National Insurance Contributions revenues for Wales. Our estimates are derived from employment and self-employment income distributions published by HMRC (published alongside the income tax estimates). The parameters of the National Insurance Contributions system were applied to those distributions to produce revenue estimates. This result for Wales was scaled using the difference between our estimates for the United Kingdom based on the same methodology and official revenue estimates.

Fuel duty

D.9 Fuel consumption in Wales as a percentage of the UK total was applied to overall UK fuel duty revenues. The fuel consumption statistics were sourced from the Department for Energy and Climate Change.
Corporation tax

D.10 There are various ways to estimate Wales’s share of corporation tax, none of which immediately stands as being a superior method. The method applied in Government Expenditure and Revenue Scotland apportions a share of UK corporation tax revenues based on the economic activity undertaken in Scotland measured by Scotland’s share of profits, less holding gains, of all public and private corporations in the United Kingdom as reported in the ONS Regional Accounts (called gross operating surplus). This measure therefore includes all activity based in a locality rather than being based on the location of the company headquarters.

D.11 An alternative method for estimating the regional shares of UK corporation tax is using the net tax liabilities of companies with a post code in that region. This is the method used for estimating the Northern Ireland share of UK corporation tax revenue in Rebalancing the Northern Ireland Economy. However, this method does not include branches of UK firms based in Northern Ireland. It is recognised that this approach is likely to underestimate the true size of the corporation tax base in a locality.

D.12 On balance we have decided to use the GERS methodology as our central estimate while noting a high degree of uncertainty with this estimate. If we apply the method used for Northern Ireland then the Welsh estimate would be in the region of £940 million for 2010-11.

Alcohol and tobacco excise duties

D.13 Wales’s share of aggregate UK revenues is based on Wales’s share of UK household expenditure on alcohol and tobacco for 2008-2010, taken from the ONS publication Family Spending 2011.

Vehicle excise duty

D.14 The estimate of revenues from Wales is based on the percentage of licensed vehicles in Wales. The vehicle licensing statistics are published by the Department for Transport. The UK vehicle excise duty estimate was taken from Budget 2012 documentation published by HM Treasury.

Stamp Duty Land Tax (SDLT)

D.15 SDLT is one of the few UK-wide taxes where data on Welsh revenues are published by HMRC. In 2010-11 SDLT revenues in Wales were £115 million. As Table 1 shows the revenue raised in 2010-11 is well below the amount raised in 2007-08 as a result of the decline in average house prices and the number of transactions during the UK-wide recession. SDLT is a relatively volatile tax with revenues clearly linked to trends in the economy.

D.16 SDLT revenues in Wales are approximately 2 per cent of the UK total. This is below Wales’s population share and below Wales’s share of the total UK housing stock. In addition, between 1997-98 and 2010-11 (the time series where data are available) SDLT revenues in Wales have grown less quickly than across the United Kingdom as a whole. This is a consequence of slower growth in Welsh property and land prices and fewer transactions as a per cent of the stock of properties in Wales than the average for the England (comparable UK data are not available).

126 The population of Wales is approximately 5 per cent of the total UK population.

127 The housing stock in Wales is approximately 5 per cent of the total UK housing stock.

128 Historically sales in Wales represent between 4-5 per cent of the total housing stock compared to 6 per cent in England.
Based on the available data the tax base in Wales is less buoyant than for the United Kingdom as a whole. If SDLT is devolved to Wales then the value of the grant off-set would need to reflect the relatively weak tax base in Wales and the volatility of the tax.

**Capital gains tax**

Wales’s share of revenues is based on its share of total UK income tax revenues as the ability to purchase and dispose of assets liable for Capital Gains Tax will be highly correlated with income.

**Stamp duty tax on shares**

The estimate of stamp duty revenues from securities and shares are based on the percentage of adults with shares from the ONS Individual Wealth and Assets Survey. The percentage of adults with shares who live in Wales was applied to the aggregate UK revenues published by HMRC.

**Insurance premium tax**

Wales’s share of total UK revenues is based on Wales’s share of UK household expenditure on insurance for 2008-2010, taken from the ONS publication Family Spending 2011.

**Betting and gaming duties**

Wales’s share of aggregate UK revenues is based on Wales’s share of UK household expenditure on gambling for 2008-2010, taken from the ONS publication Family Spending 2011.

**Landfill tax**

The current UK-wide tax return for landfill tax does not identify the geographical location of the taxable activity. Therefore, the HMRC do not publish landfill tax revenues for Wales. While there are estimates of the total waste deposited in landfill sites in Wales this is not disaggregated according to the rates of tax. However, as an approximate estimate we have applied Wales’s share of total waste deposited in landfill sites to the total UK landfill tax revenue. Using this methodology, landfill tax revenues in Wales for 2010-11 are estimated to be in the region of £60 million.

UK landfill tax revenues have been fairly buoyant with revenues almost doubling in the last decade. However, the buoyancy of the tax is a direct result of the increases in the tax rates applied rather than any growth in the taxable base. Indeed, the tax is precisely designed to reduce the taxable base by encouraging alternative methods of waste disposal. Across the United Kingdom as a whole the volume of taxable waste in 2010/11 was less than half the volume recorded in 1997/98.

**Inheritance Tax**

Revenues for Wales are published by HMRC.

**Climate change levy**

Wales’s share of revenues is based on its share of industrial and commercial consumption of electricity and gas, using sub-national energy consumption statistics published by the Department of Energy and Climate Change.
Aggregates levy

D.26 Revenues in Wales are based on its share of aggregates extracted, according to the UK Minerals Yearbook. Based on this methodology, aggregates levy revenues in Wales are estimated to be in the region of £20 million in 2010-11. This represents around 7.5 per cent of total for the United Kingdom as a whole, compared to the Welsh population share of over 5 per cent.

D.27 Across the United Kingdom the tax has been fairly buoyant as a result of increases in the tax rate rather than a growing taxable base. The taxable tonnage for the United Kingdom as a whole in 2010-11 was only 70 per cent of the value in 2002-03. While some of this decline is due to the weakening in demand as a result of weaker economic growth, a longer time series (1980 to present) shows that aggregate excavation has continued to fall across Great Britain and its regions. Another factor important in assessing the likely buoyancy of the tax is the estimated reserves. Current excavation rates for gravel and rock are around 3 per cent of the estimated reserves in Wales. This compares to over 11 per cent for sand and gravel.

Air Passenger Duty

D.28 While HMRC do not publish APD revenues for Wales, the Civil Aviation Authority publish detailed statistics on air passenger movements for all UK airports. By applying the rate of ADP to these air passenger numbers it is possible to estimate APD revenues for Wales. Historically APD has been a relatively buoyant tax with a general increase in estimated revenue. Much of this increase is as a result of the doubling of duty rates in February 2007 though the number of air passengers using Cardiff airport increased steadily until the end of the last decade.

D.29 In 2011, 32,000 passengers travelled from Cardiff airport to long haul destinations on direct flights. Those destinations were principally Egypt and Barbados. In total the APD revenue from those long haul flights was just over £1 million.

D.30 We estimate that Welsh APD revenues have fallen since 2008. This fall is much in line with the general fall in revenues across the UK since 2008. However, Figure D2 shows that Wales’s share of total UK APD revenue has fallen over the last decade. Across the UK as a whole air passenger numbers have increased by just under 22 per cent between 2000 and 2011. In Wales, air passenger numbers have fallen by around 20 per cent over the same period. The amount of APD revenue paid by passengers using airports in Wales represented only 0.4 per cent of the total UK APD revenues.

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129 UK Department for Communities and Local Government, *UK Minerals Yearbook*. 

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Figure D2: Wales’s share of UK APD revenues

Source: Commission Calculations
Annex E: Risks and scenarios

E.1 The devolution of tax powers to the Welsh Government has the potential to expose the Welsh budget to a number of risks that are at present managed at the UK level. The Commission has heard evidence suggesting that, as a consequence of a relatively weaker tax base in Wales, the budget of the Welsh Government would be much reduced if it were dependent on tax revenues raised in Wales.

E.2 It is important to consider these potential risks and the possible implications if these risks were transferred to the Welsh budget. This annex analyses those risks and uses historical data to test whether the budget of the Welsh Government would be reduced if part of this budget became dependent on tax revenues in Wales compared to a wholly block grant funded scenario.

E.3 It should be noted that this annex assumes that the Welsh Government would set the same tax rate as the UK Government. Of course if the Welsh Government set a higher rate its spending would be higher than under the current block grant funded model and if it set a lower rate its spending would be lower.

Potential risks associated with the devolution of taxation powers

E.4 The Holtham Commission identified three main potential risks associated with the devolution of tax powers:

- Macro fiscal or cyclical risk - Some tax receipts are highly cyclical with significant year on year volatility. Our estimates of tax revenues in Wales illustrate that the revenues from many UK-wide taxes can be highly cyclical. We estimate that between 2007-08 and 2009-10 total tax revenues in Wales (of UK-wide taxes) fell by around 11 per cent, or by approximately £1 billion. Of course, during more stable economic times the risk of such volatility is much reduced.

- Differential tax base growth - This is the risk that the tax base in Wales grows differently from the equivalent tax base across the United Kingdom as a whole and therefore over time generates differing levels of resources for the Welsh Government than it would have received from a grant-based regime that is ultimately sourced from the UK tax base.

- Policy risk - If powers over the overall structure of a devolved tax (such as the size of each tax band and allowances in the case of income tax) are retained at the UK level, there is a risk that a policy change by the UK Government could have a large impact on the revenue raised by the devolved tax. A practical example of policy risk stemming from UK Government would be any decision to increase the personal allowance for income tax. Without other changes to the income tax structure this would have an impact on Welsh income tax revenues. Similarly, Welsh policy risk arises if decisions by Welsh Ministers impact on the Welsh tax base and affect the revenue raised by a devolved tax.

E.5 The Holtham Commission concluded that the risks consequent on the actions of the Welsh Government should be borne by its budget and risks consequent on the action of the UK Government should be borne by UK budgets. External risks arising from elsewhere should
be pooled across the Union. We agree with those conclusions. It follows, therefore, that the Welsh budget should not be exposed to cyclical or UK policy risk, as these are not under the control of Welsh Ministers. The extent to which it is appropriate for the devolved budget to be exposed to differential tax base growth risk is not straightforward because the risk may materialise as the result of Welsh policies or it may arise due to actions outside the control of the Welsh Government. However, for the devolution of powers over taxation to operate effectively, it is essential for the Welsh budget to be exposed to the potential impact that differential tax policies may have on the tax base in Wales. It is our view that of the three main risks identified, the Welsh budget should only be exposed to differential tax base risk.

E.6 The extent that risks are transferred to the Welsh budget is dependent on the grant off-set mechanism applied and we discuss this below.

Grant off-set mechanisms

E.7 In the event of the devolution of tax powers the Welsh budget would be dependent on its own tax revenues. To reflect this, at the point of devolution there would need to be an initial deduction from the block grant then subsequent deductions in future years.

E.8 The Holtham Commission discussed four options for making this deduction to the block grant and termed them, own base deduction; indexed deduction; proportionate deduction; and fixed deduction. Further details are available in Chapter 5 and Annexes 7 and 8 of their Final Report, *Fairness and accountability: a new funding settlement for Wales*.

E.9 We have taken further evidence on the grant-off set mechanism and we have considered the detailed analysis from the Holtham Commission. We agree with their recommendations. For income tax we recommend that the indexed deduction grant off-set mechanism should be applied. For smaller taxes such as Stamp Duty Land Tax, aggregates levy, landfill tax and Air Passenger Duty the fixed deduction grant off-set mechanism should be applied.

Indexed deduction

E.10 Under this approach the revenue from devolved taxes would flow directly to the Welsh budget, and the size of the off-setting deduction in the block grant would be calculated annually, based on the growth across the United Kingdom of the taxes devolved to Wales. In the example of income tax, the grant deduction would be based on the growth in UK income tax revenues and the Welsh Government would then receive the revenues from their share of income tax revenues paid in Wales.

E.11 This approach does not transfer cyclical risk because if, for example, there is a UK-wide recession which reduces the flow of tax revenues then the block grant reduction will also be less since UK-wide tax revenues will also have fallen. The other main advantage of this approach is that it does not transfer UK policy risk. If in the case of income tax, for example, the UK Government decided to change the structure of the tax by increasing the personal allowance then this would reduce income tax revenues in Wales but would also reduce the block grant deduction.

Fixed deduction

E.12 For this approach there is a fixed deduction to the block grant that would be made each year. The most obvious value for this deduction is the most recent tax revenues in Wales for the specific tax in question.
E.13 For some taxes it may not be appropriate to use the most recent tax revenue figure for the off-set as some taxes are highly volatile. This is the case for Stamp Duty Land Tax. The fixed deduction would, therefore, need to reflect the likely revenues from the tax in the future. Landfill tax by design has a declining taxable base and the same is true for aggregates levy with greater use of recycled aggregates. Air passenger numbers from airports in Wales have also been falling recently and would need to be considered in the fixed deduction.

**SCENARIO ANALYSIS**

E.14 This section looks at the potential impact of the devolution of tax powers to Wales. For this analysis we have focussed on the risks associated with the devolution of income tax powers. There are good reasons for focussing on income tax. First, income tax raises the most of all UK-wide taxes in Wales so, if devolved, then this tax has the potential to transfer risks to the Welsh budget. SDLT, aggregates levy, landfill tax and APD collectively raised just over £200 million in 2010-11. The risks associated with those taxes are, therefore, much reduced. Secondly, we are recommending that SDLT, aggregates levy, landfill tax and APD for long haul be fully devolved. As a result the Welsh Government could radically reform those taxes. This makes any analysis of likely budgetary scenarios difficult as we do not know what form the new devolved taxes could take. As we are recommending that income tax would be shared, the Welsh Government could not reform income tax in Wales beyond changes to the main rates. As a result we can analyse with greater certainty the likely budgetary scenarios.

E.15 As we have discussed above, the indexed deduction method has a number of advantages in terms of the transfer of risk. As a result the only main risk that remains is differential tax base growth, that is whether the growth in income tax revenues in Wales grow faster or slower than for the rest of the United Kingdom.

E.16 The important point to note is that it is not the actual level of tax revenue that is raised in Wales that would determine whether the budget of the Welsh Government would be more or less than in a wholly block grant funded scenario. The important determinant is the relative growth in tax revenues in Wales compared to the rest of the UK as a whole.

E.17 The other important point to note is that under the indexed deduction method the growth in devolved spending (the block grant) does not determine the relative size of the budget for the Welsh Government in an era of devolved tax powers as compared to a wholly block grant funded scenario. This is an important benefit of this method as it does not transfer what the Holtham Commission called UK policy risk.

**How the system would work**

**Year 1**

E.18 In the event of the devolution of tax powers the Welsh budget would be partly dependent on its own tax revenues. To reflect this, at the point of devolution there would need to be an initial deduction from the block grant. It is important to note here that the deduction to the block grant in the first year would be identical to the tax revenues for the devolved tax in Wales.

E.19 In the first year, the budget of the Welsh Government would be identical to that if it were funded wholly by the block grant.
**Year 2 and beyond**

E.20 In future years the deduction to the block grant will depend on the growth in the tax revenues for the devolved tax across the rest of the UK as a whole while the amount raised from the devolved tax in Wales would then be added to the remaining part of the block grant.

E.21 The approach can be summarised in the following steps:

- **Step 1** – The block grant is calculated in relation to growth in comparable spending in England. At present this is calculated using the Barnett formula.
- **Step 2** – The initial deduction from the block grant is equal to the devolved tax receipts collected in Wales when the tax is devolved. In the case of income tax, this is £2.0 billion which is the current amount that the devolution of income tax along the lines of our recommendations would represent.
- **Step 3** – The block grant deduction changes at the same rate as the change in income tax revenues for the rest of the United Kingdom.
- **Step 4** – Wales keeps the devolved tax revenue each year. This would change each year depending on the change in income tax revenues in Wales.
- **Step 5** – Income tax revenues in Wales are added to the reduced block grant to give overall devolved resources.

**Historical Trends and possible scenarios**

E.22 There are of course a whole range of possible scenarios for the growth in income tax revenues in Wales and the rest of the United Kingdom. The most obvious starting point is to review the most recent trends and analyse the impact if those trends continued in the future.

**Growth in income tax receipts**

E.23 The only factors that will influence the relative size of the Welsh budget compared to the fully block grant funded model is the growth in income tax revenues in Wales compared to the rest of the UK.

E.24 As noted above with any forecasting it is difficult to know how income tax revenues in Wales will grow compared to the rest of the United Kingdom. What we can do though is look at historic trends.

E.25 HMRC produce data on Welsh income tax receipts from 2000-01 with a breakdown of the source of this income. From this we can estimate a time series of income tax revenues excluding saving and dividend income for Wales and the rest of the UK for the period 2000-2010. Due to methodological problems, HMRC has not yet published data for 2008-09. We have not included our estimates for income tax revenue in Wales for 2010-11 as those are based on applying UK-wide forecasts for the economy so would not incorporate any factors that may have resulted in differential growth in income tax revenues in Wales compared to the rest of the United Kingdom.

E.26 Over the period 2000-2010 income tax revenues excluding savings and dividend income have increased on average by 4.1 per cent per annum in Wales compared to 3.8 per cent for the United Kingdom as a whole excluding Wales.\(^\text{130}\)

\(^{130}\text{In practice it makes little difference to the trends if we exclude Wales from the UK to compare growth in Wales to the ‘rest of the UK’ as income tax revenues in Wales account for such a small proportion of total UK income tax revenues.}\)
This relatively high growth in Wales is a result of the favourable labour market conditions seen in Wales over the last decade resulting in the narrowing of the historical gap in the employment rate in Wales compared to the average for the United Kingdom as a whole.\(^{131}\)

If this recent historical trend were to continue in the future then the budget of the Welsh Government would be greater than if fully funded by the block grant. Table E1 sets out a scenario that projects those trends in the future. The final column in the table shows the difference between the budget of a Welsh Government partly dependent on income tax revenues and a budget that is wholly block grant funded. Under this scenario the budget of the Welsh Government would be greater than if fully funded by the block grant by just over £6 million per year which cumulatively would result in an additional £27 million in Year 5.

### Table E1: Illustrative Welsh Funding scenario, projecting historic trends

<table>
<thead>
<tr>
<th>Year</th>
<th>Comparable Expenditure - England</th>
<th>Wales unadjusted block grant</th>
<th>Block grant deduction</th>
<th>Devolved tax revenues</th>
<th>Total Welsh Budget</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>226,740</td>
<td>14,968</td>
<td>3.80%</td>
<td>4.10%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>240,911</td>
<td>15,785</td>
<td>2,000</td>
<td>2,000</td>
<td>15,785</td>
<td>0</td>
</tr>
<tr>
<td>2</td>
<td>255,968</td>
<td>16,654</td>
<td>2,076</td>
<td>2,082</td>
<td>16,660</td>
<td>6</td>
</tr>
<tr>
<td>3</td>
<td>271,966</td>
<td>17,577</td>
<td>2,155</td>
<td>2,167</td>
<td>17,589</td>
<td>12</td>
</tr>
<tr>
<td>4</td>
<td>288,964</td>
<td>18,557</td>
<td>2,237</td>
<td>2,256</td>
<td>18,577</td>
<td>19</td>
</tr>
<tr>
<td>5</td>
<td>307,024</td>
<td>19,599</td>
<td>2,322</td>
<td>2,349</td>
<td>19,626</td>
<td>27</td>
</tr>
</tbody>
</table>

Source: Commission Calculations

(a) Although the growth in devolved spending in Wales does not determine the relative size of the Welsh budget this will of course determine the overall size of the budget for the Welsh Government. Since the early 1990s devolved spending in Wales has increased on average by 6.25 percent per annum. We use this figure by way of example as the precise value does not have any influence on relative impact from the devolution of income tax to Wales. This is not intended to be a forecast.

There are of course a range of alternative scenarios.\(^{132}\) The period 2000-10 includes the impact of the UK-wide recession, a recession that was particularly hard hitting in Wales.\(^{133}\) Including the recession in our analysis may not be representative of the likely future relative growth in income tax revenues in Wales. If we look at a scenario from 2000-07 that does not include the impact of the recession then income tax revenues excluding savings and dividend income have increased by 6.4 per cent in Wales compared to 5.8 per cent for the United Kingdom.

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\(^{131}\) The employment rate in Wales was 67.6 per cent for those aged 16-64 during May to July 2000, this compares to 72.6 per cent for the United Kingdom as a whole. During May to July 2012 the employment rate for those aged 16-64 in Wales was 68.6 per cent compared to 71.2 per cent for the United Kingdom as a whole.

\(^{132}\) We have not based our analysis on published economic forecasts due to the inherent difficulties in accurately forecasting future economic indicators. However, the historic growth in employment in Wales is consistent with long term historic forecasts for Wales. For example, in July 2009 Cambridge Econometrics forecast that employment in Wales would grow by 0.5 per cent per annum compared to growth of 0.4 per cent per annum for the United Kingdom as a whole.

Empowerment and Responsibility

Kingdom as a whole excluding Wales. Under a scenario using those figures the budget of the Welsh Government would be greater than if fully funded by the block grant by nearly £13 million per year which cumulatively would result in an additional £57 million in Year 5.

E.30 The above analysis shows the potential impact if the historical trends continued in Wales. Of course, there is the risk that those positive scenarios do not materialise. If on the other hand we consider the impact of the inverse of the trends shown between 2000-2007, that is income tax revenues grew below the average for the rest of the United Kingdom as a whole by 0.6 percentage points (5.8 per cent in Wales and 6.4 per cent for the United Kingdom excluding Wales) then the budget for the Welsh Government would be nearly £13 million lower per year.

E.31 During our evidence gathering we heard a range of factors that may influence the likelihood of those historical trends continuing. We discuss some of these below.

Demographic Drivers

E.32 We have heard evidence that demographic change in Wales could pose a risk to the relative growth in the income tax revenues in Wales.

E.33 The number of people in Wales that are of non working age (termed dependent age) is higher in Wales than for the United Kingdom as a whole. Based on the population projections published by the ONS the number of people of working age is projected to remain fairly stable in Wales while across the United Kingdom as a whole the number of working age people is projected to increase by around 0.5 per cent per annum.

E.34 If we were to assume that the relative growth in the income tax revenues is in line with the relative growth in the working age population then the risks posed by the relative increase in the dependent population in Wales compared to the United Kingdom as a whole would result in the budget for the Welsh Government being some £13 million lower per year. This scenario is in line with the inverse of the historic trends for 2000-2007 outlined above.

Economic Drivers

E.35 A number of our evidence gathering sessions discussed the potential impact that Wales’s relative high public sector employment could have on future income tax revenues. In Wales 26.2 per cent of all employment is in the public sector. This is the third highest figure across all the devolved countries and English regions. We were made aware of concerns that the current austerity measures will have a greater negative impact in Wales then across the rest of the United Kingdom. In particular, the proposed regional pay for public sector workers would also have greater negative impact in Wales than the rest of the United Kingdom.

E.36 As yet it is unclear what impact the current austerity measures will have on the labour market in Wales. The latest employment figures show that the reduction in public sector employment in Wales over the last year has been less severe than across all other devolved countries and English regions.134 In addition, over the last year total employment in Wales has increased by 0.4 percent which is in line with the average for the United Kingdom as a whole.135

134 There was a 1.5 per cent reduction in public sector employment in Wales between Q1 2011 and Q1 2012. This compares to a reduction of 4.5 per cent across the United Kingdom as a whole.

135 Change on year since April to June 2011.
E.37 It is also unclear what impact any proposals to introduce regional public sector pay could have on income tax revenues in Wales. Any proposals that would result in reductions in pay levels for public sector workers in Wales could have an impact on total income tax revenues. However, the public sector, while relatively large in Wales, is only 26.2 per cent of total employment so any negative impacts could be offset by growth in private sector employment in Wales.

E.38 It is also important to consider the timescales for our recommendations for the devolution of income tax powers to Wales. Chapter 8 shows that it is unlikely that our recommendations for income tax will become operational until 2020. It is only after 2020 that the potential risks from differential tax base growth would be transferred to the Welsh budget. By such a time it is expected that the public sector finances would have stabilised.

CONCLUSION

E.39 In the first year the budget for the Welsh Government would be identical to that if it were fully funded by the block grant.

E.40 In future years the extent that the Welsh budget would be different compared to the current wholly block grant funded scenario depends on the growth in Welsh income tax revenues compared to the comparative growth in UK income tax revenues.

E.41 Recent trends show that the growth in Welsh income tax revenue excluding savings and dividend income has exceeded the growth in UK wide income tax revenues. Providing Welsh income tax revenues carry on growing at a faster rate than across the UK as a whole the budget of the Welsh Government would be higher than if it were wholly dependent on the block grant. Since 2000, on average, this has been the case.

E.42 Whether these recent trends continue is of course unknown and there are always downside risks. In addition, it might be argued that if the fiscal impacts are limited, there is no strong case for change. However, if the Welsh Government becomes partially dependent on tax revenues in Wales then this would provide a greater incentive for the Welsh Government to grow the economy in Wales, and thus to grow the tax base in Wales over time.
Annex F: Cross-Border Analysis

F.1 Some of the evidence we have received discussed the high level of integration between the economy in Wales and England, and the potential for significant economic distortions and relocation of individuals and businesses should taxes in Wales be set at a different rate from those in England. This potential consequence is particularly relevant for income tax. This was one of the main consequences we considered when developing our recommendations. This annex summarises the evidence.

The porous border

F.2 The analysis from the Holtham Commission highlights the porous border between Wales and England. Approximately half of the Welsh population live within 25 miles of the border with England and approximately 10 percent of the English population live within 25 miles of the border. This is in contrast with the border between Scotland and England where only 3.5 percent of the Scottish population live within 25 miles of the border between Scotland and England and only 0.5 percent of the English population live within 25 miles of the border.

F.3 The high level of economic integration can also be illustrated by looking at the commuter flows between Wales and England. It could be argued that for people that live in Wales but work in England (and vice versa) the incentive to move in response to any tax differential is greater than for those that live and work in the same area.

F.4 Table F1 provides a summary of the number of people that commute between local authority areas in Wales and England. It shows that every day around 125,000 people travel between Wales and England for work, a similar population size to Newport in Wales or Cambridge in England. These flows are highest in North East Wales; Flintshire and Wrexham in particular. However, even within these local authority areas the vast majority (69 per cent and 83 per cent respectively) of residents who work do so in Wales. Across Wales as a whole 94 per cent of all working Welsh residents work in Wales.

Table F1: Commuting between Welsh Local Authorities and England, Year ending 30 September 2011

<table>
<thead>
<tr>
<th>Welsh Local Authority</th>
<th>Commute from Welsh LA to England</th>
<th>Commute from England to Welsh LA</th>
<th>Net Commute from Welsh LA to England</th>
<th>Percentage of residents working in Wales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Isle of Anglesey</td>
<td>600**</td>
<td>-</td>
<td>400</td>
<td>97</td>
</tr>
<tr>
<td>Gwynedd</td>
<td>1,000**</td>
<td>-</td>
<td>-</td>
<td>97</td>
</tr>
<tr>
<td>Conwy</td>
<td>1,400**</td>
<td>-</td>
<td>100</td>
<td>96</td>
</tr>
<tr>
<td>Denbighshire</td>
<td>3,400</td>
<td>-</td>
<td>1,800</td>
<td>92</td>
</tr>
<tr>
<td>Flintshire</td>
<td>21,300</td>
<td>8,300*</td>
<td>13,000</td>
<td>69</td>
</tr>
<tr>
<td>Wrexham</td>
<td>13,200</td>
<td>7,900*</td>
<td>5,300</td>
<td>83</td>
</tr>
<tr>
<td>Powys</td>
<td>6,800</td>
<td>4,200**</td>
<td>2,600</td>
<td>88</td>
</tr>
</tbody>
</table>

Persons, rounded (a)
<table>
<thead>
<tr>
<th>Welsh Local Authority</th>
<th>Commute from Welsh LA to England</th>
<th>Commute from England to Welsh LA</th>
<th>Net Commute from Welsh LA to England</th>
<th>Percentage of residents working in Wales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pembrokeshire</td>
<td>700**</td>
<td>-</td>
<td>-500</td>
<td>98</td>
</tr>
<tr>
<td>Carmarthenshire</td>
<td>1,100**</td>
<td>-</td>
<td>-</td>
<td>97</td>
</tr>
<tr>
<td>Swansea</td>
<td>-</td>
<td>-</td>
<td>500</td>
<td>98</td>
</tr>
<tr>
<td>Neath Port Talbot</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>99</td>
</tr>
<tr>
<td>Bridgend</td>
<td>1,200**</td>
<td>-</td>
<td>-</td>
<td>96</td>
</tr>
<tr>
<td>The Vale of Glamorgan</td>
<td>1,300** 4,600**</td>
<td>-</td>
<td>-3,300</td>
<td>97</td>
</tr>
<tr>
<td>Cardiff</td>
<td>3,100** 3,800**</td>
<td>-</td>
<td>-700</td>
<td>97</td>
</tr>
<tr>
<td>Rhondda, Cynon, Taff</td>
<td>2,100**</td>
<td>-</td>
<td>1,800</td>
<td>98</td>
</tr>
<tr>
<td>Merthyr Tydfil</td>
<td>500**</td>
<td>-</td>
<td>-</td>
<td>98</td>
</tr>
<tr>
<td>Caerphilly</td>
<td>1,900**</td>
<td>-</td>
<td>600</td>
<td>97</td>
</tr>
<tr>
<td>Blaenau Gwent</td>
<td>1,000**</td>
<td>-</td>
<td>-600</td>
<td>95</td>
</tr>
<tr>
<td>Torfaen</td>
<td>1,300**</td>
<td>-</td>
<td>900</td>
<td>96</td>
</tr>
<tr>
<td>Monmouthshire</td>
<td>7,700 5,600*</td>
<td>-</td>
<td>2,200</td>
<td>80</td>
</tr>
<tr>
<td>Newport</td>
<td>4,600</td>
<td>-</td>
<td>3,200</td>
<td>94</td>
</tr>
<tr>
<td><strong>Wales</strong></td>
<td><strong>76,700</strong> <strong>47,700</strong></td>
<td><strong>25,900</strong></td>
<td><strong>94</strong></td>
<td>**</td>
</tr>
</tbody>
</table>

(a) Figures may not sum due to rounding.
(-) The data item is disclosive or not sufficiently robust for publication.
(*) The data item is based on between approximately 25 and 40 responses to the survey, and is categorised as being of limited quality. Only estimates based on 40 responses or more are categorised as robust.
(**) The data item is based on between approximately 10 and 25 responses to the survey, and is categorised as being of low quality.

**International evidence of tax-induced migration**

F.5 Wales is not alone in the high level of economic integration between countries or economic areas and indeed between regions within countries. There are many examples of highly decentralised financial arrangements within economic areas that are economically integrated including those in Switzerland and the USA. One of the main areas of international empirical investigation is the extent that differences in tax rates within regions of a single country incentivise individuals and businesses to move.

F.6 The international evidence does not present a clear picture on the extent that differences in tax rates between regions within a country result in a significant migratory response. The very fact that regions within countries like the USA and Switzerland have such differing tax burdens suggests that large behavioural responses do not materialise.
A body of evidence exists for Switzerland where there are wide differences between local tax rates between fairly small local areas. Switzerland’s federal structure gives individual cantons and municipalities relatively far reaching tax-varying competencies. Tax rates and tax allowances are determined by the cantons with the municipalities (smaller areas within the cantons) able to determine the tax thresholds applying to their residents. As a result, there are large differences between the tax burden for residents between very small geographical areas. This is shown in Figure F1. The tax burden is an indicator for taxes on income and wealth at the federal, cantonal and municipal level, the lower the tax paid, the lower the burden and vice versa.

Figure F1 shows the existence of differences in the tax burden between the cantons with a clear East-West split. It is also interesting that within the cantons there are significant differences in the relative tax burden between municipalities.

Figure F1: Personal tax burden, Swiss cantons and municipalities, 2010

Source: Braingroup, Credit Suisse Economic Research, Geostat (Not available in Welsh)

There are 26 cantons in Switzerland. The smallest is Appenzell Innerrhoden with a population of just over 15,000. The Cantons are then divided into municipalities. In 2010 there were 2,596 municipalities.

Individual income tax rates in Switzerland consist of Swiss federal, cantonal and communal taxes. While the maximum rate of federal tax rate is 11.5 per cent; adding the cantonal and municipal taxes, the total tax burden on individuals varies between 22.42 per cent - 42.28 per cent.
Besides the well-known differences in the tax burden, other factors determine the financial attractiveness of a municipality for living and hence the financial incentive to move between areas. Different real estate prices, health insurance premiums, family allowances, commuting costs and other factors in sum lead to significant differences between localities. A comprehensive indicator of the financial attractiveness of a municipality for living is the freely disposable income, which denotes the income that remains available to a household after the deduction of all mandatory charges and fixed costs.

As Figure F2 shows once these factors are taken into account a different picture emerges. It is not necessarily the case that cantons with a relatively high tax burden have lower disposable income. In many of these areas relatively low housing costs and lower costs for public services compensate for the higher tax burden equalising the financial impacts from living in a high tax area. Figure F2 shows that it is not just the tax burden that influences the relative financial attractiveness of a locality. Housing and commuting costs and the charges for public services determine the level of disposable income.

Figure F2: Freely disposable income, Swiss cantons and municipalities, 2011

A number of empirical studies have tried to estimate whether differences in the tax burden between cantons in Switzerland has lead to any migratory responses. The findings are inconclusive. One study concludes that tax burdens have no significant impact on the migration decisions, which instead are primarily determined by housing related factors such

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as house prices and rent levels. However, an alternative study found\textsuperscript{139} that tax rates have an influence on the distribution of high-income earners across cantons.

F.12 Further evidence\textsuperscript{140} from Switzerland shows that younger individuals react more to tax differences than older people and that more educated households react more than less educated ones. This is a general finding from the evidence\textsuperscript{141} on migration where the most mobile individuals and households, irrespective of any tax differentials, tend to be the younger and the more highly educated.

F.13 The USA provides another good case for comparison as there are wide differences in income taxes, property taxes, corporation taxes, sales or excise taxes between the individual states. There are several instances of states with relatively high tax burdens bordering states with relatively low tax burdens. This is highlighted by the difference between the small neighbouring states of Vermont and New Hampshire where the per capita tax burden in Vermont is twice as high as in New Hampshire.\textsuperscript{142} This analysis was published by HM Treasury\textsuperscript{143} with the conclusion that “this suggests that even with a high degree of factor mobility, there is still some freedom for states to vary tax rates relative to their neighbours”.

F.14 Another area of investigation has been the extent that individuals and households migrate to areas with relatively higher levels of public expenditure or in the case for Switzerland discussed above, lower costs for public services. Evidence\textsuperscript{144} from the USA shows that households do tend to migrate to states with higher per pupil expenditure on education. This suggests that households are willing to pay higher tax if they also receive enhanced public services.

F.15 This is also the main finding from Canada. Canada is one of the most decentralised federations in terms of taxation. Analysis\textsuperscript{145} of migration patterns shows that net fiscal differentials between the provinces have not been the major reason for the inter-provincial migration between the provinces. There is little evidence of tax-induced migration, with higher health and education spending found to be the main fiscal factor that influences migration.

F.16 There is, therefore, a wide range of evidence that supports the theory that individuals and households move in response to differing levels of public expenditure and corresponding tax rates. It is not simply the case that a difference in the relative tax burden between areas will result in a migratory response. Of course, taxation funds public services and the evidence shows that individuals value these public services and choose their location decisions based on the trade-off between the tax burden and the valuation that they place on the public services that are provided.


\textsuperscript{142} $3,600 per capita for Vermont compared to $1,500 for New Hampshire, US Census Bureau 2009.

\textsuperscript{143} HM Treasury (2003) The United States as a monetary union, EMU study.


F.17 One important feedback mechanism that may limit the extent of migration is the movement of relative house prices in response to tax changes. The empirical literature\textsuperscript{146} on the extent to which tax variations are capitalised in house prices contains a broad range of possibilities, but “best bet” estimates are that between ten and 35 per cent of the difference in relative tax rates between jurisdictions are offset by house price variations. While the evidence is uncertain, it therefore seems likely that variations in relative house prices will act to reduce any migration response from a change in relative tax rates. The adjustment in house prices may well be sufficient to enable a locality to maintain a different tax burden than its neighbour without experiencing large migratory flows.

**Evidence from the United Kingdom**

F.18 The United Kingdom has a highly centralised tax system meaning that we cannot draw from a wide body of evidence of the impact of differential tax burdens between regions. However, there are wide differences in council tax levels between Wales and England and between local authority areas within Wales. It is possible to draw some conclusions from those differences.

F.19 Historically, comparisons of council tax rates were relatively straightforward as there was a common tax structure across England, Wales and Scotland including common council tax banding (the framework from which the rate of tax is set). It was possible to compare the average Band D council tax rate across jurisdictions to assess relative tax effort. This comparison is no longer possible. An alternative method is to compare the average council tax as a percentage of the average house prices.

F.20 In Wales the average council tax as a percentage of average house prices is higher than in England and Scotland. Part of the explanation for this has been higher increase in council tax in Wales than in England. This is shown in Figure F3. Figure F3 shows that there have been some large differences between the average increase in council tax in Wales and England over the last 15 years.

**Figure F3: Annual average council tax increases, Wales and England**

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure_f3.png}
\caption{Annual average council tax increases, Wales and England}
\end{figure}

Source: Welsh Government and Department for Communities and Local Government

Table F2: Council tax increases 2009-10 to 2012-13, Wales/England border

<table>
<thead>
<tr>
<th>Council Areas – England</th>
<th>£ per annum</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A</td>
</tr>
<tr>
<td>Wirral</td>
<td>21</td>
</tr>
<tr>
<td>Cheshire West and Chester UA</td>
<td>28</td>
</tr>
<tr>
<td>Cheshire East UA</td>
<td>29</td>
</tr>
<tr>
<td>Shropshire UA</td>
<td>19</td>
</tr>
<tr>
<td>Herefordshire UA</td>
<td>27</td>
</tr>
<tr>
<td>Gloucester</td>
<td>23</td>
</tr>
<tr>
<td>South Gloucestershire UA</td>
<td>30</td>
</tr>
<tr>
<td>Bristol UA</td>
<td>25</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Border Areas – Wales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Council tax band</td>
</tr>
<tr>
<td>Denbighshire</td>
</tr>
<tr>
<td>Flintshire</td>
</tr>
<tr>
<td>Wrexham</td>
</tr>
<tr>
<td>Powys</td>
</tr>
<tr>
<td>Monmouthshire</td>
</tr>
</tbody>
</table>

Source: Welsh Government and Department for Communities and Local Government

Of course, there are also quite wide differences in council tax levels within Wales. Many of these differences are between bordering local authority areas and can be significant. The difference between the Band I council tax level between Blaenau Gwent and Caerphilly is £846. Few people in those areas will be paying at Band I, but even at Band D the difference is £353. Similar differences exist between Pembrokeshire and Carmarthenshire (£271 difference at Band D) and Denbighshire and Conwy (£175 difference at Band D) and many other local authority areas within Wales. Figure F4 summarises the levels of Band D council tax by local authority area in Wales.
Figure F4: Average Band D council Tax Levels, 2012-13

SUMMARY

F.23 The economy in Wales is highly integrated with the economy in England and we note the potential that this high level of integration could have on distorting behaviour if personal income tax rates were different in Wales as opposed to England.

F.24 Since the United Kingdom has a highly centralised tax system, we have reviewed the available international evidence as to whether different tax rates between areas have resulted in tax-induced migration.

F.25 The very fact that regions within countries like the USA and Switzerland have such differing tax burdens suggests that large behavioural responses do not materialise.

F.26 Taxation funds public services and the evidence shows that individuals value these public services and choose their location decisions based on the trade-off between the tax burden and the valuation that they place on the public services that are provided.

F.27 There is already a differential in the availability of public services between Wales and England as a result of devolution. At the local level there are also differentials in council tax levels. The recent policy in England to freeze increases in council tax which has not been replicated in Wales has resulted in much smaller increase in relative council tax levels in border areas in England as opposed to Wales. There is no evidence that this has resulted in large tax-induced migratory flows. Within Wales there are also large differences in council tax levels even between bordering local authority areas.

F.28 In conclusion, the evidence we have reviewed does not suggest that modest differences in income tax levels between Wales and England would result in significant cross-border movements.
Annex G: Comparison of our income tax proposals with Calman and Holtham

G.1 In Chapter 5 we outlined our proposals for the devolution of powers over income tax to Wales. We considered the detailed design of the sharing of responsibility for income tax and we believe that our proposals are right for Wales. As discussed in Chapter 5, our recommendations for Wales differ from the devolution of income tax to Scotland outlined in the Scotland Act and from the recommendation from the Holtham Commission in Wales. In this annex we outline the main differences.

THE CALMAN COMMISSION

G.2 The Scotland Act 2012 sets out how powers over income tax are being devolved to Scotland. The design details are mostly based on the recommendations from the Calman Commission. The main exception is the methodology used to make deductions from the block grant. Here, the recommendation from the Holtham Commission has been applied in Scotland, which we have also endorsed for Wales. We therefore do not consider the Calman block grant deduction method any further.

G.3 The following provides a summary of the Calman proposals for the devolution of income tax to Scotland:

(a) Each UK rate of income tax would be reduced by 10p for those defined as Scottish taxpayers;

(b) The Scottish Government would propose a Scottish income tax rate to the Scottish Parliament on the level of Scottish income tax rate. The Scottish income tax rate would apply equally to all of the reduced main UK rates. We refer to this as the Scottish ‘lockstep’;

(c) There are no restrictions on the level that the Scottish income tax rate can be set.

Our Assessment

Devolving 10p of each UK tax rate

G.4 It is clear to us that to improve the financial accountability and empowerment of the Welsh Government and to enhance the incentives to foster economic growth in Wales, a material part of the budget for the Welsh Government should be dependent on tax revenue collected in Wales. Devolving 10p of each band in Wales would yield approximately £2 billion (around 15 per cent of the Welsh budget). We consider this to be a material sum. The devolution of 10p, therefore, satisfies our principles of accountability and economic incentivisation.
The Scottish ‘lockstep’

G.5 We do not think that the Scottish ‘lockstep’ system is appropriate for Wales. We believe that for there to be a real change in the financial accountability and empowerment of the Welsh Government it needs the autonomy to be able to vary each rate of income tax separately. Wales, unlike Scotland, has a large proportion of its population living near its border with England. In the Welsh context, the Scottish ‘lockstep’ does not provide the Welsh Government with sufficient autonomy nor empowerment, and may result in greater economic distortion across the border. As a result the financial accountability of the Welsh Government would not be sufficiently improved under the Scottish ‘lockstep’ mechanism.

Unrestricted ability to set income tax rates

G.6 We believe that the Welsh Government should have the autonomy to set income tax rates without any restrictions in place. As devolved income tax revenues would become an important part of the budget for the Welsh Government, it would need to consider carefully the impact that its setting of income tax rates could have. As a result, there are unlikely to be very wide differences between Welsh and English tax rates. We believe that the ability to set income tax rates in Wales without restriction, best meets our principles of autonomy and empowerment.

THE HOLTHAM COMMISSION

G.7 The Holtham Commission recommended that income tax should be devolved to Wales in order to address what they called the “accountability deficit”.

G.8 The following provides a summary of the Holtham Commission proposals for the devolution of income tax to Wales:

(a) Each UK rate of income tax would be reduced by half for those defined as Welsh taxpayers;
(b) The Welsh Government should be able to vary separately all rates of Welsh income tax;
(c) Each income tax rate in Wales should be allowed to vary by no more than three pence relative to the prevailing rate set by the UK Government.

Our Assessment

Devolution of half of each UK tax rate

G.9 We believe that the Holtham Commission made some valid reasons for devolving half of the income tax base to Wales. We are conscious that devolving half would potentially expose the budget of the Welsh Government to greater risk than devolving 10p of each band. We believe that devolving 10p would represent a material part of the income tax base and therefore sufficiently meet our principle of accountability and would also minimise the potential risk. However, we also recommend that over time and if there were consensus in support, the Welsh Government’s share could increase to half of each rate.

The ability to separately set rates

G.10 We agree with the Holtham Commission and our arguments against the Scottish ‘lockstep’ are outlined above. We believe that the autonomy to separately vary each rate is an essential component of the design of the devolved income tax system in Wales.
Restricted ability to set income tax rates

G.11 We believe autonomy over the setting of income tax rates in Wales is required to empower the Welsh Government as discussed above.

SUMMARY

G.12 Our package of recommendations build on the proposals for Scotland and the recommendations from the Holtham Commission to design a devolved income tax system that best meets our principles and fits the Welsh context. Our recommendations give the Welsh Government sufficient autonomy and economic incentivisation, thus delivering a real increase in empowerment and accountability.
Annex H: Other capital funding options

H.1 In our report we recommend that the Welsh Government should be given new borrowing powers to increase investment and economic growth.

H.2 However we have also received evidence in support of other funding mechanisms to promote increased public and private sector investment in Wales. These other innovative approaches to increasing investment in Wales are discussed in this annex, although these are mainly devolved matters for the Welsh Government. We do not see a need to devolve further powers, but we do recommend in our report that the UK and Welsh Governments should work together closely to promote increased investment in Wales through all possible means.

The Wales Infrastructure Investment Plan

H.3 The Welsh Government published a first iteration of its new plan in the spring of 2012; and a more detailed version is being published in the autumn of 2012 following a consultation process. This is expected to include a number of innovative methods for funding capital projects.

H.4 Around £15 billion public sector investment is expected over the next decade. The plan also encourages investment by the private sector by increasing the clarity of its forward plans for investment and creating arrangements to facilitate appropriate private sector investment. The Welsh Government’s draft budget published in October 2012 sets out further details of its capital plans.

H.5 These investment priorities, which reinforce the Welsh Programme for Government and the Welsh Government’s focus on growth and jobs, are set out below:

- improving transport networks, in particular east-west links in North and South Wales;
- improving telecommunications networks;
- supporting the development of the energy industry in Wales;
- investing in housing;
- delivering more efficient and economical public services;
- improving the quality of the educational estate; and
- developing Enterprise Zones.

The UK National Infrastructure Plan

H.6 The UK Government is promoting increased investment in Wales in schemes in non devolved areas such as rail electrification in South Wales, power station development in Anglesey, the Green Investment Bank and super connected (broadband) city funding for Cardiff. The UK Government is also engaging with the Welsh Government on improvements to the M4 in south east Wales. In addition, the UK Government’s National Infrastructure
Plan published in Autumn 2011 included policies that may directly benefit Wales, while others might be studied by the Welsh Government and adopted by them if they think appropriate, including:

- improved procurement practices with the intention of making the UK a better place to invest, which will potentially benefit Wales;
- reducing the costs of delivery of infrastructure by 15 per cent by the end of 2014-15 plus publishing a UK infrastructure pipeline. The Welsh Government has also published project pipelines in its infrastructure plan;
- a range of measures for improving the planning and consenting regime;
- new sources of finance including increased pension fund investment in infrastructure. The Welsh Government could work closely with the UK Government to ensure Welsh infrastructure benefits from this source of funding;
- use of concessions and tolls/charges to attract private investment;
- leveraging private investment in local infrastructure including through the Growing Places Fund and Regional Growth Fund in England; and
- use of PFI: While the Welsh Government has so far decided to make relatively little use of PFI it is possible that they might be more attracted to a reformed model being considered by the UK Government. This is intended to be less expensive and more transparent in getting a fair deal for the taxpayer.

H.7 The UK Government announced in July 2012 that it is making available innovative new guarantees for major infrastructure projects that have stalled because of lack of available finance; and a new temporary lending programme will provide support to public private partnerships that are struggling to get financing. It announced in September 2012 that it is taking forward the necessary UK legislation; and it announced changes in the planning system in England.

Local authority prudential borrowing

H.8 Welsh local authorities are making increased use of self-financed prudential borrowing to finance increased investment. The Assembly Finance Committee report ‘Borrowing Powers and Innovative Approaches to Capital Funding’ notes that levels of unsupported borrowing have increased from £30 million in 2004-05 to £256 million in 2011-12. In total since 2004-05 there has been almost £1 billion borrowing in Wales. This is additional to the Welsh Government DEL and partially offsets cuts to Welsh capital DEL, although all borrowing has to be accommodated by the UK Government within its overall UK public sector borrowing forecasts.

H.9 The Welsh Government has also launched the Local Authority Borrowing Initiative, which is a scheme where local authorities utilise their prudential borrowing powers in order to fund approximately £170 million of highways improvements with the Welsh Government funding the repayment costs.

Welsh Housing Revenue Account surplus

H.10 The Housing Revenue Account (HRA) is the basis of the system of local authority housing finance. The account is a ring-fenced account containing income and expenditure relating to a local authority’s housing stock. The reform of the Housing Revenue Account in England will mean that Councils will be able to make local decisions on how to manage or improve
their existing stock, pay back debt owed to central Government or, quite possibly, build new homes in the future, or a combination of all of these. It is open to the Welsh Government to undertake a similar reform.

H.11 Some evidence we have received refers to the issue of surpluses in the account in Wales. At present where a local authority has a surplus in its HRA, it must pay this amount to Welsh Ministers. These sums are treated by HM Treasury as AME and are netted off of the Welsh Government’s total AME. Evidence has considered whether this might be a source of Welsh funding and there have been suggestions that Wales has been unfairly treated. However, we note that the Welsh Minister for Housing, Regeneration and Heritage, announced last year that Wales has not been disadvantaged.147

**Not-for-distributable-profit companies**

H.12 There are various not-for-distributable-profit company models that generate investment in transport, schools, hospitals, new homes, and the wider infrastructure projects. In Wales, Glas Cymru operates within this model as a single purpose company formed to own, finance and manage Welsh Water. Any financial surpluses are retained and reinvested. In Scotland, the Scottish Future’s Trust works along those lines, delivering value for money across infrastructure investment in Scotland. A similar proposal has been made for a Build for Wales Company.

H.13 This is a devolved matter for the Welsh Government to consider including the potential impact on the Welsh Government’s budget. If such a company was structured as a private sector company like Welsh Water, its spending would be private sector spending. If it were controlled by the public sector, it would be treated as a public sector company and its spending would be part of the Welsh Government’s budget.

**Prepayments and RDEL to CDEL switching**

H.14 The Scottish Government is funding the second Forth Bridge with Treasury agreement including using prepayments to help smooth capital spending over time. The Welsh Government could similarly seek to use this funding method if it wished.

H.15 The Welsh Government is also able to increase capital spending by switching money from its resource budget to its capital budget.

**Investment in public sector housing**

H.16 One option open to the Welsh Government is to transfer local authority housing stocks to private sector registered social landlords (RSLs). Where receipts are less than the debt, HM Treasury meets the overhanging debt as it does in England. This has already happened (or plans have been approved) in many local authority areas in Wales while in others a majority of tenants voted against the proposed transfer (the transfer of local authority housing to RSLs requires the approval of a majority of tenants).

**City regions**

H.17 The Haywood review of Welsh city regions published in July 2012 included recommendations that the Welsh Government should explore the full range of funding

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147 See the Written Statement from the Welsh Government for further details: http://www.assemblywales.org/bus-home/bus-business-fourth-assembly-written-ministerial-statements/dat20110705-e.pdf?langoption=3&ttl=Welsh%20Housing%20Quality%20Standard%20and%20Housing%20Revenue%20Account%20Subsidy%20(PDF%2C%20169KB)
tools available to support the city region approach in Wales; and should seek a compact with the HM Treasury to obtain borrowing powers to increase total capital expenditure available to it. Our recommendations are therefore consistent with this report. The Haywood review also pointed to the use of EU structural funds as a possible source of increased infrastructure investment in Wales.
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