Response to Holtham Commission's Consultation on Tax and Borrowing Powers for Wales

"As we begin to consider the case for Wales to acquire some powers and responsibility for taxes and borrowing, it is important that everyone who would like to make a contribution to this question is able to bring their views and evidence to the table. I encourage everyone, expert and non-expert alike, to get in touch" (Gerald Holtham, 23 July 2009).

1. I have written extensively about taxation powers for Devolved Administrations, including Heald (1976) which proposed a tax-variation power for Scotland along the lines of what became the Scottish Variable Rate of Income Tax (SVR or 'tartan tax') (Heald and Geaughan 1997). In my evidence to the Calman Commission (Heald 2008), I set out my understanding of why that power has not been used by the Scottish Parliament in the period 1999-2009. That explanation is highly relevant to the Holtham Commission's second-stage report on taxes and borrowing powers, but I will not repeat that discussion here.

2. When considering the policy question of whether there should be additional *taxation* powers for Wales, there are prior questions that must be addressed:

   - Is the funding system to remain *expenditure-based* (sufficient resources will be available to the Welsh Assembly Government so that it can provide an overall level of public services broadly comparable to that elsewhere in the United Kingdom) or will it become *revenue-based* (the resources available to the Welsh Assembly Government will substantially depend on the revenue-generating capacity of Wales)?[1] Funding systems do not necessarily take a pure form, but this distinction is vital. The Barnett-formula system is clearly expenditure-based, though devolved control over the local government financing system does confer some ability to set the overall level of public expenditure in Wales. Over the period 1999-2007, when the Barnett pipeline was gushing large amounts of formula consequentials, the Devolved Administrations in Scotland and Wales reduced the level of local government taxation relative to that in England

   - How important – to Wales, to the other Devolved Administrations, and to the UK Government – is some degree of uniformity in the funding system? The objective circumstances of Wales differ substantially from those of Scotland. However, there may be prestige reasons for Wales to wish to avoid having less fiscal accountability and discretion than Scotland

   - If the Welsh Assembly Government were to gain additional *taxation* powers along the lines proposed for Scotland by the Calman Commission, then:

     - Would the resources available to the Welsh Assembly Government be lower as a result of the *lower per capita tax base* in Wales? This raises the

[1] In relation to Scotland, Hallwood and MacDonald (2009) strongly criticise not just the Barnett formula but also the principle of block-grant funding. Without the Scottish Parliament raising its own revenue, the lack of fiscal autonomy is viewed as responsible for an excessively large public sector. I note, but do not examine, their viewpoint in this submission, but have previously considered the issues in Heald and McLeod (2003).

question of whether there would be tax-base equalisation, for example in relation to a Calman-type devolved income tax

- Would the Welsh Assembly Government carry the *macro-fiscal risk* of its devolved income tax? For example, lower levels of economic activity as a result of an economic recession would temporarily depress the yield of a Calman-type devolved income tax
- Would the Welsh Assembly Government carry the *policy risk* in relation to UK decisions – taken shortly before or even after the beginning of a financial year – that reduced the Welsh yield? For example, there have been proposals to markedly increase the personal allowance and this would have a large effect on the yield of a Calman-type devolved income tax[2]
- What mechanisms would protect the block grant from adjustment by the UK Government in response to upward or downward variation of devolved income tax rates? This sounds like a technical point but is, in fact, a fundamental question about the fiscal architecture of the United Kingdom.

3. This list of prior questions is not tabled in an obstructive spirit. I have long supported greater taxation powers for Devolved Administrations. However the benefits in terms of devolved policy discretion, for example control over total expenditure, will only be achieved if both conceptual and practical issues are addressed at the policy design stage.
4. When considering the policy question of whether there should be borrowing powers for Wales, there are prior questions that must be addressed:
   - If the funding system is expenditure-based, and that includes scoring permissions to borrow as well as expenditure, then borrowing powers do not necessarily lead to increases in total expenditure. Much advocacy of borrowing powers seems to assume that these would permit more expenditure now, without offsetting reductions at a later date.[3] In other words, borrowing is advocated so that more can be spent, rather than to retime the cost of a given level of expenditure. This association with higher expenditure is a legitimate reason for the UK Government to be hostile to unconstrained borrowing by Devolved Administrations. There have been periods when the indebtedness of certain Canadian provinces became a serious problem for the Federal Government
   - Sub-national government borrowing is included in the UK borrowing and net debt figures regarding which the UK Government has EU obligations under the Stability & Growth Pact. Some of the advocacy of borrowing powers, certainly in Scotland, is to allow the Devolved Administration to run its own counter-cyclical policy independent of the UK Government. Public-finance theory suggests that counter-cyclical policy should be the prerogative of the highest level of

[2] The same issue would apply to assignment of VAT revenues. The Pre-Budget Report 2008 temporarily reduced the standard rate of VAT from 17.5% to 15% until 31 December 2009 (Treasury 2008).
[3] Northern Ireland's Reinvestment & Reform Initiative allows a specified amount of borrowing and cumulative borrowing outside the Barnett formula. The political context of this example of 'Barnett plus' should be noted.

government; much of the Scottish controversy is a proxy debate about the benefits and costs of independence

- While the funding system is expenditure-based, and includes the scoring of borrowing, there is limited practical significance in which tier of government within Wales exercises borrowing powers. The fact that the Welsh Assembly Government has none,[4] while local authorities have them, is a good debating point but not of substantive importance at the Wales level
- Borrowing powers are the essential counterpart of significant dependence upon own tax revenues. In terms of access to resources, it would not matter whether the Devolved Administrations borrowed from the Treasury against future allocations if revenue fell short of forecasts or whether they borrowed from the market. However, there might be signalling and political-response differences between these two scenarios
- If the funding system became *revenue-based*, the unpredictability of revenue would greatly enhance the importance of borrowing powers for retiming purposes. If there were a sudden shortfall in forecast revenues, whether for reasons of macro-fiscal risk or policy risk, there would have to be a mechanism to prevent equivalent reductions in expenditure. Such cutbacks would both disrupt programmes and also make the finances of the Devolved Administrations operate in a strongly pro-cyclical manner.

5. Having set out the broad issues, I will now focus on the taxation options for Wales:
   - Whereas the present funding system provides for accountability for expenditure (there is an opportunity cost attached to spending on x versus y), there is insufficient fiscal accountability at the margin. Therefore I favour, certainly in the case of Scotland, the principle accepted by the Calman Commission that there should be a transfer of 'tax points' from the UK Government.[5] The details of design and implementation are so vital to credibility that the Devolved Administrations should not give up the stability and predictability of the Barnett formula (or comparable mechanisms) unless those details are satisfactorily resolved:
   - The design of the fiscal arrangements must address the prior questions identified above. In particular:
     - There must be mechanisms that guarantee, as far as this is possible within a unitary state, that the exercise of devolved taxation powers will not be offset by actions taken by the UK Government
     - There must be a degree of joint decision-making by the Devolved Administrations and the UK Government over tax structure in relation to

[4] When the Welsh Development Agency was abolished and functions brought into the Welsh Assembly Government, its borrowing powers also transferred. My understanding is that, if these were used by the Welsh Assembly Government, then the Treasury would make an offsetting reduction to the Assigned Budget. This is an excellent illustration of how discussion about formal legal powers must take account of the operation of the non-statutory funding system.

[5] The reasons for focusing on income tax are examined in Heald and McLeod (2003).

those taxes (most obviously income tax) whose bases are accessed by both tiers of government. Both the principle and practice of decision-sharing would require a dramatic change in the centralised UK fiscal culture, particularly at the Treasury,[6] with regard to substance, process and timing

- A devolved income tax must involve actual tax payments by actual taxpayers reaching the Devolved Administration, and not be based on statistical estimates, except perhaps as a time-limited interim measure
- In terms of income tax revenues per taxpayer (UK = 100, 2006-07), Wales at 68 is the lowest of 12 UK 'regions'. Only three regions, London (164), South East (125) and East of England (103) have indexes above 100. Scotland is fourth at 86, with Northern Ireland tenth on 78 (HMRC, 2008, Table 3.11).[7] Whereas the Calman Commission rejected tax-base equalisation,[8] an equalisation mechanism would presumably be necessary if Wales and Northern Ireland were included
- If Wales had a Calman-type power, it would be more difficult to use in Wales than in Scotland because (a) the SVR, albeit not used, has prepared the political and administrative ground in Scotland, and (b) the Wales:England border cuts through areas of population and economic activity, not aligning with travel-to-work areas. If an appropriate equalisation system were designed, the lower capita tax base in Wales would not be a barrier to use. An important lesson of the SVR is that the Devolved Administration should be required to move a resolution proposing a particular rate, even if that is identical to the UK rate
- The argument is frequently made that a Devolved Administration without a substantial responsibility for raising its own revenue is lacking in fiscal accountability. There is an irony in that, throughout Great Britain, the tax-raising discretion of local authorities has been curbed by formal measures and by informal pressure. In my view, the argument holds at both levels: the Devolved Administrations should have access to a significant tax base; and local authorities should have substantial discretion over the local government property tax (council tax in Great Britain).

6. Whereas the SVR applies only to the basic rate of income tax (+/– 3p), Calman's Scottish income tax would apply to all rates (+/– 10p). One of the consequences of this difference is that there is no cap on total liability under the Calman proposal, and therefore a stronger incentive at high income levels to change or mis-report residence. Moreover, as a development unconnected with devolution funding, the introduction in 2010-11 of a new 50% rate may make the upward use of the Calman tax more

[6] It would also require a cultural adjustment on the part of politicians and the media.
[7] Three regions (East of England, London and South East) contributed 48% of income tax revenues in 2006-07.
[8] Calman (2009, para 3.206) makes no reference to equalisation of tax bases. Note, however, the issue of whether the deduction from the Scottish Assigned Budget on the establishment of a Calman income tax would be (a) the UK average yield of a 10p rate or (b) the Scottish yield.

difficult.[9] Although the top rates will only apply to a limited number of taxpayers the reputational fears of being portrayed internationally as a high-tax jurisdiction might be a powerful deterrent to upward use. There is a parallel with the way in which the introduction in 1999-2000 of the 10p rate band changed the incidence and yield of the SVR.

7. The Calman Commission (2009, para 3.206, Recommendation 3.2) proposed that the Scottish Parliament should have control of four taxes that are minor in revenue terms. These are stamp duty land tax, aggregates levy, landfill tax and air passenger duty, with combined estimated 2006-07 receipts of £774 million.[10] Within the context of UK devolution funding, I doubt the value of this proposal. The yields might well be unpredictable, and they might distort the location of activity, certainly leading to allegations that this was happening. If there was no tax-base equalisation, the uneven regional distribution of potential revenue would be problematic in terms of access to resources to fund public services.[11] If there was tax-base equalisation, much of the yield would be pooled across the United Kingdom.

8. Attention now turns to borrowing power options for Wales. My view is that decisions about borrowing powers follow naturally from decisions about taxation powers, as explained above. A separate macroeconomic policy for Wales is not a credible option. Borrowing powers would be in relation to the timing of expenditure and revenue, not a means to additional expenditure. If there were a Calman-type devolved income tax, there must be borrowing powers to deal with the unpredictability and cyclicality of yield, though establishing their necessary size will be less easy than it would have seemed before the present recession.

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[9] The marginal rates facing certain bands of high earners will be further increased from 2010-11 by (a) the restriction of personal allowances and (b) proposed changes to tax relief on pension contributions (HMRC 2009). Moreover, taxpayers affected by the 50% rate may have opportunities to transform income into capital gains taxed at 18%.

[10] The data for the stamp duty land tax actually refers to 2007-08, this yield constituting 72% of the estimated yield of the four minor taxes.

[11] A sub-national government might be expected to propose taxes on economic activity which is geographically concentrated in its jurisdiction, particularly if there are economic rents or the taxes are ‘exported’. However, other jurisdictions and the central government might be expected to object. The outcome will depend on multiple factors, such as constitutional and fiscal history, the extent of commitment to territorial equity, and the location of political power.

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