

Commission on Devolution in Wales

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Summary:

- There are many reasons for a subcentral government to have substantial revenues from taxes over whose rate it has some discretion. These reasons include enabling it to alter its spending levels, 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.
- In half the OECD countries for which we have data, tiers of states and local authorities raise more from taxes than from grants. Many of these subcentral OECD taxes are ones where there is some subcentral discretion over the rates.
- In order for the National Assembly for Wales (NAW) to raise a significant proportion of its revenue from taxes over whose rates it could have some discretion, we suggest that it needs a high-yielding income tax. There is also a case for some tax on businesses, such as non-domestic rates. We note that a similar approach to taxes is used in Spain for the Basque and Navarre provinces.
- We would advise against any form of ‘devo max’ in which the NAW might seek to raise taxes that covered all its expenditure. Wales has a lower income per head than the UK, and if it relied on its own taxes, it would have either relative poor services or relatively high tax rates.
- We would advise Wales to press for any system of grants paid by Westminster to replace the rather ad hoc Barnett formula by needs assessment, because Wales has relatively high needs that may not be fully addressed in future owing to the Barnett squeeze.

Introduction

- 1 This evidence is submitted following an invitation sent in November 2011 to Professor King. In his evidence, he is joined by two colleagues who, with him, are working on an ESRC project looking at needs assessment as an alternative to the Barnett formula.
- 2 The evidence begins, as requested, with some comments about accountability. We then consider what can be learned about appropriate tax revenues for the NAW from devolved finance in other OECD countries, and especially Spain. Finally, we consider the continuing need for some grant receipts.

Accountability and taxes

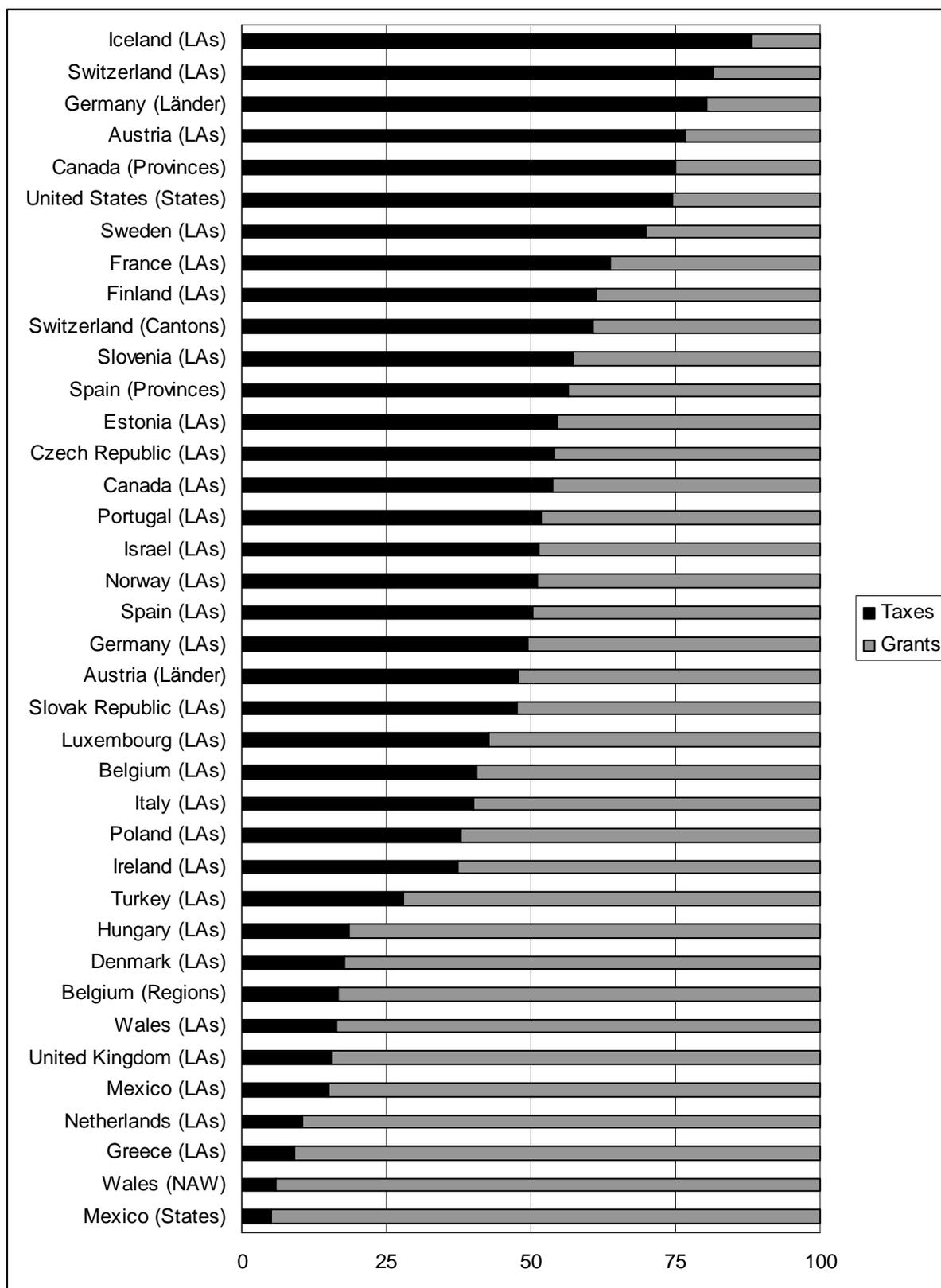
- 3 The UK government sector raises large sums in taxation and must be accountable to voters for its use of these funds. In essence, the sector should attempt to spend the funds efficiently and in line with the preferences of taxpayers. In the case of subcentral or devolved governments, there are several reasons for believing that accountability is best served if the government does not rely too heavily on grants, but instead raises much of its revenue with taxes, preferably ones over whose rates it has some discretion.

- 4 The main reasons for this belief are as follows:
- (a) If a devolved government relies heavily on grants, there may be conflicts between it and the central government which pays the grants. The central government is accountable to its electorate for what happens to their taxes, and national voters may have different preferences from the subcentral government's voters. In the case of the NAW, however, this argument may be weak, because the UK government has, so far, given the devolved administrations considerable freedom over how their funds are spent.
 - (b) If a devolved government relies heavily on grants, it may spend its revenue inefficiently and blame poor services on underfunding.
 - (c) Elected representatives and officials in a devolved government may take less care over funds which are raised centrally and given to them in grants than they take over funds they raise themselves.
 - (d) Unless a devolved government can vary the rates of taxes that raise a large percentage of its revenue, then it will be very hard to change its spending and tax levels in line with the preferences of its own voters.
 - (e) If the grants paid to a devolved government are based on underestimates of its needs, then it requires some taxes whose rates it can vary to secure extra revenue.
 - (f) Grants make it harder for a devolved government's voters to appreciate the full cost of its services, and may encourage them to seek excessive spending levels.

Tax and grant revenues in OECD countries

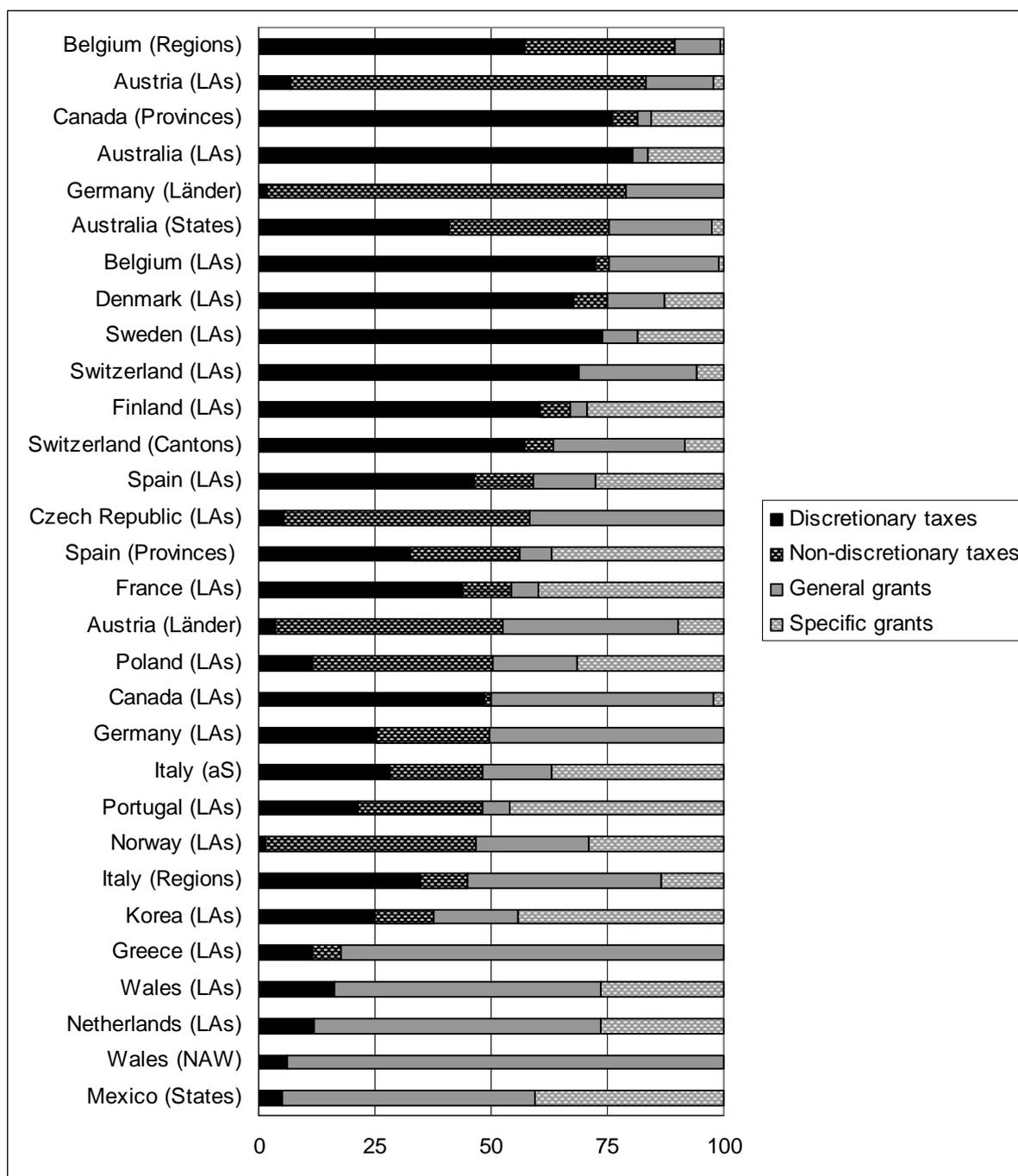
- 5 Compared with subcentral governments elsewhere in the OECD, the UK's devolved administrations have exceptionally low ratios of tax revenues to grant receipts. Figure 1 shows the position in 2009 for the 36 tiers of regional government and local authorities (LAs) in the countries for which the OECD has data. We have added the NAW and Welsh LAs for comparison purposes, and we have taken non-domestic rates to be a tax levied by the NAW. The bars in the figure use solid black for taxes and solid grey for grants. In 19 cases, taxes account for over half the total revenue from grants and taxes, and in the other 19 cases taxes account for under half. The NAW has the lowest reliance on taxes of all tiers except states in Mexico.
- 6 Figure 1 has two limitations: it does not divide taxes into those where the administrations have at least some discretion over the rate and those where they have no discretion; and it does not divide grants into general grants, which may be spent at the recipient's discretion, and specific grants, which must be spent on services specified by the grant payer. The OECD does not collect annual data on this, but a study for 20 countries in 2002 produced the results shown in Figure 2. Again we have added Wales.
- 7 The bars in Figure 2 use solid black only for taxes where there is some subcentral discretion over the rate, which we take to apply to the NAW in respect of non-domestic rates, and they use solid grey only for general grants. It is clear that most tiers raise a significant amount of revenue from taxes over whose rate they have some discretion, and many other tiers have only a modest reliance on grants. Perhaps one point in favour of the NAW's current position is that its reliance on specific grants is very small, and it is this revenue source which confers least freedom on the recipient.

Figure 1: The relative shares of taxes and grants for regional governments and local authorities in 30 OECD countries, 2009, ordered by tax shares.



Source: OECD on-line data.

Figure 2: The percentage of subcentral revenue accounted by discretionary taxes, non-discretionary taxes, general grants and specific grants, for 21 tiers of regional governments and local authorities in OECD countries in 2002, ordered by tax shares.



Source: H Blöchliger and D King, 2006, 'Less than you thought: the fiscal autonomy of sub-central governments', *OECD Economic Studies* 43, 2006:2, and later data for Wales.

Choosing taxes for the National Assembly for Wales

- 8 If it is accepted that the NAW should raise much of its revenue in taxes where it has some discretion over the rate, there arises the question of which tax or taxes it should use. The fiscal federalism literature abounds with criteria for good subcentral taxes, and none is perfect. But there is little doubt that the NAW should have as its main tax a personal income tax. To show this, Table 1 gives estimates of the yields from various taxes in Wales in 2010-11. NAW expenditure in that year was around £15,000m, and the table shows that only a personal income tax could raise even a third of that sum – and to do so, Westminster would have to cede the entire yield of the tax. Westminster is unlikely to cede so much, in order to retain some ability to use this tax for fiscal policy and redistributive purposes, but we support the Holtham Commission’s view that at least half of this tax should be raised by the NAW.

Table 1: Estimated tax revenue raised in Wales in 2007-08, at 2010-11 prices

<i>Tax</i>	<i>Estimated revenue (£m)</i>
Personal income tax	5,600
National insurance contributions	3,985
Value Added Tax	3,877
Corporation Tax	1,615
Council tax	969
Non-domestic rates	862
Alcohol and tobacco excise duties	862
Vehicle excise duty	323
Stamp duty	323
Fuel duty	215
Capital gains tax	108
Betting and gaming duties	108
Inheritance tax	108
Insurance premium tax	108
Landfill tax	43
Climate change levy	43
Aggregates levy	32
Air passenger duty	11
Total	19,191

Source: Holtham Commission.

- 9 There is also strong case for the NAW to levy one or more taxes on businesses, because some of its services directly benefit businesses – for example roads and police. Non-domestic rates are reasonably well suited for this purpose. If the NAW levied about half of the personal income tax along with non-domestic rates, these taxes would fund about a quarter of its spending. We feel this is the minimum that the NAW should press for.
- 10 A tax on business incomes or profits, such as corporation tax, is another possibility, but this would require a formula to allocate between Wales and the rest of the UK the profits of business which operate both in Wales and outside. More seriously, the Treasury might be reluctant to let the NAW set a rate different from that in England. Indeed there is a danger of competitive reductions by the other devolved

administrations and England to secure a greater proportion of business HQs; as a result, the corporate sector might pay much less tax in the UK overall.

- 11 The NAW might also push for a share of some taxes on expenditure. But EU rules would preclude devolving the rate of VAT, and with VAT and the other major indirect taxes, such as alcohol, fuel and tobacco duties, a problem with devolving rates is that any efforts by the NAW to raise revenue by having higher rates might be offset by inducing Welsh consumers to do their shopping in England. However, the NAW could be given some discretion over the tax rate for motor vehicle duties, although it would need to be aware that high rates on commercial vehicles could encourage the owners of fleets of vehicles used in Wales to try and register them in England.
- 12 Table 1 indicated that there are some other low yielding direct taxes, such as landfill tax and council tax, where the NAW could also determine the rate, although we would prefer council tax to remain with local authorities. The NAW might also propose some smaller taxes where it could set the rate, such as a tourism tax and a natural resources tax, as suggested by the Holtham Commission.

Devolution in Spain

- 13 In the work for our ESRC funded project on needs assessment, we have given close attention to Spain. Spain is of special interest because it has a similar type of asymmetric devolution to the UK. As in the UK, the central government provides defence, foreign relations and social security. Devolved and municipal governments provide health and education, transportation, social services and other local services.
- 14 A major difference is that Spanish devolved administrations have much more tax power than those in the UK. Spain actually has two types of financial devolution: the FORAL system, which is used only in two provinces, the Basque country and Navarre, and the COMMON system, which is used in the remaining fifteen provinces. We will comment on the FORAL system, which is most relevant for the UK's devolved administrations.
- 15 In the FORAL provinces, all taxes are collected locally, but some of the revenue is paid to the central government for the services which it provides. The arrangement is that these provinces pay to the central government 6.25% of the total expenditure that it makes on services such as defence that benefit all provinces. This avoids complex calculations about exactly what is spent where.
- 16 Although the FORAL provinces collect all taxes, they do not have fully devolved taxation powers, and the arrangements have a striking similarity to those we have suggested for the NAW. Thus the FORAL provinces have almost complete autonomy over direct taxes such as income tax and property tax, and also inheritance tax. The income tax in these provinces is in fact slightly lower than in the COMMON regions but more progressive.
- 17 There is a particular problem with corporation tax. The agreement between the FORAL regions and the central government says that they should have full autonomy on corporation tax, but it also says that they should not distort the economy. The FORAL provinces would like to vary the rate of corporation tax but have been told by the central government that they cannot, and the dispute is now with the courts.
- 18 In contrast, with taxes on expenditure, such as VAT, these provinces have almost no autonomy, for the reasons mentioned in paragraph 11.

- 19 It should be noted that the FORAL provinces are small highly industrialised areas which are amongst the wealthiest in Spain. Some Spanish commentators argue that they have a privileged position because, among the fifteen COMMON provinces, there is an element of cross-subsidy from the richer ones to the poorer ones, and the FORAL provinces escape making such a subsidy.

Spending needs in Wales

- 20 In considering what lessons might be learned from the FORAL provinces in Spain, it should be remembered that these are relatively wealthy areas. Accordingly, it suits them to have a high degree of fiscal autonomy and avoid any subsidy to poorer areas. In contrast, Wales is not one of the wealthier parts of the UK, and it also has higher per capita spending needs. To maintain services at the levels enjoyed in England, without needing higher tax rates, Wales requires an element of block grant from the UK government. We now turn to this issue.
- 21 Table 2 compares spending per head on the devolved services in Wales with spending per head in England and spending per head in the UK as a whole. Total spending per head in Wales is 14% higher than in England and 10% higher than in the UK. Wales's spending differential is largely the result of the application of the Barnett formula from the historical 'baseline' in 1980. A frequently asked question is the extent to which this spending differential is a 'fair' reflection of Wales's spending needs.

Table 2: Spending per head on devolved functions in Wales, relative to England and UK

<i>Devolved function</i>	<i>Spending in Wales 2009/10 (£ per head)</i>	<i>Index of spending per head in Wales (England = 100)</i>	<i>Index of spending per head in Wales (UK = 100)</i>
General public services	267	221	191
Economic affairs	881	143	130
Environment protection	191	115	110
Housing and community amenities	209	88	81
Health	1,975	105	104
Recreation, culture and religion	209	169	151
Education	1,446	103	102
Total expenditure	5,178	114	110

Source: *Public Expenditure Statistical Analysis*, HM Treasury (2011).

- 22 As part of our current ESRC funded research, we have recently undertaken a comprehensive assessment of Wales's relative spending needs for healthcare. Our analysis exploits the fact that both the NHS in England and the NHS in Scotland use funding formulae to allocate healthcare resources to different areas within their territories (Primary Care Trusts and Health Boards, respectively). Both the English and the Scottish funding formulae aim to allocate resources to different areas so that all areas can provide similar levels of healthcare for populations with similar needs. We applied both formulae to Wales, in order to assess Wales's healthcare spending needs relative to the rest of the UK.
- 23 Both formulae allocated resources according to (a) the age structure of the population, (b) the additional healthcare needs of the population resulting from morbidity and socio-economic deprivation, and (c) the relative costs of healthcare delivery in different areas - for example, delivery costs are higher in some urban areas because of high wage and land costs, and also higher in some sparse rural areas because of diseconomies of scale. However, the two formulae differ appreciably in terms of the specific indicators

they use, and the weights attached to those indicators. Also, the English formula has an extra component (d) which specifically aims to tackle health inequalities between areas.

- 24 Both formulae suggest that Wales has higher per capital spending needs for healthcare than England. The Scottish formula puts the differential at 10% while the English formula puts it at 15%. These differences are much larger than the 5% extra healthcare sending per head in Wales compared with in England noted in Table 2.
- 24 The first report of the Holtham Commission applied some other existing resource allocation formulae to assess Wales's relative spending needs for a variety of devolved services. Compared with England, they suggested that spending needs per head in Wales were 2% higher for schools; 6% higher for further education; 17% higher for higher education, and 32% higher for local government services. Aggregated together with healthcare, these results suggest that Wales's overall spending need per head is around 14% than England's. The Holtham Commission's final report used an alternative regression methodology to estimate Wales's total spending needs for devolved services relative to England, and this methodology also found that Wales spending needs were around 14% higher per head than England's.
- 26 Although Wales undoubtedly has relatively high spending needs, its tax yields relative to its spending needs are lower than in other parts of the UK. In 2010-11, for example, the yield of taxes in Wales covered only 66% of all identifiable public expenditure in Wales. This figure can be compared with 81% for Scotland, even ignoring revenues from North Sea oil and gas, and an equivalent figure for the UK as a whole of 79%.
- 27 While the precise extent of Wales's relative spending needs can no doubt be disputed, we would argue that any moves towards greater fiscal autonomy for Wales, which we support for reasons of accountability, need to be complemented with a reform of the block grant system to ensure that grants are based on spending needs. Otherwise, public services for which the NAW is responsible could deteriorate, because the Barnett formula embodies the Barnett squeeze, which means that it aims to reduce over time the extent to which the devolved administrations enjoy higher spending per head than England.