

**Date:** 10 January 2002  
**Time:** 14:00 to 16:05  
**Venue:** Committee Room 3, National Assembly, Cardiff Bay  
**Title :** FISCAL VARIATIONS AND OPERATING AIDS - ACTIONS TO DATE

**Issue**

1 This paper fulfils the undertaking I gave at the Economic Development Committee of 28 November to set out in more detail the information provided in my progress report to the Committee meeting on 31 October and the Action Plan provided on 28 November (both annexed). The Committee is invited to note the successes so far achieved, the areas that the Assembly Government has decided not to pursue further at present, and those we are still pursuing. I will provide further reports on those matters as they develop.

**Methodology**

2 As noted in paragraphs 3 & 4 of Annex 1, Operating Aids may be tax incentives or assistance provided by other methods. Regionally differentiated tax incentives may be Operating Aids or other types of State Aid.

3 Operating Aid is subject to the EC Guidelines on Regional State Aid, as interpreted by the EC's Competition Directorate (DG Comp). Tax incentives are, with the exception of Business Rates, subject to the approval of the Chancellor of the Exchequer. Thus, either one or two hurdles may have to be passed for any particular proposal.

4 In general, our approach has been to deal with Treasury on the tax matters that fall within its purview since it is necessary to persuade Treasury of the need for and appropriateness of a regionally differentiated tax incentive before there is any point in approaching the Commission about it. Once persuaded, Treasury would be responsible for obtaining any State Aid clearance needed from the Commission. Operating aids that are not tax incentives, or those relating to Business Rates, are the responsibility of the Assembly Government and responsibility for securing that they conform to the State Aid rules rests with us. This may require discussions with DG Comp.

**Treasury Constraints**

5 Members of the Committee may recall the discussion at the meeting of 22 June 2000 with Daniel Storey, an official from Treasury. During that discussion, two main arguments were

deployed against regionally differentiated tax incentives. The first concerned "leakage", the possibility that tax credits might well be collected by firms using addresses of convenience in the Objective 1 area without actually carrying out any additional activity in that area. The second concerned "deadweight", the possibility that a tax incentive might only or largely fund activity that would have taken place anyway. Both possibilities are real dangers to the effectiveness of any tax incentive, raising their costs without securing policy objectives. Both difficulties have to be addressed in any proposal.

## **Competition Directorate constraints**

6 The State Aids guidelines appear to permit Operating Aids in areas benefiting from the derogation in Article 87(3)(a) of the Treaty (Objective 1 areas). The guidelines set out a number of rules, the most important and explicit of which is that any operating aid must be proportional to the problem it seeks to counter. That is, it must be closely targeted on a specific form of economic behaviour, and be clearly able to change that behaviour. A general reduction in business expenses, whether by a regional tax reduction or other means, would not be allowed. The Commission's rationale for this is that such a general measure would be anti-competitive; providing a form of protectionism that the Single Market was explicitly set up to abolish. It also matches concerns about deadweight - if a tax incentive could be captured by firms without changing their behaviour, the costs would greatly outweigh any possible benefits.

7 Not all of the forms of business incentives that we would be interested in bringing in are defined as Operating Aids. There are occasions when the incentives being considered can more easily gain EC approval under another part of the State Aids rules.

## **The needs for incentives in West Wales & the Valleys**

8 The analysis in the Objective 1 Single Programming Document, which has subsequently been confirmed in "A Winning Wales", points to a need to encourage business investment in all its forms: premises; plant and equipment; intellectual property; R&D; and skills, and to encourage enterprise and entrepreneurship. These areas were also identified in the PricewaterhouseCoopers (PWC) report. That report made the important recommendation that tax incentives should not be considered in isolation from other forms of incentives that were within the responsibilities of the Assembly Government. Accordingly, the report recommended changes in our programmes of financial assistance to businesses, as well as suggesting areas in which tax incentives could be effective. The Assembly Government has sought to make progress on both fronts.

### Premises

9 The PWC report identified four types of incentive that could apply to premises:

- Business Rates could be reduced;
- Stamp Duty on land transactions could be reduced or abolished;
- Capital Allowances could be enhanced;
- The WDA could offer reductions in rents or rent free periods on premises they own.

10 Much good progress has been made in this area:

- On 24 October, the Assembly Government enhanced the Rural Rate Relief Scheme.
- Consultation on a Business Rates Relief scheme for SMEs in Wales will be commenced in March 2002.
- From 30 November, 363 Electoral Divisions in Wales, containing 47 per cent of the population, were exempted from Stamp Duty on land transactions below £150,000. In his Pre-Budget Report, the Chancellor undertook to pursue further enhancements of Stamp Duty exemptions in these areas with DG Comp.
- The Chancellor also undertook to pursue the possibility of tax incentives for Urban Regeneration Companies, such as the one that may be set up in Newport in the wake of the Corus job losses. Assembly Government officials are feeding suggestions into this work.

11 Rate relief is largely funded by the non-domestic rates pool. This reduces the amount of redistributable rates that goes back out to all 22 Welsh local authorities. The shortfall is picked up by the Treasury in the form of Revenue Support Grant, so that the overall funding for local government stays the same. However, under the funding rules, the Treasury reserves the right to reduce the Assembly's assigned budget in the event of it introducing policies that would have the effect of reducing rates income (in excess of comparable decisions in England) thereby increasing the demand for cash from the Exchequer. This means that the Assembly, rather than the Treasury, might have to cover the cost of relief.

12 On the other hand, DG Comp will not permit the WDA to provide the kinds of rent relief that PWC proposed. However the Agency can, and does indeed, provide some forms of rent relief/ abatements, but only in line with what is available on the commercial market. For example, the Agency might consider offering a 6 month rent free period on a property if that sort of deal would be available from a commercial landlord.

### Plant, equipment and intellectual property

13 Investments of this type are most often supported by grants and loans, sometimes by investments in the equity of the business concerned. The PWC report urged that we rationalise the way we provide financial support in this area. An Enterprise Support Task and Finish Group was established to consider Enterprise Grant support and I presented the Group's report and the actions the Assembly Government will be taking as a result to the Committee's meeting of 12 December. The new "menu-based" approach, as recommended by PWC, will be

operational from April.

14 In addition to the reorganisation of Assembly Government programmes, Finance Wales have introduced an interest rate relief scheme to run alongside loans provided to appropriate firms from the funds secured for their Objective 1 project.

### Encouraging entrepreneurship

15 Further support to businesses is to be provided through the Community Investment Tax Credit (CITC), which is to be introduced by the UK Government in the next tax year. The intention of this tax credit is to encourage investment and stimulate an entrepreneurial attitude in deprived communities. The details of the scheme are still being worked up. Assembly officials are in consultation with Inland Revenue and DTI on these details. I have set up a Task & Finish Group to look at the possibility of using CITC to stimulate the establishment of an organisation to provide special help to the social economy across Wales. However, the CITC support is not limited to this possibility, but can also encourage support for entrepreneurship in the market economy.

### Research & Development

16 Support for R&D can be provided by way of grant or by a tax incentive. The PWC report suggested that the Assembly Government's SMART Wales programmes be improved and that a regional enhancement to the R&D Tax Credit be pursued.

17 The Enterprise Support Task & Finish Group's report also covered support for R&D. As noted in the paper put to the Committee on 12 December, the SMART Wales programmes that provide grant support to R&D will be redesigned and incorporated with WDA innovation support programmes from April 2003.

18 The R&D Tax Credit that was under discussion in 2000 has been introduced, without, however, any regional differentiation. In the Pre-Budget Report, the Chancellor announced consultation on its enhancement, and this consultation is under way. Treasury's new proposals still include no regional differentiation. The Assembly Government nonetheless continues to pursue this vital area. Following the Pre-Budget Report, I have again written to the Chancellor urging that this possibility be reconsidered and suggesting a way in which the problem of leakage might be avoided.

### Skills

19 The Task & Finish Group's report also covered support for skills development. As noted in the paper put to the Committee on 12 December, ELWa will offer assistance to firms for training, and firms seeking investment assistance will be referred to ELWa in order to ensure

that they have available the skills needed to make the best use of the investment. While ELWa's support will be important, and the explicit link to investment support will, I hope, command the support of the business community, it is clear from our own and UK-wide research that far too little training is undertaken by SMEs, particularly the very smallest of firms. There is therefore a long way to go before we have an environment in which workforce development is a widespread component of business life at all levels.

20 A report from the Performance and Innovation Unit, published at the same time as the Chancellor's Pre-Budget Report, analysed the market for workforce development in considerable detail. The main thrust of the report's recommendations was that workforce development would have to be demand led and required efforts from Government, employers and individuals. In order to stimulate demand from firms in a way that did not require them to use one specific product or another, the possibility of providing tax credits was canvassed. The Chancellor's Pre-Budget Report indicated that more work would be done on this.

21 The Assembly Government greatly welcomes this move. The Minister for Education and Lifelong Learning and I have both written to our UK Government colleagues urging the use of fiscal measures to support training. Our suggested way of avoiding leakage could be used in the training context as well as in relation to R&D.

### **Suggestions that are not being pursued at present**

22 The PWC report also suggested that Employers' National Insurance (NI) contributions could be reduced in order to reduce the costs of employment. Such a measure, even limited to incremental increases in employment, would fall foul of the two problems set out in paragraphs 5 and 6 above. From the Commission's point of view, a general reduction of NI costs in West Wales & the Valleys would clearly go further than would be necessary to counter the specific problems in the area. From Treasury's point of view, the deadweight costs of such a measure would be unacceptably high since a very large number of new jobs is created every year without the incentive. Following initial exploration with Treasury, it is unlikely that we will make progress with this proposal.

23 A tax incentive to encourage telecommunications firms to provide broadband ICT infrastructure in sparsely populated parts of West Wales & the Valleys has also been considered. Treasury view the market for this type of infrastructure as too immature to know whether there is market failure. While we have a strong view that many sparsely populated areas could miss out in the provision of broadband infrastructure, at present there is no hard evidence from our discussions with the industry to contradict Treasury's view. We will continue to monitor this market and may return to the issue if there is any change in circumstances.

24 In the meantime, the Assembly Government's policy is to establish a coherent Action Plan to address supply and demand side measures. WDA are preparing this Action Plan which we

expect later this month. A key part of this is to concentrate on creating greater incentives for infrastructure development by aggregating public sector demand and targeting public sector spend. Aggregating the collective spend of the public sector (schools, libraries, health centres etc) for an area should make it more viable for suppliers to deliver high capacity services which are then available to other users. The Plan will also consider appropriate use of subsidies to help stimulate both the demand and supply sides of broadband roll-out in Wales

## Summary

25 The Operating Aids or Fiscal Variations that have been agreed or implemented so far are:

- Enhancement of the Rural Rate Relief Scheme;
- Stamp Duty exemptions up to £150,000 implemented in many areas of Wales;
- Assembly Government programmes of financial support to business to be reorganised from April 2002;
- Finance Wales Interest Rate Relief Scheme to run alongside Objective 1 loan fund;
- ELWa to provide assistance for training in firms from April 2002.

Schemes already agreed but still under development are:

- Community Investment Tax Credit agreed for next tax year;
- SMART Wales programmes to be enhanced from April 2003.

Measures not yet agreed, but which the Assembly Government or the UK Government are actively pursuing, are:

- Scheme for reduced Business Rates for SMEs in Wales – consultation to commence in March 2002;
- Enhancement of Stamp Duty exemption to cover all business premises in the designated deprived areas;
- Urban Regeneration Companies;
- Regional enhancement of R&D Tax Credit;
- Regionally based Tax Credit for training in firms.

Measures not being pursued at present are:

- WDA rent reliefs;
- NI reductions for additional employees;
- Tax incentive to stimulate broadband infrastructure.

26 I will provide the Committee with details of the schemes still being developed when these are finalised. I will also report further on measures that are still being pursued.

**Annex 1 (extract from Economic Development Minister's report to the meeting of 31 October)**

**FISCAL VARIATIONS**

**Issue**

1 This paper fulfils the undertaking the First Minister gave at the last Economic Development Committee meeting to provide an update on action to pursue Fiscal Variations, which was discussed at the meeting of 27 June 2001.

2 The Committee is invited to note progress.

**Background**

3 Fiscal variations are variations in taxes, duties or other government levies which may be applied at different rates to business in different parts of the country. These will usually be considered to be a State Aid, and hence be subject to State Aid rules, but are not necessarily operating aids. For example, support for training counts as a training aid; capital allowances on buildings would count as an investment aid. Each type of aid is subject to its own (and different) State Aid rules.

4 Operating Aids are aids which assist a business by helping with 'general' running costs. Like any aid, they are subject to State Aid rules which specify where and in what circumstances and at what levels they are permitted. They can be provided via fiscal variations - but equally in other forms such as rent-free periods, wage or interest rate subsidies, or cash grants.

5 The PricewaterhouseCoopers (PWC) report, which was presented by Glen Massey at the meeting, contained a number of recommendations on regional tax incentives for us to pursue with Treasury.

6 Officials have, and are still, pursuing a number of different aspects of the recommendations. This paper summarises the main points of action undertaken since the discussion in June and what further actions are planned.

## **Summary of action so far**

7 Several meetings have been held with Treasury; these covered a wide range of possibilities including a discussion on Environmental Taxes and tax incentives for broadband communications. The First Minister has also written to the UK Government making suggestions for tax incentives in the context of the forthcoming pre-Budget Report.

8 The WDA report that they have sought to persuade the European Commission's Competition Directorate that they should be permitted to make more use of their powers to assist firms in their property deals, and particularly to provide rent-free or reduced rent periods, as recommended in the PWC report. The Commission have been absolutely opposed to this.

9 Good progress has been made with rationalising the schemes of business support grants. An Action Plan is being worked up and will be presented to the Committee shortly.

## **Future action**

10 Treasury have now passed responsibility for developing the Community Investment Tax Credit to DTI and a meeting has been scheduled for next month with DTI on that subject. Further meetings will be held with Treasury following the pre-Budget Report, covering Training, Urban Regeneration Companies, Stamp Duty Exemptions, Capital Allowances and Research & Development.

## **Economic Policy Division October 2001**

## **Annex 2 : (extract from Economic Development Minister's report to the meeting of 28 November)**

### **FISCAL VARIATIONS AND OPERATING AIDS**

#### **Issue**

1 This note fulfils the undertakings I gave at the Committee meeting of 31 October to provide an update on action to pursue Fiscal Variations and Operating Aids.

2 PricewaterhouseCoopers (PWC) gave a presentation of their report at the Committee's meeting of 21 June 2001 – a copy is attached.

3 Since then, an Action Plan has been developed to pursue the measures recommended by PWC – a copy, current up to mid-November, is attached.

4 The thrust of the PWC report was that fiscal incentives should be considered as part of an overall business support strategy, and offered in economic opportunity areas. A number of meetings have been held with Treasury on various fiscal aspects, while others within the powers of the National Assembly have been pursued separately.

5 Further actions may be needed following the Chancellor's Pre-Budget Report on 27 November. I shall provide a further update on this at the meeting on 28 November.

6 The Committee is invited to note progress.

**Rhodri Morgan**  
**First Minister**  
**November 2001**

### **PriceWaterHouseCoopers Report**

This is provided as a separate document, given its large size.

### **FISCAL VARIATIONS – ACTION PLAN** **National Assembly Programmes**

(Page numbers refer to the PricewaterhouseCoopers report)

<b>Recommendation</b>	<b>Actions</b>	<b>Result or Target</b>
1 RSA: fast track process (p35).	Introduce for grants up to £250,000.	Introduced for grants up to £25,000.
2 RSA: soften additionality criterion for indigenous SMEs and knowledge-based firms (grants up to £250K)(p36-37).	Consider implications of obtaining value for money in different ways.	Adopted in suitable cases.
3 RSA: introduce Job Grant as basis for calculating NGE limits in suitable cases (p38).	Negotiations complete	Introduced July 2001.

<p>4 SMART WALES</p> <p>Increase value and number of awards (p38).</p>	<p>A Working Group involving National Assembly and WDA to consider making changes.</p>	<p>Changes to be worked up during 2002-03, subject to European Commission approval.</p>
<p>Remove competition element (p39).</p>		
<p>Shorten appraisal timescale (p39).</p>		
<p>Increase publicity (p39).</p>		
<p>5 RSA: raise cost per job limits for high value projects (high average salaries of value added per employee)(p37) .</p>	<p>Considered.</p>	<p>Adopted in suitable cases.</p>
<p><b>Recommendation</b></p>	<p><b>Actions</b></p>	<p><b>Result or Target</b></p>
<p>6 New SME scheme: replace plethora of small existing schemes, including those run by local authorities (p40-41) and introduce de minimus menu system of Investment aid; start-up aid; R&amp;D assistance;</p> <p>payroll incentives; and link all other de minimus aid to menu.</p>	<p>Enterprise Support Task &amp; Finish Group established in May 2001.</p>	<p>Group has reported. Details to be announced in December.</p>
<p>7 Training Grant: establish company investment training fund focusing on bespoke training for knowledge-based companies (p42-43).</p>	<p>Enterprise Support Task &amp; Finish Group established in May 2001.</p>	<p>Group has reported. Details to be announced in December.</p>
<p>8 WDA property powers: employ more actively and extend to include rent-free periods (p44).</p>	<p>WDA views sought.</p>	<p>Operating Aid – unlikely to make progress.</p>
<p>9 Overall strategy.</p>	<p>Covered in A Winning Wales.</p>	<p>Draft circulated October 2001</p>
<p>10 Interest Rate Relief Scheme.</p>	<p>To run alongside Finance Wales Objective 1 loans.</p>	<p>To be commenced in December 2001.</p>
<p>11 Support for lone parents starting businesses.</p>		<p>Being considered by WDA as part of Entrepreneurship Action Plan</p>

Recommendation	Actions	Result or Target
<b>Tax Incentives</b>		
12 National Insurance credit.	Meetings held with Treasury.	Raised with Treasury. Pre-
		Budget Report to be
13 Capital allowance.		monitored for progress on
		all these items
14 Business Start-up support		
through Community Investment		
Tax Credit.		
15 Training.		
16 Broadband incentives.		
17 URCs and Environmental taxes.		
18 R&D tax credit.		
19 Business Rates	Scope of Rural Rate Relief	24 October 2001
	Scheme extended.	
		Timing not yet agreed
	Within context of general	
	business rates reform, consult	
	further on details of Rate	
	Relief Scheme for small	
	businesses in Wales (primary	
	legislation needed).	