Inquiry into the implementation of the Wales Act 2014 and operation of the Fiscal Framework
Professor Gerry Holtham
Additional Information following Professor Holtham's attendance on 9 November 2020

Block Grant Adjustment (BGA)

When taxes are devolved the block grant must be adjusted (reduced) to allow for the new revenue available to the devolved government and the equivalent loss of revenue to the UK Treasury. In the first year of devolution it suffices to deduct from the block grant the actual or projected revenue from the tax in question. That procedure cannot be followed in subsequent years, however.   It would negate much of the point of devolution if the block grant altered to offset every change in tax revenue in the devolved jurisdiction. On the other hand the BGA cannot remain unchanged because, with economic growth and inflation, tax revenues would grow and the BGA would not reflect the value of the devolved tax base.

An ideal system would adjust the BGA for changes outside the control of the devolved government but leave it unaffected by actions of that government. The consequences of policy changes would then be borne by the devolved country but it would not penalised for things beyond its control.

It is hard to achieve that ideal. In practice, the BGA for income tax devolution in Wales is indexed to so as to change over time, reflecting what happens to comparable revenues in England and Northern Ireland (ENI). Since income tax is fully devolved in Scotland it is excluded from the comparison.   That means, the Welsh government retains the revenue effect of tax changes it makes and is not penalised for events that befall the UK as a whole. It does, however, take on the risk of events affecting Wales disproportionately, which could thereby affect its revenues disproportionately.

The simplest method and the one adopted for the first few years of tax devolution in Scotland would be to change the BGA by population growth in the devolved country plus the percentage changes in revenue per head in ENI.   Adjusting for population is appropriate because different rates of population growth clearly can affect revenues and are not under the immediate control of government. That "proportionate" method was not adopted for Wales.   Instead a method known as the Comparable Model was adopted.. This operates, as it should, separately on each income tax band – the basic, higher and additional rates – as follows.

First the cash change over the previous year in the equivalent ENI revenue is taken. This is then adjusted by a comparability factor, which reflects the level of the tax revenue per person in Wales as a proportion of revenue per person in ENI at the time of devolution. This adjusts for initial tax capacity in Wales; since tax receipts per head will be lower in Wales the adjustment scales down the BGA. The resultant sum is then multiplied by Wales population ratio to ENI. This cash sum is then added to the BGA.

If the Welsh population and tax revenues per head both grew at the same rate as in ENI this adjustment would come to the same thing as the proportionate adjustment. If Welsh revenue per head grew more slowly than in ENI, devolved tax receipts would grow more slowly than the block grant deduction so total revenue would be lower than it would have been without devolution of taxes. That is true for either method of determining BGA.

One drawback of this formulation from a Welsh viewpoint is that the tax capacity adjustment is a one-off. If economic growth in Wales trails that in ENI, tax revenue will grow more slowly relative to population and relative tax capacity will decline but the BGA ignores that and continues to use the historic tax capacity at the time of initial devolution. If ENI and Welsh growth rates differed by one per cent a year, the BGA could be about 5 per cent higher after 20 years than it would be if the tax

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capacity adjustment were updated. Nevertheless, the Comparable Model is not worse than the proportionate adjustment in the face of different rates of per capita revenue growth.

More seriously, the Comparable Model exposes the Welsh government to population risk. Even if revenue growth per head is the same in Wales and ENI the Comparable Model will lead to the BGA deduction growing if Welsh population growth falls short of that in ENI – which is not true of the proportionate adjustment. This is clearly a basic fault in the system since population growth is not primarily the result of government policy. The effect occurs because the deduction operates on the total revenue increase in ENI, the sum of revenue increases per head and population increase. This sum is adjusted for the relative size of populations but that does not remove the effect of population growth in ENI.

Quantitatively, the effect may not be enormous. If population growth in ENI were 0.5 per cent a year while in Wales it ran at 0.25 per cent, the BGA could be about 2 per cent higher after ten years. No doubt for that reason the Welsh government accepted this flawed formula in exchange for an expenditure factor of 105 per cent applied to the Barnett consequential while Wales was above the 115 per cent floor.

It nevertheless leaves hanging the question of why the UK government pressed for this flawed formula. It will mean that the BGA will probably exceed devolved tax revenues in future and will surely do so unless the growth in per person revenues in Wales rises above the ENI rate.