The Welsh Government's response to the call for evidence by the Commission on Devolution in Wales

Summary

Approach

- Financial reform is an important priority for the Welsh Government. We strongly believe that this issue requires a comprehensive approach that addresses not just tax devolution and borrowing powers, but also includes a new and fairer method for determining the Welsh block grant. We see the work of the Silk Commission, and our ongoing talks with the UK Government about a funding floor and access to existing borrowing powers, as being inextricably linked. If progress can be achieved on these lines, we feel this would add to public confidence in the process and would be a good outcome for devolution.

- The submission is based on the assumption that consideration of tax devolution is part of a wider package of measures that includes, at least initially, a funding floor and also borrowing powers. If that were not to be the case, the Welsh Government's approach to tax devolution would change.

Tax devolution

- In general, the Welsh Government is open-minded on the case for tax devolution. The case for or against devolution of any specific tax is highly dependent on the precise details of any proposal; in particular the interaction of devolved tax revenue with the block grant would be of great importance in determining whether devolution was of benefit to Wales.

- In the Welsh Government's view, 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 Welsh Government has not sought devolution of powers to vary income tax rates. We believe that, given the Scottish precedent in 1997, and the fact that the Welsh referendum in 2011 was expressly stated not to be relevant to taxation issues, there would need to be another referendum before such powers could be transferred to Wales. We are also mindful of the need to ensure that any proposals on income tax must take account of Welsh socio-economic circumstances. That said, we are not ruling out income tax as a potential source of revenue for Wales over the longer term and we will consider proposals from the Commission on this issue as on all others.

Borrowing powers

- We believe that the Welsh Government should be able to borrow to fund capital investment, irrespective of whether or not significant tax devolution takes place. The Welsh Government already has borrowing powers in law, but at present Treasury rules prevent us from exercising these powers in a way that would benefit Welsh citizens.

- At present, the Welsh Government's capital budget is set in a way that is driven by capital spending needs in England and Welsh Ministers lack the ability to smooth the costs of large capital projects over time. Access to borrowing powers would provide an important additional flexibility to the Welsh Government to manage its capital spending and implementing a prudent additional investment programme in a way that better meets the needs of Wales.

- In the event of significant tax devolution, the resulting budgetary volatility might well require further borrowing powers that could be used to finance recurrent spending as well as capital investment.

Introduction

1. The Welsh Government's total Departmental Expenditure Limit in 2011-12 is £14.6 billion, of which a little under 10 per cent or £1.3 billion is for capital expenditure. If the Holtham Commission recommendations for tax devolution were implemented in full, around a sixth of the block grant would be replaced by revenue receipts. This would still leave over £12 billion of spending on public services in Wales funded via the block grant mechanism.

2. Financial reform is an important priority for the Welsh Government. We strongly believe that this issue requires a comprehensive approach that addresses not just tax devolution and borrowing powers, but also includes a new and fairer method for determining the Welsh block grant.

3. We recognise that the current funding arrangements - whereby tax receipts are pooled at the UK level and the Welsh Government is almost wholly reliant on a block grant drawn from that pool - is very unusual in an international context. Furthermore, in principle there is a good case for believing that a more direct link between Welsh tax receipts and the funding of the Welsh Government could strengthen democratic engagement. However, it is also the case that the method used to determine the block grant is seriously flawed, since it has an inbuilt tendency over time to drive Welsh relative spending per head ever-closer to the all-England average, with no account taken of Welsh needs. We believe that the Welsh Government is already significantly under-funded, having regard to those needs; and any move towards significant tax devolution would bring with it additional risks to the Welsh Government's budget.

4. Specifically, tax devolution may impose the following budgetary risks:

   i) **volatility:** tax receipts are likely to be more variable and less predictable than block grant funds, which are drawn from a UK-wide pooling of tax receipts;

   ii) **cyclicality:** many taxes are strongly tied to the economic cycle, resulting in a sharp downturn in receipts at times of economic stress, when the pressure on other aspects of the Welsh budget is likely to be particularly acute;

iii) **policy risk:** if a tax base is shared between the Welsh and UK Governments, policy decisions at the UK level may result in large and sudden changes in Welsh tax receipts;

iv) **differential tax base growth:** if over time a tax grows less rapidly in Wales than in the rest of the UK, then devolution of that tax will tend to impose a financial penalty on the devolved budget.

5. In considering the feasibility of devolving a tax to Wales, the Holtham Commission[1] usefully set out the criteria which they considered should be used:
   - accountability;
   - economic efficiency;
   - administrative efficiency;
   - policy relevance;
   - legal constraints; and
   - the impact on the UK tax base.

   We believe that those criteria would also be very useful for the Commission's deliberations.

6. Those risks do not necessarily make tax devolution unworkable; the Holtham Commission provided useful analysis of how they could be managed. Nonetheless, it is clear that tax devolution would result in additional risks to Wales. We believe it would be wrong to accept those risks without agreement to put the block grant on a fairer and more sustainable basis.

7. Moreover, we believe that failure to ensure the stability of the block grant would undermine a key goal of tax devolution, which is to strengthen the accountability of the devolved institutions to Welsh citizens. A devolved power is only meaningful if it could be exercised in practice, and it would become ever-harder to lower tax rates - if that was what Ministers and citizens wished to do - in a world where the block grant was declining remorselessly in relative terms.

8. The Welsh Government is currently in discussion with the UK Government about the case for introducing a funding floor for Wales and enabling Welsh Ministers to exercise their existing borrowing powers to assist in their infrastructure investment plan. The outcome of those discussions will determine whether or not a comprehensive set of financial reforms can be developed. It is likely that we will have a clearer idea of the outcome of the inter-governmental talks in the spring.

9. This submission is therefore conditional; it assumes that tax devolution is part of a wider package of measures that includes at least a funding floor and also borrowing powers. If that were not to be the case, the Welsh Government's approach to tax devolution would change.

10. The submission focuses on the Commission's three core questions posed in the call for evidence and addresses each in turn. The Welsh Government would be happy to provide further evidence, and to respond in detail to the Commission's supplementary

[1] 'Fairness and accountability: a new funding settlement for Wales' (page 45), Independent Commission on Fairness and Funding for Wales.

questions, once the UK Government's approach to the issues being considered in the intergovernmental talks has become clearer.

Response to the Commission's core questions

I. *What, if any, tax powers including new possible new taxes and levies should be transferred to Wales?*

11. In certain areas, Wales already has significant powers over tax. The Welsh Government plays an important role in council tax, which is levied by Welsh local authorities. In addition, non-domestic rates are pooled at the all-Wales level and Welsh Ministers have powers to determine levels of business rate relief.I n aggregate, these two taxes raise over £2 billion in Wales.

12. Many taxes that are currently levied at a UK level are not suitable candidates for devolution to Wales for a variety of reasons: administrative complexity, legal barriers, likely economic distortion and/or risks to the integrity of the tax base of the UK. The Holtham Commission conducted a thorough review of existing UK taxes and considered whether or not each was suitable for devolution. In broad terms, the Welsh Government believes that the Holtham Commission did a good job in identifying taxes that could potentially be devolved, but we will of course give serious consideration to any alternative proposals from the Silk Commission.

13. Of the taxes identified by Holtham as potentially suitable for devolution, the case for or against devolution in any particular case is highly dependent on the precise details of any proposal; in particular the interaction of devolved tax revenue with the block grant would be of great importance in determining whether devolution was of benefit to Wales. We would encourage the Commission to build on the work of the Holtham Commission on this matter, so that individual proposals for tax devolution can be assessed with a good understanding of the likely budgetary consequences.

14. In the Welsh Government's view, 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.

15. Where taxes could be used as policy levers, there is a case for consistent treatment of the devolved administrations. For instance, we note that the UK Government has announced its intention to devolve air passenger duty to the Northern Ireland Executive and we favour the devolution of that tax to Wales as part of a package of reforms.

16. The Welsh Government would support proposals to allow the introduction of new taxes in Wales that would help deliver the policy aims of Welsh Ministers, but as is the case with existing taxes the details of any proposal would be crucial in determining whether or not this power would be of benefit to the people of Wales. In particular, it would be essential to ensure that any revenue raised through additional tax effort by Welsh citizens or businesses resulted in additional resources being

retained in Wales. It would not be acceptable for the revenue from a new tax levied in Wales to be 'netted off' the overall budget.

17. 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 tied to the economic cycle. There would therefore be significant budgetary risks to Wales that would need to be mitigated in any proposal for devolution. If corporation tax were to be devolved to Wales and other devolved administrations there would also be a clear risk of a 'race to the bottom' in tax rates, resulting in reduced revenue but with little net impact on the location of business activity. In addition, there would be significant legal and administrative challenges to be addressed before any proposal could be implemented. We believe that any scheme to devolve corporation tax would have to address each of these issues. We are aware that the UK Government and the Northern Ireland Executive are currently considering devolving corporation tax to Northern Ireland. If that were to happen we would expect Wales to be made an equivalent offer, but the Welsh Government's view on its appropriateness would be dependent on the details of the proposal.

18. Income tax is primarily, though not exclusively, a means of raising revenue as opposed to being a lever to achieve a specific policy goal. The value of income tax receipts in Wales - around £5 billion or so - means that devolution of this tax would have substantial risks and challenges. The Welsh Government has not sought devolution of powers to vary income tax rates. We believe that, given the Scottish precedent in 1997, and the fact that the Welsh referendum in 2011 was expressly stated not to be relevant to taxation issues, there would need to be another referendum before such powers could be transferred to Wales. We are also mindful of the need to ensure that any proposals on income tax must take account of Welsh socio-economic circumstances, particularly the integrated nature of the Welsh and English economies. That said, we are not ruling out income tax as a potential source of revenue for Wales over the longer term and we will consider proposals from the Commission on this issue as on all others. The First Minister's speech to the Institute of Welsh Politics on 14 November 2011 discussed one way in which income tax might over time come to play a part in the financing of devolved government in Wales in a way that leaves the final decision on rate-varying powers with the people of Wales.

19. In general, we do not see a strong case for tax assignment (i.e. allocating revenues from a particular tax to Wales, but without devolving rate-varying powers over that tax). Under the current funding regime, most tax receipts are pooled at the UK level and as a consequence the Welsh budget is insulated from region-specific revenue shocks. Over the longer term, UK-wide pooling of tax receipts also ensures that the benefits of economic growth in the UK's most affluent regions are shared by all. While tax assignment may have merit as a staging post to full devolution in certain circumstances, assignment without rate-varying powers seems unattractive as a goal in itself; it is likely to reduce risk pooling and increase the volatility of the Welsh budget but without the compensating benefits of strengthened devolved policy levers or enhanced accountability. However, if the Commission develops proposals for tax assignment that limit these disadvantages, we would of course be willing to consider them.

II. What, if any, borrowing powers should be transferred to Wales?

20. The Welsh Government already has certain borrowing powers in law that are drawn from the Welsh Development Agency Act (1975) - see the Annex to this submission for a summary of those powers. However, Treasury rules mean that if we were to exercise those powers there would be no net benefit to the Welsh budget. This issue is currently under discussion in the inter-governmental talks on funding reform.

21. The Welsh Government should be able to borrow to fund capital investment, irrespective of whether or not significant tax devolution occurs. At present, the Welsh Government's capital budget is set in a way that is driven by capital spending needs in England and Welsh Ministers lack the ability to smooth the costs of large capital projects over time. Access to borrowing powers would provide an important additional flexibility to the Welsh Government to manage its capital spending and implementing a prudent additional investment programme in a way that better meets the needs of Wales.

22. While we believe that devolution of borrowing powers should not be dependent on tax devolution, we are aware that the UK Government takes the opposite view. If a number of smaller taxes were devolved to Wales, then that would - we presume - overcome the UK Government's objections and enable Welsh Ministers to borrow in order to fund capital investment. For example, if stamp duty land tax, air passenger duty, aggregates levy and landfill tax were devolved to Wales (as the Holtham Commission proposed), they could provide an annual revenue stream of around £200 million. On current interest rates, that would be sufficient to support a borrowing-funded investment programme of over £3 billion.

23. We are in favour of Welsh Ministers having the maximum flexibility to borrow that is consistent with the UK Government's legitimate role in protecting the fiscal position of the UK. That means that borrowing powers would need to operate in a well-defined framework that included limits to ensure the sustainability of any debt repayments.

24. It is likely that the most straightforward method of borrowing would be via the Debt Management Office, but we would welcome the Commission's views on whether borrowing from other sources, including bond issuance, would be advantageous to Wales and whether it could be made to operate effectively within a UK framework.

25. In the event of significant tax devolution, the resulting budgetary volatility might well require further borrowing powers that could be used to finance recurrent spending as well as capital investment. The extent of this volatility - and the resulting need for borrowing powers - would very much depend on which taxes were proposed for devolution and on the offset mechanism used to link tax revenues with the block grant. We encourage the Commission to consider this issue in the course of its work.

III. Do you have any other proposals for improving the financial accountability and empowerment of the Welsh Government?

26. Taken as a whole, the Welsh Government's financial reform objectives - a fairer and more stable block grant, borrowing powers to finance investment and perhaps also strengthened accountability through tax devolution - are substantial and ambitious. If achieved, they would greatly strengthen the devolution settlement, which would be of benefit not just to Wales but to the UK as a whole. Of course, successful reform

cannot be delivered by the Welsh Government acting in isolation, but nor can it be imposed from outside; it requires the active co-operation of both Governments and the support of the people of Wales.

27. The Welsh Government further believes that there are a number of detailed changes to the funding system that would improve its transparency and enable Welsh Ministers to better allocate resources in line with Welsh circumstances. In particular:

    i) Welsh Ministers should have freedom to move funds between capital and resource budgets without the need for Treasury approval;

    ii) the Welsh Government should have unrestricted ability to save unspent resources and to spend those funds in future years without requiring Treasury consent - the current 'Budget Exchange' scheme is inadequate in this regard;

    iii) the Statement of Funding Policy - the rule book that governs the financing of devolved administrations - should as far as possible become a jointly-owned document of the UK Government and the devolved administrations. At present, it is wholly under the control of the UK Government and the Secretary of State for Wales agrees the document on behalf of Wales. In the event that joint agreement is not possible in certain matters, we accept that the UK Government would have the right to impose its decisions, but we would want this to be done in a transparent way;

    iv) technical aspects of the funding regime should be administered by an independent body that operates at arm's length from both the Welsh Government and the UK Government. The UK Government should be able over-rule the decisions of the independent body, but would have to make public its reasons for doing so.

28. In addition, the Welsh Government would welcome the Commission examining the UK's public spending framework and budgetary and accounting regime as they apply to Wales, and considering whether there are any aspects which are inappropriate to a devolved administration.

Annex:

Summary of the borrowing powers of the Welsh Ministers under the Welsh Development Agency Act 1975

1. The legal power to borrow for the purposes of the Welsh Ministers' functions under the 1975 Act is in Schedule 3 to that Act, which is operative by virtue of section 18. Paragraph 3 provides that:

For the purpose of exercising their functions under the 1975 Act, the Welsh Ministers may borrow money from any person (including their wholly owned subsidiaries), but any borrowing in a currency other than sterling requires the approval of the Treasury.

2. The majority of the main functions of the Welsh Ministers under the 1975 Act are set out in section 1(3) and are:

   (a) to promote Wales as a location for businesses[2], or assist or concert its promotion as such a location;

   (b) to provide finance for persons carrying on or intending to carry on businesses;

   (c) to carry on businesses and to establish and carry on new businesses;[3]

   (d) otherwise to promote or assist the establishment, growth, modernisation or development of businesses, or a particular business or particular businesses;

   (da) to make land available for development;

   (f) to provide sites, premises, services and facilities for businesses;

   (g) to manage sites and premises for businesses;

   (h) to bring derelict land into use or improve its appearance;

   (i) to undertake the development and redevelopment of the environment;

   (j) to promote the private ownership of interests in businesses by the disposal of securities and other property held by the Welsh Ministers or any of their subsidiaries.

3. The Welsh Ministers' functions under the 1975 Act may be exercised for any of the purposes set out in section 1(2), which are:

   (a) to further the economic and social development of Wales or any part of Wales, and in that connection to provide, maintain or safeguard employment;

   (b) to promote efficiency in business and international competitiveness in Wales;

   (d) to further the improvement of the environment in Wales (having regard to

[2] "business" is defined as including any industrial, commercial or professional activities (whether or not with a view to profit) and the activities of any government department or any local or other public authority;
[3] The Welsh Ministers can only exercise this function through subsidiaries.

existing amenity).

4. Therefore, the purposes for which the Welsh Ministers may exercise their functions under the 1975 Act are wide, encompassing both the economic and social development of Wales, and improving the environment in Wales.

5. Section 1.(6) gives the Welsh Ministers a power to do anything, whether in Wales or elsewhere, which is calculated to facilitate the discharge of their functions set out in section 1(3) above, or is incidental or conducive to their discharge:

6. Section 1(7) provides that the Welsh Ministers have power in connection with their functions under the 1975 Act—

   (a) to acquire, hold and dispose of securities;

   (b) to form bodies corporate;

   (c) to form partnerships with other persons;

   (d) to make loans;

   (e) to guarantee obligations (arising out of loans or otherwise) incurred by other persons;

   (f) to make grants;

   (g) to act as agent for other persons;

   (h) to acquire and dispose of land, plant, machinery and equipment and other property (land may be acquired by agreement or compulsorily) ;

   (i) to manage land, and to develop land and carry out works on land, and to maintain works or assist in their maintenance;

   (k) to make land, plant, machinery and equipment and other property available for use by other persons;

   (l) to provide advisory or other services or facilities in relation to any of their functions, or assist in their provision; and

   (m) to promote or assist in the promotion of publicity relating to any of the functions of the Welsh Ministers under the 1975 Act.

7. Section 9 of the 1975 Act clarifies that the powers of the Welsh Ministers under section 1(3) to provide and manage sites and premises for businesses, to provide related facilities, and to make land available for development, includes the power to modernise, adapt or reconstruct buildings. The Welsh Ministers may also acquire and provide temporary sites for the business occupants of buildings which are being modernised etc under this power.

8. Section 9 also allows the Welsh Ministers to provide business premises rent free for such time as they consider appropriate, if they consider that there are circumstances

which justify the giving of special assistance.

9. Section 10 gives the Welsh Ministers the power to undertake or assist in the provision of means of access or other services or facilities in or for an area, where this appears expedient to contribute to or support the development of businesses in that area.

10. The Welsh Ministers have a duty under section 1(14) of the Act to publish from time to time programmes for the performance of their functions under the 1975 Act. Such programmes can be implemented by the Welsh Ministers themselves, jointly with others or through others acting on the Welsh Ministers' behalf, for the improvement, development or redevelopment of the environment in Wales.

11. Section 15(2) allows the Welsh Ministers to make payments to any authority or person of such amount and in such manner as it may determine, for carrying out work which the Welsh Ministers consider will contribute to the purposes of such a programme.

12. Section 16 gives the Welsh Ministers powers in relation to derelict, neglected, or unsightly land where they are satisfied steps should be taken for bringing it into use or improving its appearance. They can acquire or carry out works on the land, or give a grant to the local authority for the area to do the same.

13. There is a duty on the Welsh Ministers to secure that none of their wholly owned subsidiaries formed under the 1975 Act borrow money otherwise than from them or another of their wholly owned subsidiaries, except with their (the Welsh Ministers) consent.[4]

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[4] Paragraph 5 of Schedule 3 to the 1975 Act.