Tax devolution and funding floors:

What can Northern Ireland learn from Wales' fiscal framework?

Nevin Economic Research Institute Seminar

07/12/2023

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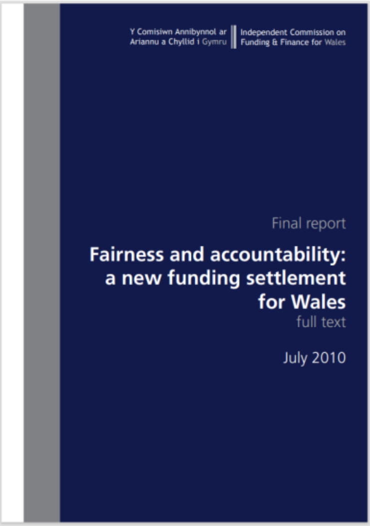
Wales Fiscal Analysis, Wales Governance Centre, Cardiff University

Contents

Background

Journey to further fiscal devolution in Wales:

- Holtham Commission established in 2007 as part of Labour/Plaid Cymru coalition agreement – reported in 2010
    - Called for a funding floor to address underfunding and a package of tax devolution
- Silk Commission established by UK Conservative/Liberal Democrat coalition government in 2010, with representative from each Senedd party
    - Part 1 recommended fiscal devolution to increase empowerment and responsibility
- Wales Act 2014
    - Devolved smaller taxes
- Wales Act 2017
    - Removed referendum requirement for income tax devolution
- 2016 Fiscal Framework Negotiations between UK and Welsh Governments – established how tax devolution would be implemented and reformed the Barnett formula



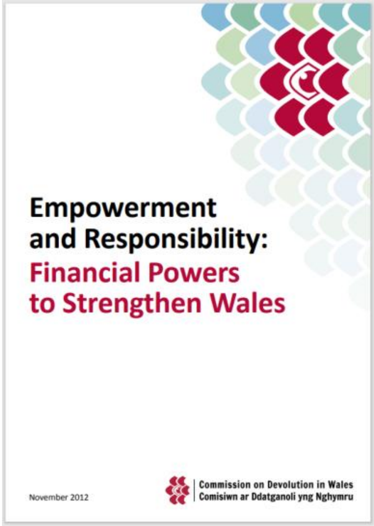
Y Comisiwn Annibynnol ar Ariannu a Chyllid i Gymru | Independent Commission on Funding & Finance for Wales

Final report

Fairness and accountability: a new funding settlement for Wales

full text

July 2010



Empowerment and Responsibility: Financial Powers to Strengthen Wales

November 2012

Commission on Devolution in Wales
Comisiwn ar Ddatganoli yng Nghymru

Historic “underfunding” in Wales

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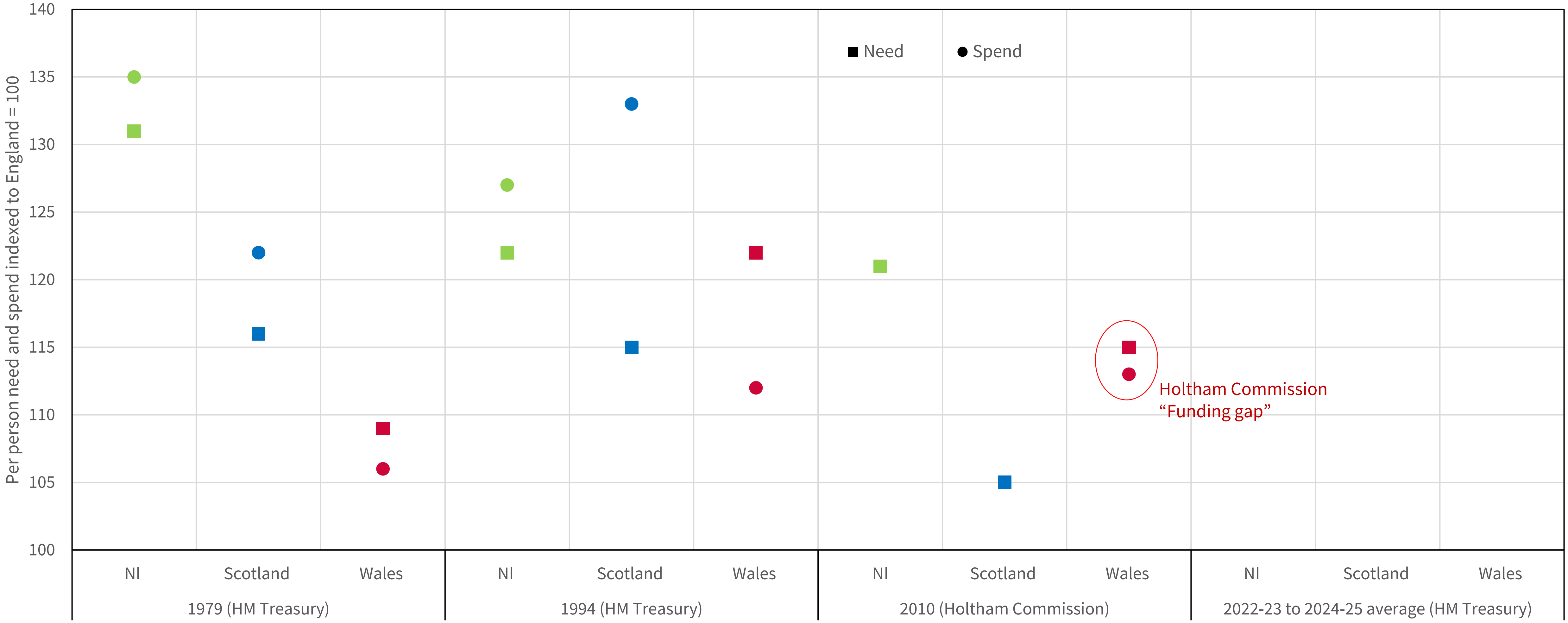

Source: Northern Ireland Fiscal Council (2023); HM Treasury (2023); Holtham Commission (2010)

Historic “underfunding” in Wales

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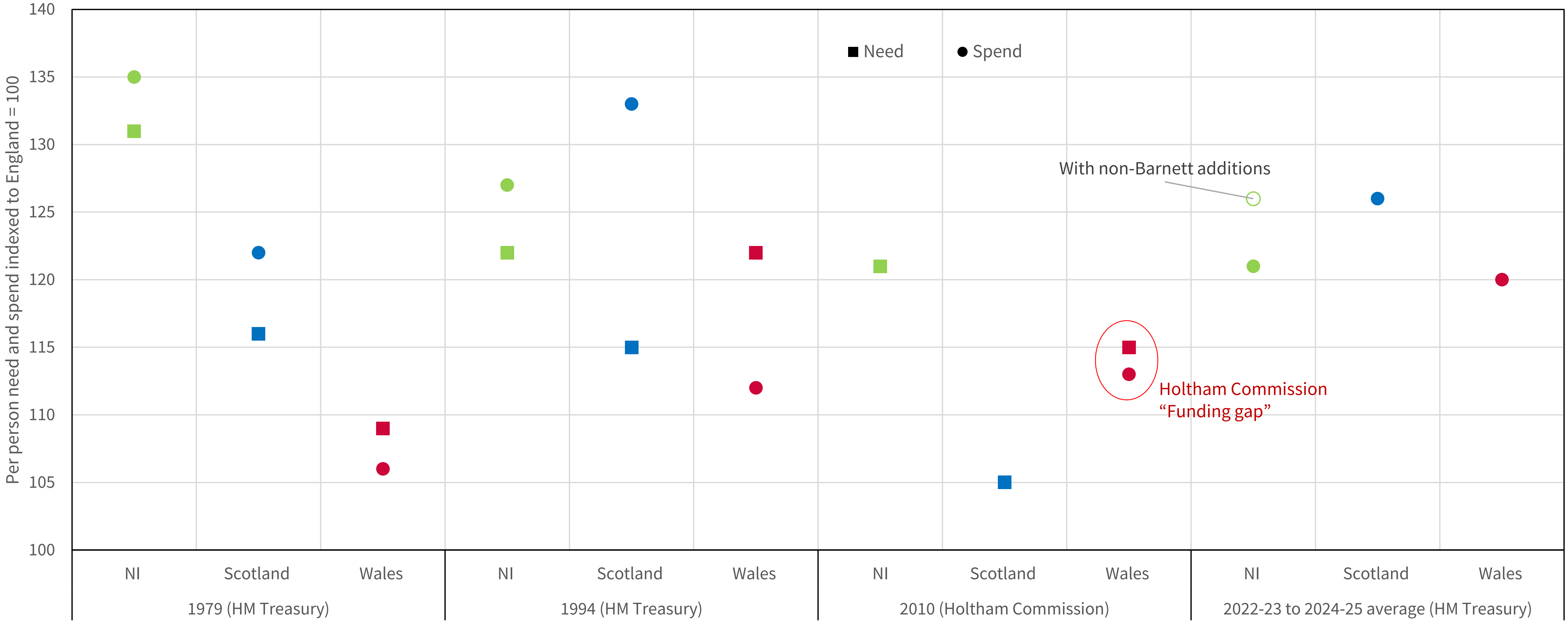

Source: Northern Ireland Fiscal Council (2023); HM Treasury (2023); Holtham Commission (2010)

Historic "underfunding" solved?

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- Holtham Commission (2010): levels of relative 'need' for public spending in Wales between 114% and 117% of the level in England.

- Relative spending levels resulting from the Barnett formula depend on:
  - Initial spending levels per person
  - Comparable spending growth in England
  - Relative growth in population

- Convergence in relative funding ('Barnett squeeze' effect) during first decade of devolution – divergence after 2010
  - Slower growth/cuts in public spending
  - Welsh population growing at slower pace

"My proudest moment was getting a new financial settlement for Wales so it now gets £120 for every £100 that's spent in England."

Then-Welsh Secretary of State, Alun Cairns MP

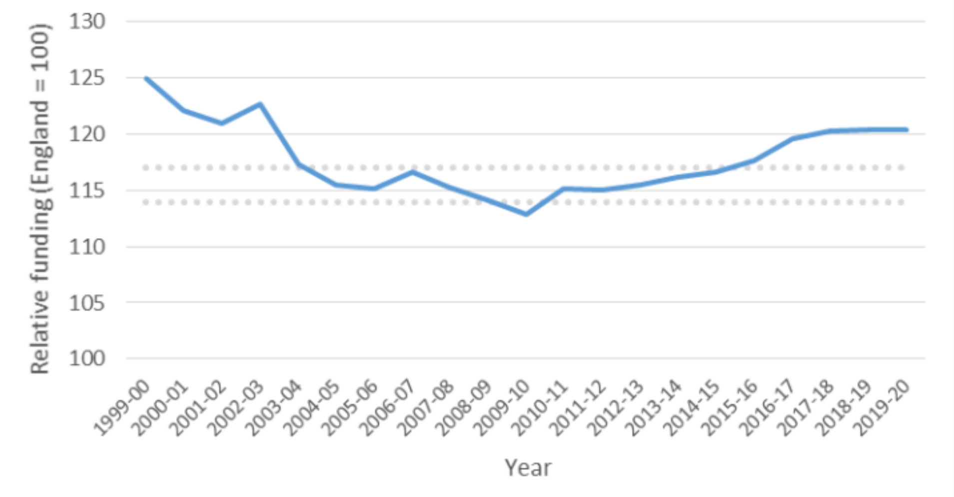
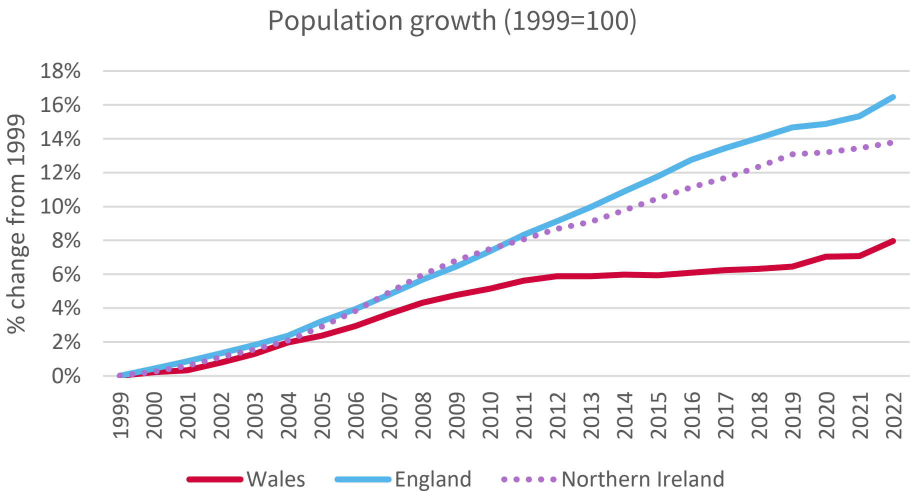


Figure 1: Welsh Government relative funding per-head, 1999 to 2020



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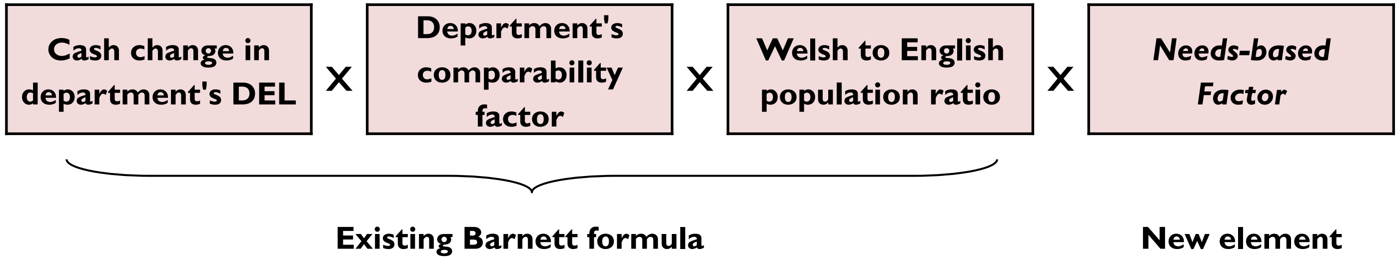
- Lessons and conclusions

Barnett formula reform

- 2015 Spending Review – funding floor guarantee announced
- December 2016 agreement between the Welsh and UK governments on the Welsh Government’s fiscal framework
- New element to the Barnett formula as applied to Wales:

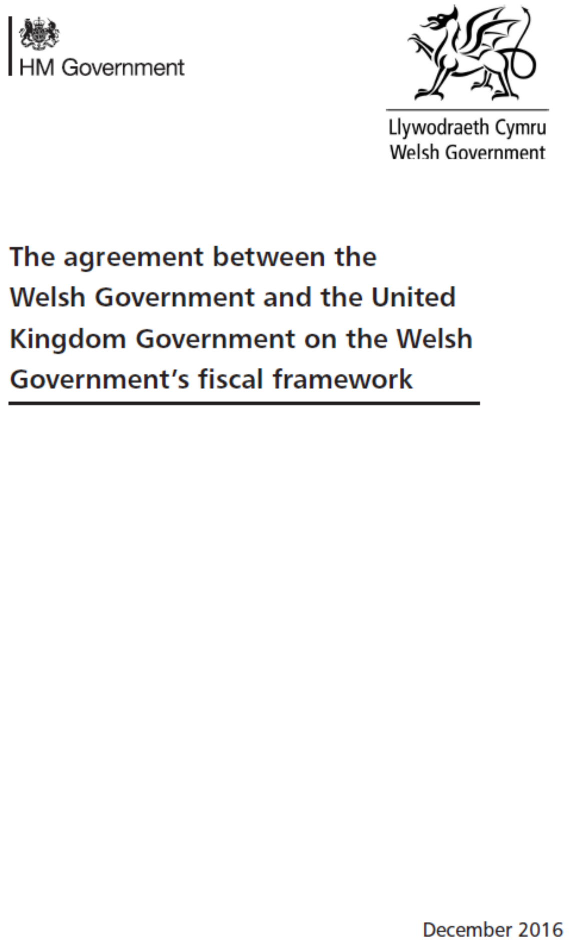


Cash change in department's DEL x **Department's comparability factor** x **Welsh to English population ratio** x ***Needs-based Factor***

Existing Barnett formula

New element

- New ‘Needs-based Factor’ – set at 105% for a “transitional” period, but will become 115% if and when funding per person falls to 115% of England’s level



HM Government

Llywodraeth Cymru
Welsh Government

The agreement between the Welsh Government and the United Kingdom Government on the Welsh Government’s fiscal framework

December 2016

Needs-based factor

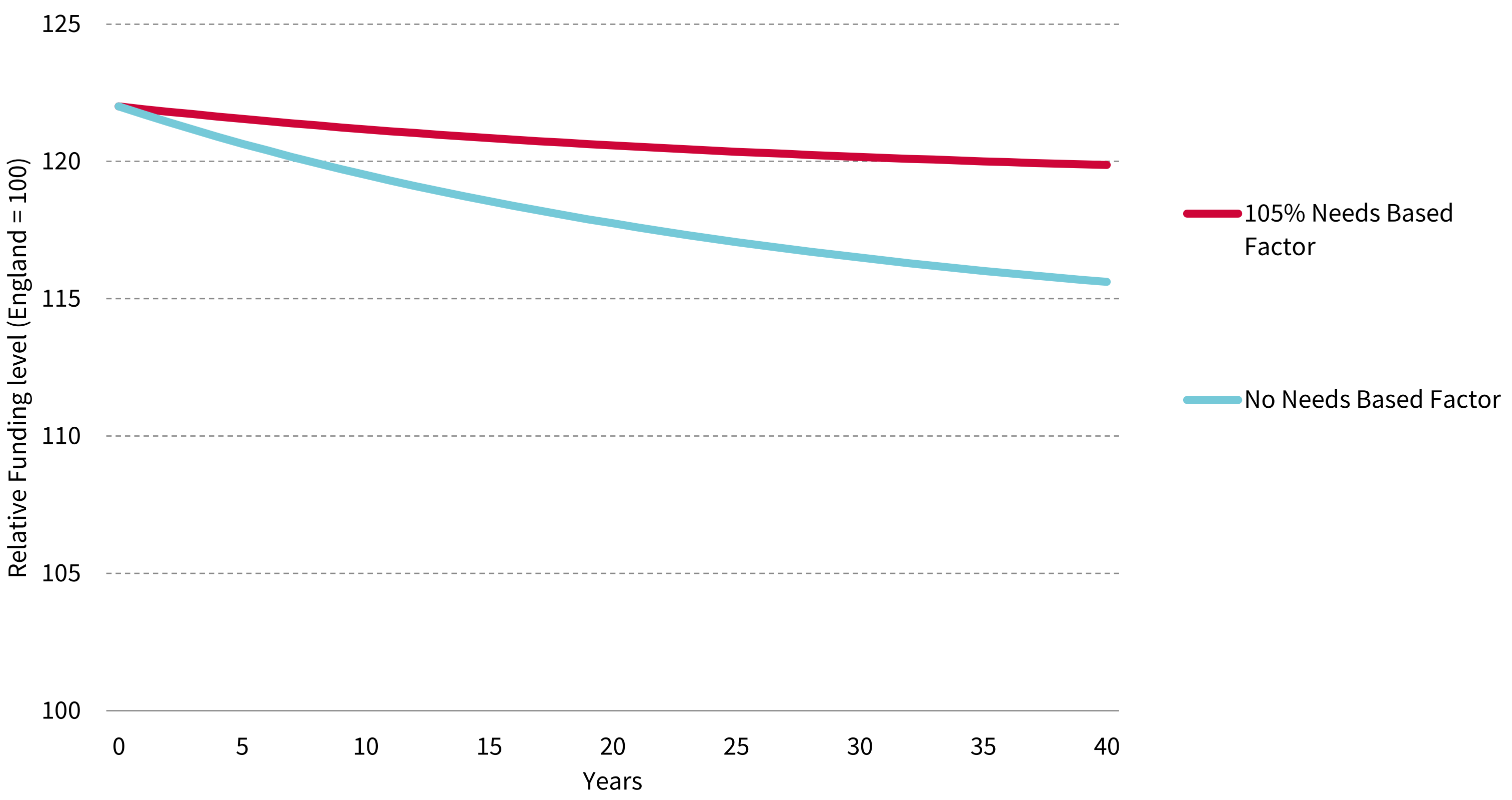
Prifysgol Caerdydd Cardiff University Dadansoddi Cyllid Cymru Wales Fiscal Analysis

- Needs-based factor – set at 105% for a transitional period

- Assume:
  - Continuation of relative population growth trends since 2011 (0.3% v 0.7%)
  - UK government spending growth of 4%

- No convergence to 115% over the next 40 years…

Illustrative relative funding per person over time (England=100)



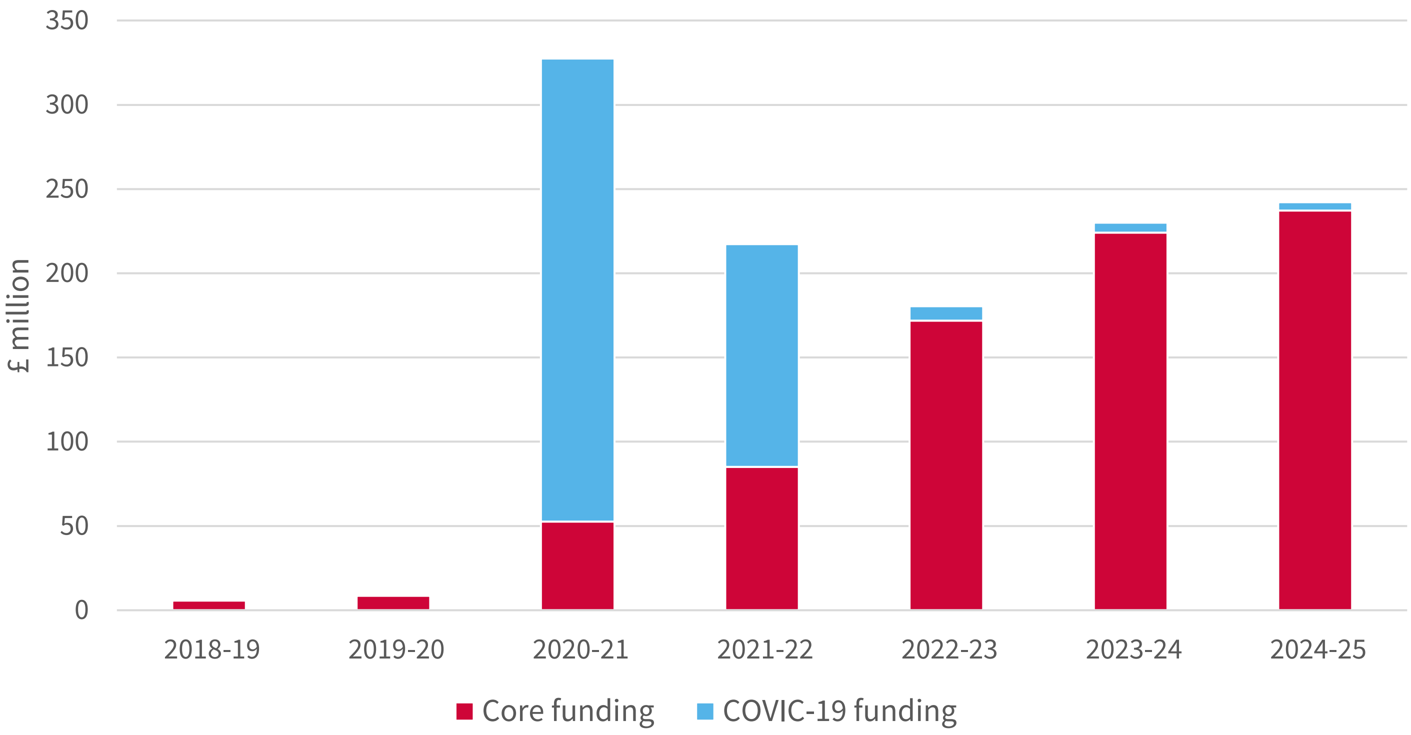
Source: Authors' calculations

The needs-based factor

- Large nominal increases in departmental spending since 2018-19 – including during Covid-19 – led to an unexpectedly large effect from the Barnett formula reform

- Additional funding as a result of the 105% Needs-Based Factor has so far amounted to £1.2 billion (£390 per person) from 2018-19 to 2024-25, and £240 million in 2024-25

Additional Welsh Government consequentials resulting from the Needs-Based Factor



Source: WFA analysis of HM Treasury (2023) Block Grant Transparency data

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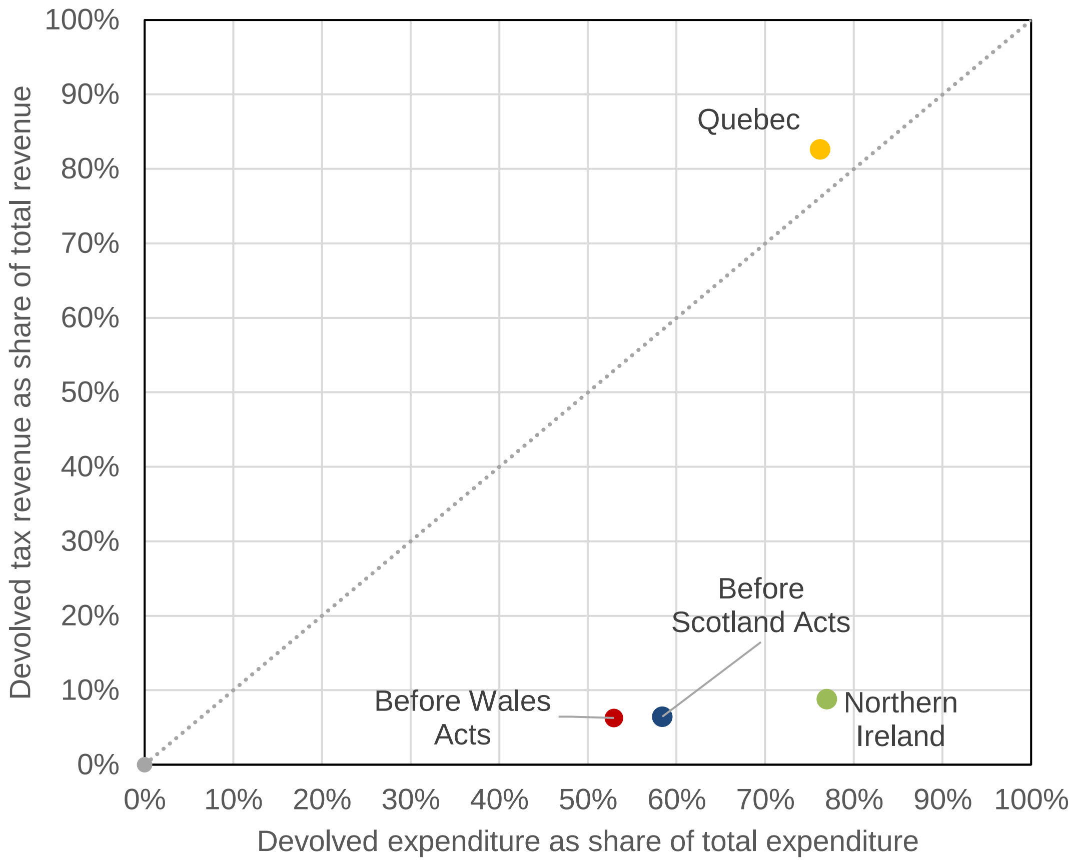
Tax devolution

- Holtham and Silk commissions recommended devolution of tax powers to the Welsh Government – to boost fiscal accountability/responsibility and address vertical fiscal imbalance

Devolved share of tax and expenditure in Wales, Scotland, and Northern Ireland (illustrative 2020-21 figures)



Source: WFA analysis of ONS (2022) Country and Regional Statistics; HM Treasury (2021) Country and Regional Analysis; Scottish Government (2022) Government Revenue and Expenditure Scotland

Tax devolution

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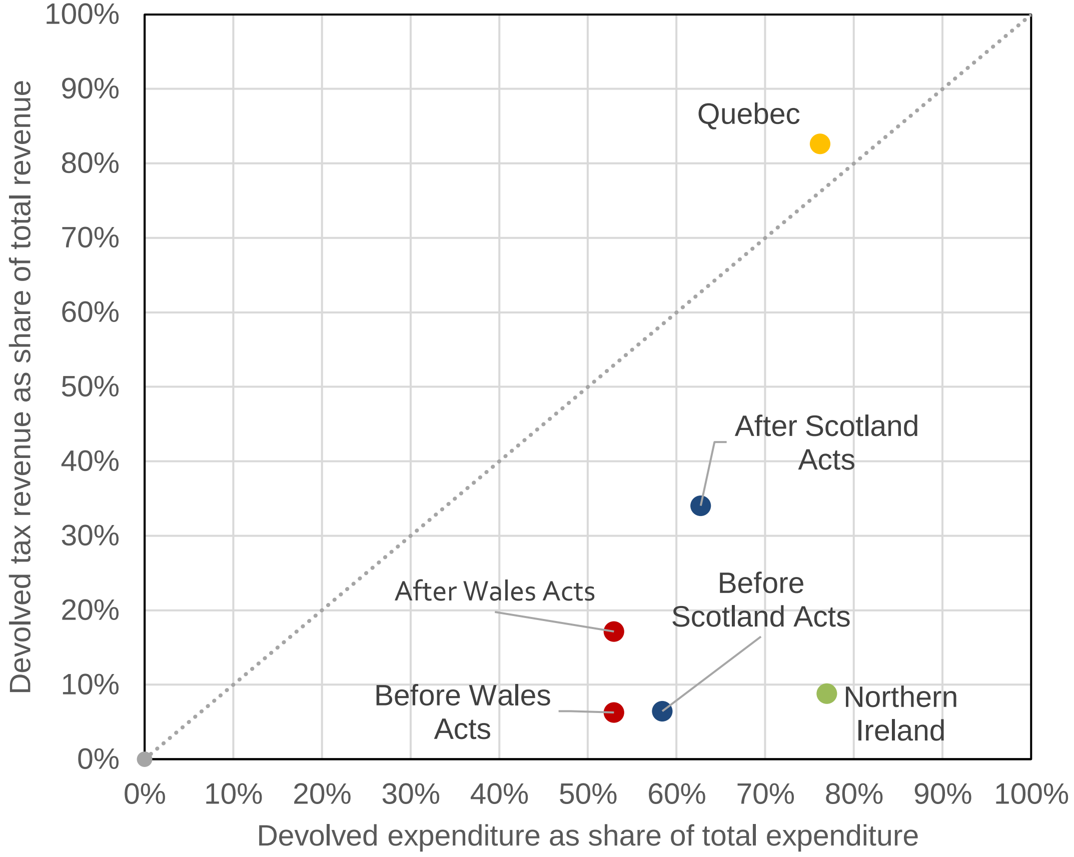
Wales Fiscal Analysis

- Holtham and Silk commissions recommended devolution of tax powers to the Welsh Government – to boost fiscal accountability/responsibility and address vertical fiscal imbalance

- Wales Acts 2014 and 2017
    - Full devolution of Business Rates from 2015-16
    - Devolution of Stamp Duty Land Tax and Landfill Tax from 2018-19
    - Partial devolution of income tax from 2019-20
    - Powers to create new taxes (subject to UKG approval)

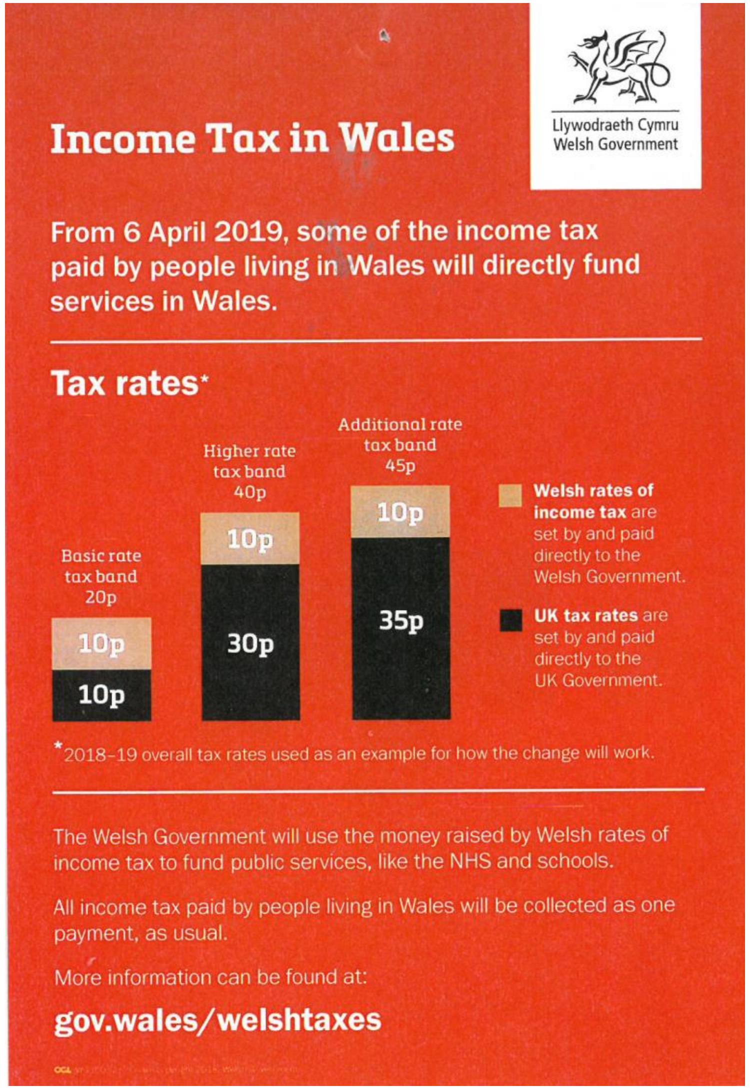
Devolved share of tax and expenditure in Wales, Scotland, and Northern Ireland (illustrative 2020-21 figures)



More tax devolution

Source: WFA analysis of ONS (2022) Country and Regional Statistics; HM Treasury (2021) Country and Regional Analysis; Scottish Government (2022) Government Revenue and Expenditure Scotland

Welsh Rates of Income Tax



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Welsh Government

Income Tax in Wales

From 6 April 2019, some of the income tax paid by people living in Wales will directly fund services in Wales.

Tax rates*

Welsh rates of income tax are set by and paid directly to the Welsh Government.

UK tax rates are set by and paid directly to the UK Government.

*2018-19 overall tax rates used as an example for how the change will work.

The Welsh Government will use the money raised by Welsh rates of income tax to fund public services, like the NHS and schools.

All income tax paid by people living in Wales will be collected as one payment, as usual.

More information can be found at:

gov.wales/welshtaxes

Tax Band	Income Threshold	UK tax rate	Welsh tax rate
Basic Rate	£12,570	20% > 10%	10%
Higher Rate	£50,270	40% > 30%	10%
Additional Rate	£125,140	45% > 35%	10%

Block Grant Adjustments

- How Wales' existing block grant should be adjusted to reflect new devolved revenues?
- What risks should be borne by the Welsh Government?
- Should the Welsh Government be accountable for changes in Welsh economic performance?
- Should Wales' lower tax revenues per person be 'equalised'?

Block Grant Adjustments

- 1st year: BGA reflecting amount of revenue devolved
  - ‘No detriment’ from devolution
  - Full ‘equalisation’ in first year
- Key question: how BGA should change over time …

- Link to ‘comparable’ UK government revenues in England & Northern Ireland
  - Creates incentives for Welsh Government – rewarded for faster growth in revenues, penalised for slower growth in revenues
  - Protects Welsh Government from UK-wide economic shocks

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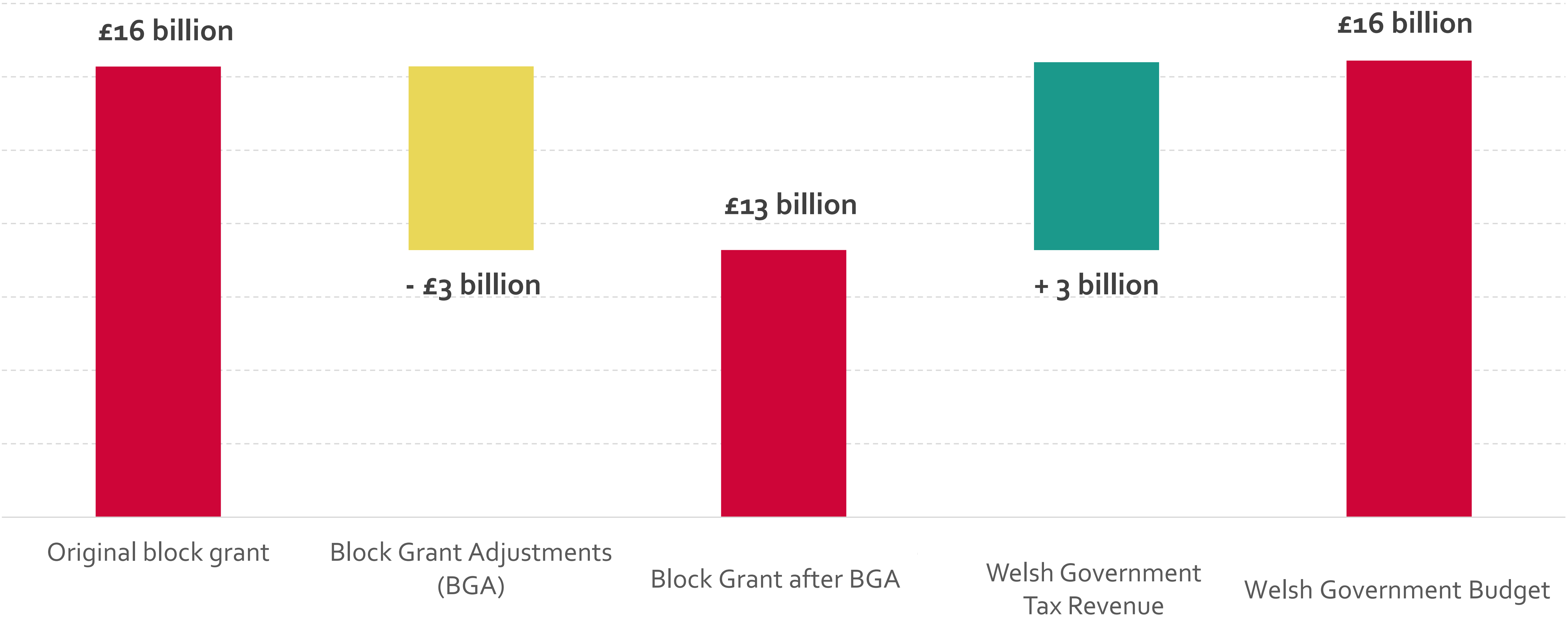
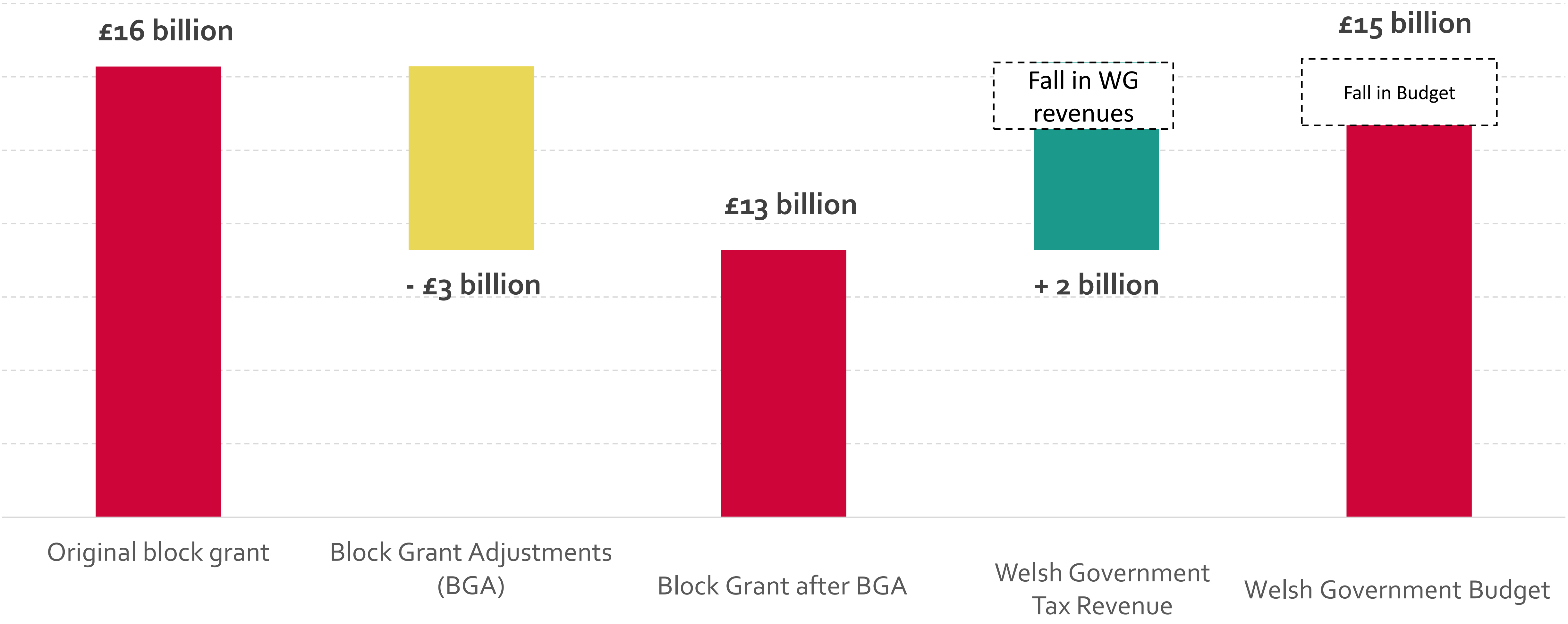
Block Grant Adjustment



Block Grant Adjustment – Welsh-specific economic hit



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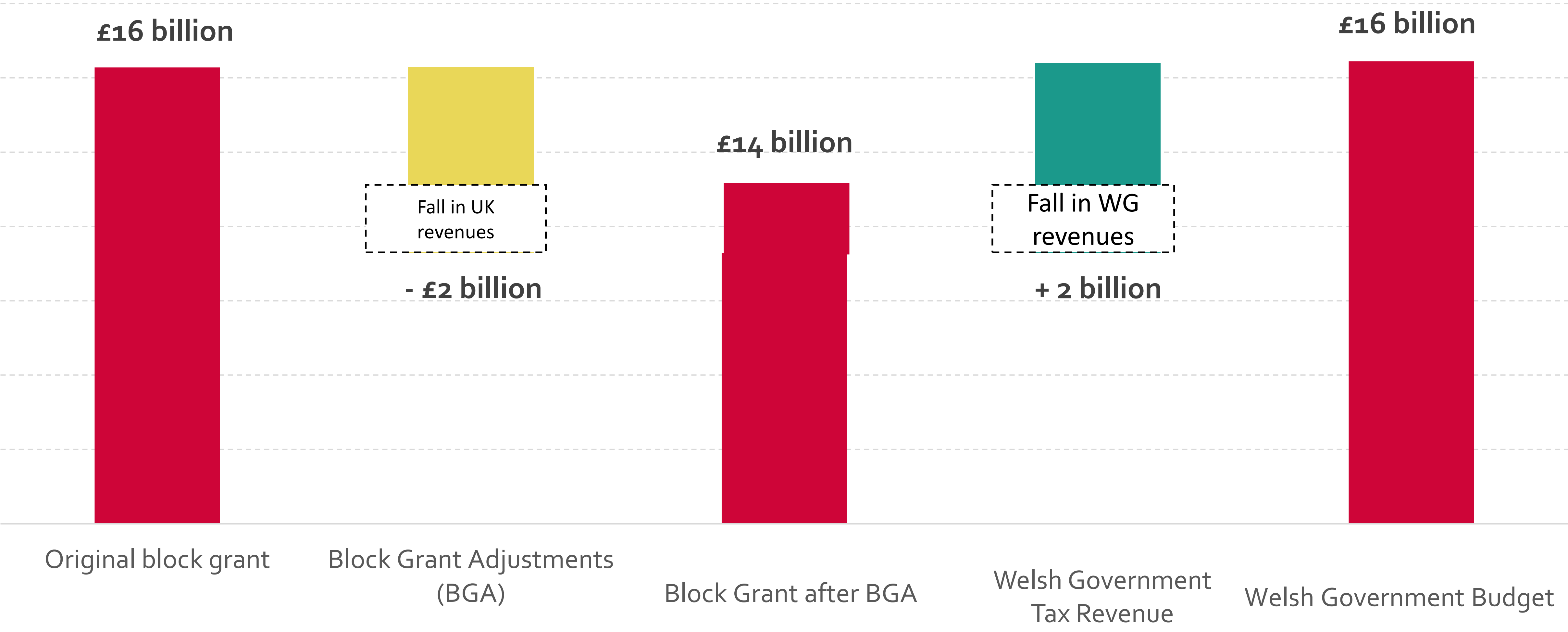
Block Grant Adjustment – UK-wide economic hit



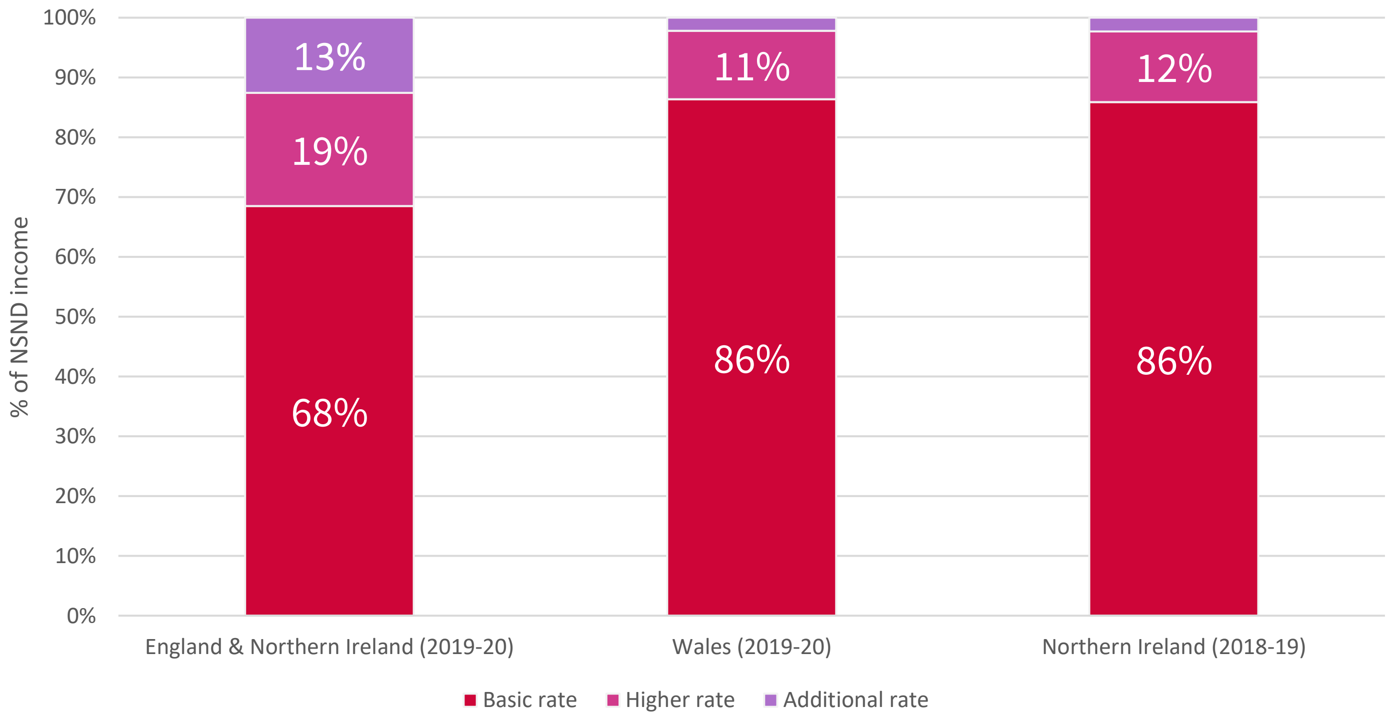
Block Grant Adjustments

- 2 issues arose for Wales…
  - Accounting for relative population growth
    - **Indexed Per Capita** – BGA increases in line with the growth in revenues per capita in England, adjusted for population growth in the devolved nation (**Scotland**’s model)
    - Or **Comparable Model** - increases the BGA in line with a tax-capacity adjusted population share of the change in England revenues, taking no account of relative growth in population (**Wales**’ model)
  - Accounting for vastly different income distribution
    - Separate Block Grant Adjustments for each tax band (**Wales**’ model)

Wales' different income distribution

- Separate Block Grant Adjustments for each tax band
- Basic rate revenues in Wales need to keep pace with basic rate revenues in England and Northern Ireland etc.
- Automatically accounts for UK-wide factors which impact different parts of the tax base asymmetrically

% of NSND income at each income tax band



Source: HMRC (2023) Welsh Income Tax Outturn Statistics; Northern Ireland Fiscal Commission (2022)

Devolved taxes and block grant adjustments

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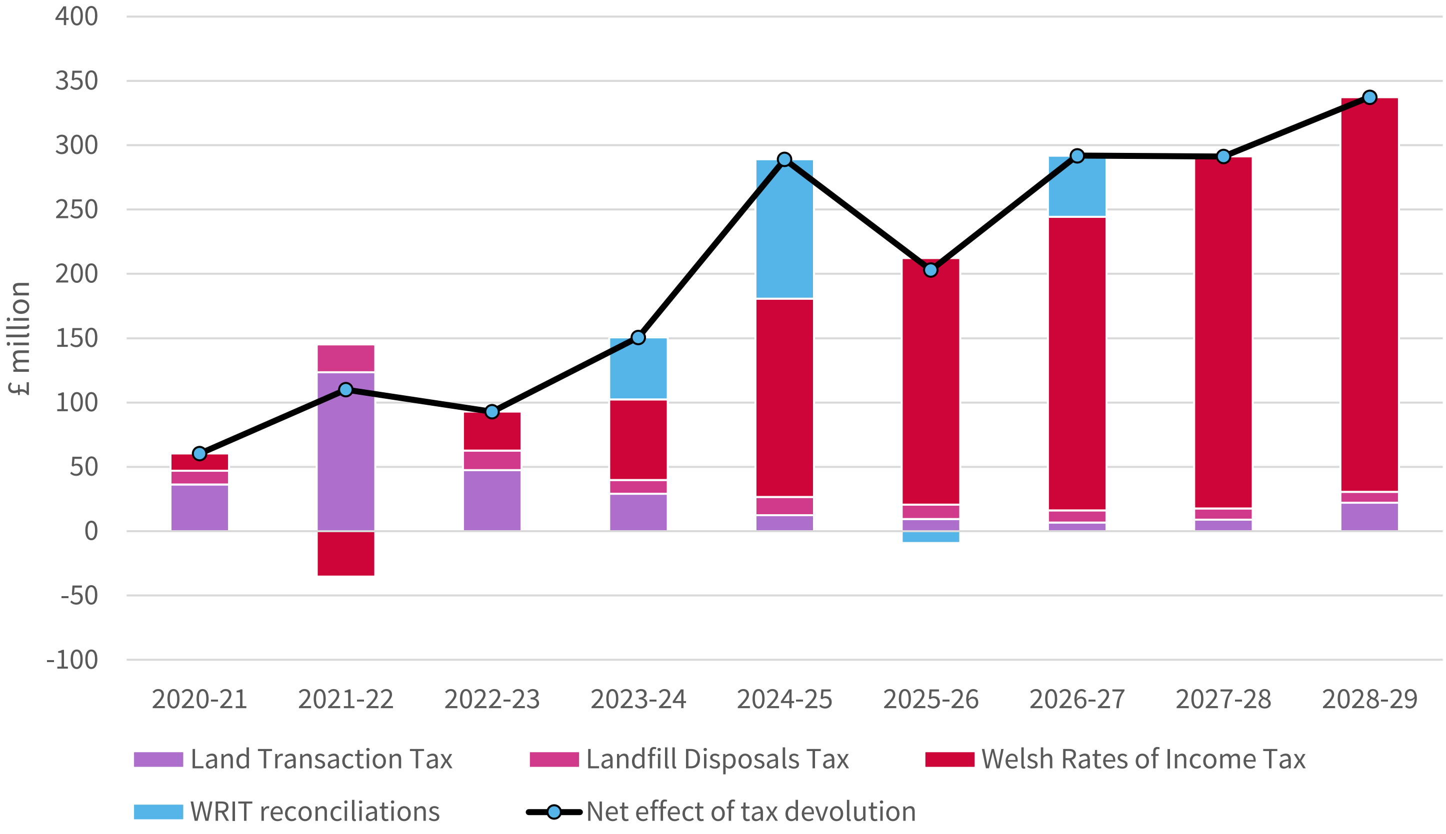
- Current forecasts suggest a positive effect of tax devolution on the Welsh Budget
- £289 million in 2024-25 – almost equivalent to a 1p rise in income tax rates
- “Reconciliations” for forecast errors likely in future, applied when outturn data is available (3 years after)



Source: WFA analysis of OBR (2023) Devolved Tax Forecasts.

Devolved taxes and block grant adjustments

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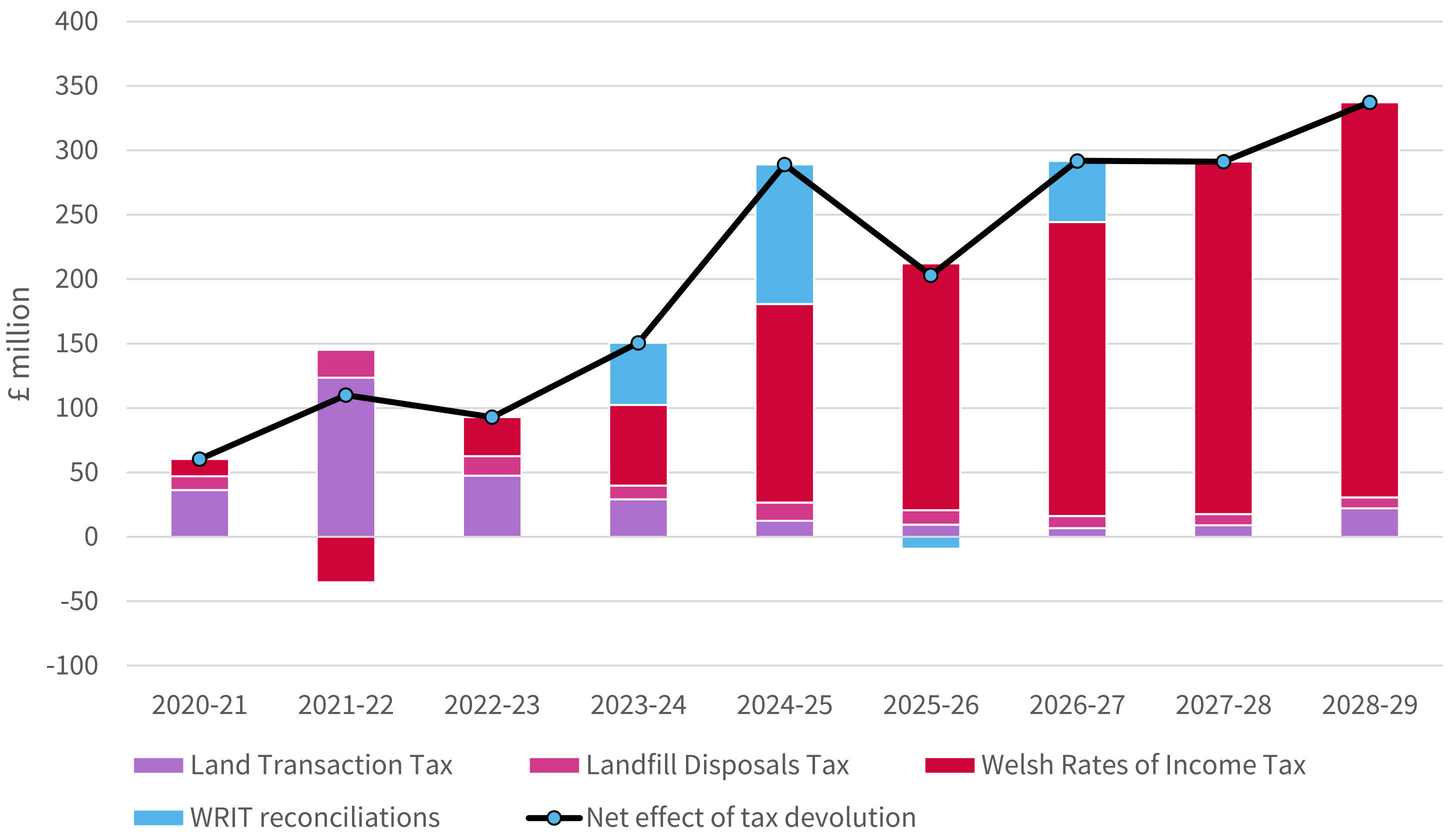
Wales Fiscal Analysis

- In sharp contrast to Scotland’s experience…
- Scottish Fiscal Commission estimated income tax policies raised an additional £750 million in tax revenue between 2017-18 and 2021-22 (relative to rUK tax policy)
- However, comparatively weaker economic performance and different income distribution - the overall increase in the Scottish budget was £85 million in 2021-22



Source: WFA analysis of OBR (2023) Devolved Tax Forecasts.

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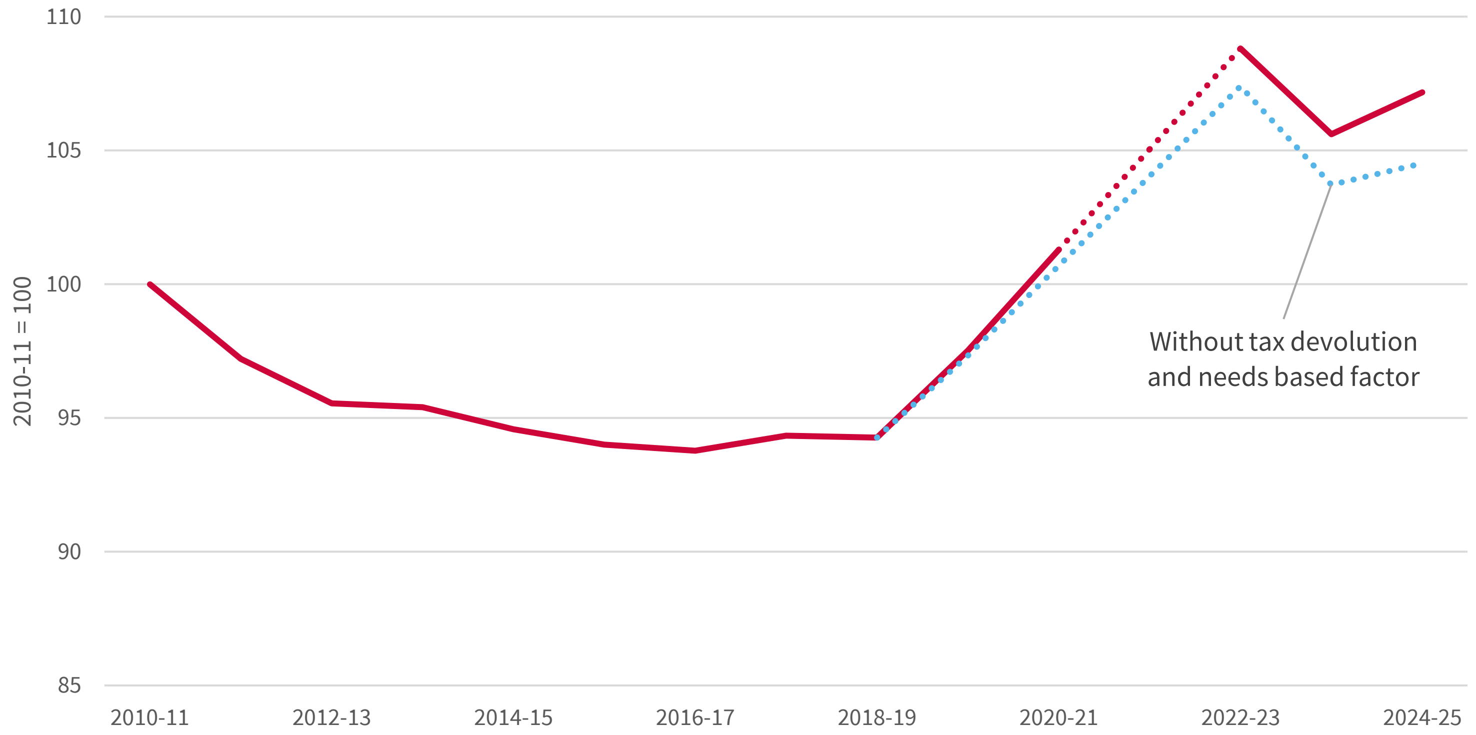
Assessing the fiscal framework

- A good financial deal for Wales – timing could not have been better…

Assessing the fiscal framework

- Additional funding as a result of tax devolution and the needs-based factor equivalent to around 2.5% of the Welsh budget for day-to-day spending in 2024-25

Real terms change in Welsh Government funding for day-to-day spending, 2010-11=100



Source: WFA analysis of HM Treasury (2023) Block Grant Transparency data; Office for Budget Responsibility (2023) Devolved Tax Forecasts

Assessing the fiscal framework

- A good financial deal for Wales – timing could not have been better…

- Some link between the relative performance of the Welsh economy and relatively strong protection against macro-economic shocks that affect the whole of the UK
    - But can Welsh Government claim credit for better performance since 2019-20?

- Full equalization of weaker tax base – but not updated to reflect changes in Wales' tax capacity (somewhat unusual in an international perspective)

- Accounting for Wales' higher levels of need for public spending for the first time
    - But the updated formula still determines *changes* in Wales' block grant, rather than actual level (as is most common internationally) – relative funding per person still influenced by a mix of historical accident, trends in relative population growth and rate of growth of spending in England
    - Needs-based element based on a decade old assessment of relative need – and fixed in time

Assessing the fiscal framework

- What about autonomy and accountability? Do current powers allow a realistic prospect of diverging away from UK government fiscal policy?
  - Usability of Welsh-style powers can be questioned (especially compared to Scotland)
  - Tax devolution has not led to a step-change in the nature of the Welsh budget-setting process
  - Tax powers did not feature in Senedd election in 2021
  - Major tax policy has been on Council Tax – which has increased much faster than in England and Scotland and set to be reformed

- Budget management tools have proved inadequate
  - Arbitrary limits on the Wales Reserve (already eroded significantly by inflation) need to be revised
  - Scope for significant borrowing powers for both revenue and capital spending within context of overall budget and devolved revenues
  - Procedural complaints – HM Treasury still “judge and jury” in its own court

Immediate budget challenges 2023-24

Winter pressure may hit NHS Wales wait targets - minister

19 November · Comments

Mark Drakeford makes 'crisis' cuts to prop-up NHS and trains

17 October

Financial Statement: Extra £425m to protect NHS - 'budget not adding up' says Plaid Cymru

WALES | WELSH GOVERNMENT | SPENDING REVIEW | HEALTH | Tuesday 17 October 2023 at 4:55pm

Welsh public services must make cuts, Mark Drakeford says

9 August

Cuts warning as Welsh councils face £395m shortfall

23 August

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Lessons and conclusions

- Poorer, peripheral countries can take on fiscal powers successfully
  - But unlikely to change longer-term economic and fiscal trajectory
- UK asymmetric devolution will continue – no UK-wide conversation/reform from first principles likely (but precedents useful)
- Developing capacity for fiscal powers - inside and outside of the executive
- The politics (internal and external) matters…
  - Needs buy-in from different political parties
  - Timing and context of negotiations
- Use political capital for one-off short-term deals or longer-term reforms that boost sustainability?

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