

Submission to the Independent Commission on Funding and Finance for Wales
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In this note I point out that

- the exercise of fiscal devolution by setting a different major tax rate in Wales from England will trigger relocation of households and firms.
- But this will not be sufficient to offset the change in tax revenue.
- Nonetheless such movement would have an effect on the economy.
- The devolution favoured here is only for corrective taxes and
- Where possible greater reliance on user charges,
- Any fiscal devolution will require explicit borrowing powers.

Accountability and Taxes

1. The strongest case for devolving taxes to Wales is to encourage policies that take into account people's preferences for private spending as well as their interest in public services, and thereby increase accountability. But this virtue of devolved taxes is not the only consideration. If the consequences of introducing different levels or types of taxes in Wales from those in England were unacceptable, the authority would never be exercised. If tax powers could not be used, they may not be worth having. So what is the likely cost of fiscal devolution?

2. This will depend upon which taxes are devolved. Table 1 shows the estimated yields of taxes paid in Wales mainly to Whitehall. The largest revenues are from income tax, National Insurance Contributions and VAT. Next in importance come fuel duty and corporation tax, generating one third or less of each of these big earners. Council Tax is already devolved in one sense and brings in about a fifth of what income tax yields. On the grounds of revenue then, one or other of the big three is a target for devolution.

Revenue Certainty

3. Another consideration in selecting suitable taxes is reliability and elasticity of tax revenue. The recent downturn in the economy and the property slump has cut back on corporation tax revenues, stamp duties and inheritance tax in particular, although on most other tax receipts as well (figure 1). Because of corporation tax receipts volatility, the OECD has often recommended reducing 'sub-national' reliance on this source of revenue (Journard and Kongsrud 2003). UK income tax receipts fell by 8 percent, NIC by 3 percent and VAT by 21 percent in 2007-9.

4. At present the Assembly Government is 'insured' against such losses by the central government that bears the risk and the borrowing. A Welsh government with devolved tax powers would lose revenue in a recession and would therefore be obliged either to cut spending, increase tax rates or raise borrowing.

Tax-induced mobility

5. How easily tax differentials between Wales and England might affect tax revenues and the location of households and businesses is suggested by the difference between

workplace and residence estimates of tax in Table 1. Because of net commuting into England, persons living in Wales in 2006-7 paid an estimated £360 million more in taxes than those merely working in Wales. This is a small proportion of the £19 billion total receipts but at present there are no differentials. If the balance of advantage from living in Wales was tilted further one way or the other by taxation, so would be the balance of residence and workplace taxes, as cross-border commuting increased or declined. In the longer run there would be relocations as well.

6. All small open economies (and Wales is very small and open) have relatively mobile tax bases. Firms and households more readily move across their national boundaries in response to tax differentials. When entirely fiscally autonomous, small economies must therefore rely less on corporate and personal income taxes than other countries. A ten percent smaller population in 1999 is associated with a one percent reduction in the ratio of personal and corporate income tax collections to total tax revenues (Hines and Summers 2009). Governments of small countries instead rely on consumption-based taxes, including taxes on sales of goods and services and import tariffs – which may bear a moral for Welsh fiscal devolution.

7. Although firms do move in response to tax incentives, a recent study concludes that between countries international corporate tax base mobility is rather modest (Riedl and Rocha-Akis 2009). On average a unilateral CIT reduction increases the CIT base less than proportionately, thereby cutting CIT revenues. This finding is robust across a wide range of specifications.

8. As far as individuals and households are concerned, tax effects are likely to be selective by types of people. High personal income tax rates reduce cross-border inflows of skilled workers and bilateral stocks of expatriates in the OECD (Egger and Radulescu 2009). The higher the pay (and thus by assumption the skill), the greater is the incentive to respond to tax differentials. Heavier regional taxes in Switzerland certainly induce migration but not enough to prevent these higher rates boosting revenue (Liebig et al 2007). Some people will be very unwilling to move even when it is apparently substantially to their material advantage. Patriotism is a disincentive for individuals to migrate from a country, regardless of its policies on taxation. Geys et al (2009) use survey and OECD taxation data to show that higher patriotism is associated with higher tax burdens, and this relation is stronger for the upper-middle range of the income distribution.

Feasibility

9. The Calman Commission's proposal, to raise perhaps 16 percent of the Scottish Parliament's current budget within Scotland, suggests how a devolved income tax could be introduced (Commission on Scottish Devolution 2009). An analogous approach for Wales would empower the Assembly to vary income tax rates by up to 10p in the pound in the basic rate tax band. In return the block grant (at present the Assembly's only funding) would be cut by an equivalent amount. This arrangement has the advantage of emphasising that the Assembly's revenue comes from the tax payer and could be returned to them.

Table 1 Estimated Receipts from Taxes in Wales 2006-7 (£ billion)

Income tax	
Residence	4.7
Workplace	4.6
NIC	
Residence	3.6
Workplace	3.5
VAT	
Residence	3.2
Workplace	3
Council Tax	0.92
Vehicle Excise Duty	0.25
Corporation Tax	1.06
Stamp Duty	0.26
Fuel Duty	1.19
Tobacco Duty	0.53
Alcohol Duties	0.39
Business Rates	0.71
Capital Gains Tax	
Residence	0.14
Workplace	0.14
Inheritance tax	0.18
Betting and gaming duties	0.07
Air passenger duty	0.04
Insurance premium	
Residence	0.09
Workplace	0.09
Landfill tax	0.03
Climate change levy	0.03
Customs duty and agricultural levies	0.09
Aggregate levy	
residence	0.01
workplace	0.01
Other taxes and royalties	
residence	0.53
workplace	0.53
Other receipts	
residence	1.26
workplace	1.29
Total Tax Receipts	
Residence based	19.28
Workplace based	18.91

Source: Constructed from Oxford Economics (2008), Economic Outlook, Regional winners and losers in UK public finances

10. Devolving income tax must be administratively feasible in Scotland because HMRC must have made provision for the exercise of the 3p 'tartan tax'. If it is feasible in Scotland then it could be made to work in Wales. Whether it is desirable is another matter. A different local basic rate income tax alters the progressiveness of the tax system, as well as influencing the location of households and businesses.

11. As mentioned earlier borrowing powers must accompany such tax devolution, for in the present and future recessions, tax revenue falls while spending requirements increase. The deficit would need to be financed. But in any case borrowing powers comparable to those of local authorities should be available to the Assembly Government with its capital spending obligations.

12. Exercising fiscal autonomy then seems feasible even in a world of internationally mobile firms and people as far as tax revenue is concerned. Taxing high earning firms or individuals more heavily will reduce their numbers in residence but raise total tax receipts. Such a policy may not necessarily be beneficial for the wider economy and living standards though; tax receipts are not the only concern.

Council and Property Taxes

13. A recent OECD survey noted that property taxes do not play as important a role in 'sub-national' finance as could be expected (Journard and Kongsrud 2003). The expectation that these taxes are useful in devolved financing is because they are hard to avoid by mobility, in contrast to most other taxes. The tax cannot be passed on in the form of higher prices, so the allocation of resources is unaffected- except by the drop in house or landowners' post-tax wealth. From the viewpoint of raising revenue the council tax is nearly ideal. If one area imposes a higher tax than another, this immediately lowers property prices. Property owners in the higher tax area incur a capital loss, but they cannot avoid it. People will not be deterred from buying into the areas. House prices or rents will simply fall to cover the greater tax, while remaining comparable with prices inclusive of taxes elsewhere. It is a hard tax to escape.

14. Rosenthal (1999) calculated that only one third of tax liabilities were capitalised in house prices. His figure of one third depends critically on the capitalisation rate- he assumed a very low rate for the time (1981-1990) 3 percent. A more plausible 9 percent discount rate implies a 100 percent capitalisation. Even more intriguing, he found no capitalisation of local expenditure benefits in the UK, in contrast to the US, indicative presumably of the local valuations placed on the more redistributive benefits financed by British local government.

15. The local authority council tax is the only currently available example of Welsh tax independence. One possibility is that, if their tax base does not grow strongly enough to support planned expenditure, the Assembly Government with tax powers will simply raise income tax rates above English levels. This may be desirable; under a fully accountable system, such a rise would simply reflect electoral preferences. On the other hand, if full accountability is still emerging, there could an indeterminate period over which taxes rise with less warrant.

16. Council tax revenues in Wales increased by a greater percentage than in England between 2001 and 2007 - 58 percent compared with 54 percent. The Welsh excess might have been an adjustment upwards from too low a rate before devolution; Welsh local taxes were lower than elsewhere, but then so was Welsh income. Such an increase might be expected if local authorities just decided on their spending, without worrying about the amount of tax it was reasonable to extract. The elasticity of the tax in both England and Wales is notable, and consistent with the difficulty of avoiding it; HMRC revenue in total increased by only 40 percent over the same period.

User Fees

17. Not subject to the problem of inducing mobility of the tax base, or not in the same way, is greater reliance on user fees. By reinforcing market signals, more user fees could promote efficiency but may also raise questions of equity, where redistributive public services (in particular health care and education) are concerned. The Assembly Government has moved in this direction with higher education fees. But there are other products and services not currently subject to impositions for which fees could be introduced, such as prescription charges. These have been abolished in Wales but in England the fee is over £7. Yet 89 percent of English prescriptions are dispensed free and still £400 million is released for use elsewhere in the Health Service.

Corrective Taxes

18. A subsidiary case for selective fiscal devolution is that powers over setting corrective taxes are desirable alternatives or supplements to direct controls. Corrective taxes discourage activities that create adverse effects otherwise not taken into account by the beneficiaries of the activity.

19. Alcohol and tobacco taxes might be interpreted as reducing the demands made upon the NHS. Environmental taxes have been increasing, although are still responsible for a small proportion of revenue (figure 1). Aggregates taxation, of sand, gravel and rock dug from the ground, or dredged from UK waters, is intended to address the environmental damage caused by these activities¹. The landfill tax is designed to encourage firms to produce less waste and to adopt alternative waste management strategies. The Climate Change Levy on energy sales for business is a way of fulfilling the Kyoto Protocol obligations for reduction in greenhouse gases. Fuel taxes could also be interpreted in this way and perhaps as a limited congestion charge.

20. Corrective taxes highlight an important trade-off between revenue generation on the one hand and other objectives of policy- discouraging harm or resource misallocation - on the other. The more successful is policy at reducing the harm, the lower may be tax receipts. For this reason, as well as because of their small prospective yield, such taxes cannot be counted upon as a significant source of Assembly Government revenue.

¹ In figure 1 the aggregates levy is missing for the first period because revenue (£247 million) only began flowing in 2002/3. The yield has not increased since 2003/4.

Conclusion

21. In principle devolving taxes is desirable on grounds of accountability for public spending. However for many people including the author, there are doubts about how fiscal devolution would initially be exercised that outweigh the eventual gain of a more accountable system. One piece of evidence supporting these doubts is Welsh Council Tax increases compared to those in England. Another related item is the suspicion that the public sector in Wales is already too large for the good of the economy as a whole (Foreman-Peck and Lungu 2009) – outside recessions- and that substantial fiscal devolution would make it larger. So in practice the case seems stronger for devolving corrective taxes that are of minor revenue significance. In the evolution of a fiscal system there is good reason to take a smaller step first. Anyway devolved corrective tax rates are more likely to be altered than would be major revenue yielding taxes. Even if only this small step were taken it would need to be supported by explicit Assembly borrowing powers.

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Figure 1

