Impact of variations in national and sub-national income tax

I would like to thank the members of the Finance Committee for their report on the 'Impact of variations in national and sub-national income tax'. As we move forward, considerations around our devolved tax powers will play an increasingly important role in considering the opportunities and responding to the challenges we face in Wales.

Having access to the relevant data and strengthening our relationship with key partners such as HMRC will be critical as we determine the way forward for Wales. Variations between national and sub-national income tax is a relatively new concept for the UK, and we are just beginning to understand the possible impacts on our communities. I therefore welcome the Committees views on this very important issue.

I have set out my response to the report's individual recommendations below.

Recommendations

Recommendation 1. The Committee recommends greater collaboration between the Welsh Government and HMRC to improve Welsh data collection and dissemination, and urges the Welsh Government to explore how HMRC's Knowledge, Analysis and Intelligence Division can be utilised to support research into tax divergence.

Accept

The Welsh Government has close links with analysts across UK Government, including HMRC's Knowledge, Analysis and Intelligence (KAI) Division as set out in the Service Level Agreement (SLA). These links are further strengthened through regular meetings to discuss developments in the scope, presentation, and analysis of Welsh tax data.

Data from the first full year of income tax devolution (2019-20) will start to become available from summer 2021. A detailed data set for that year will be available in 2022. The Welsh Government is working closely with HMRC on the presentation and dissemination of this information.

There are challenges regarding the level of detail that can be made available for research. Tax data is highly sensitive and there are restrictions on data sharing to preserve taxpayer confidentiality. The Welsh Government is working with HMRC to ensure data can be provided in an accessible and useful way for researchers, whilst maintaining that confidentiality.

One area of research the Welsh Government is undertaking in conjunction with HMRC's Knowledge, Analysis and Intelligence Division relates to estimating the behavioural impacts from tax divergence, to better account for potential sub-UK differences in tax rates. This technical work builds on the evidence the Welsh Government presented to the Committee for this inquiry. It also reflects the well-established methods which HMRC and the Office for Budget Responsibility have developed over the years to model the revenue impact of income tax policy changes.

Financial Implications – None. Any additional costs will be drawn from existing programme budgets.

Recommendation 2. The Committee recommends that the Welsh Government works closely with stakeholders to support them in obtaining the necessary data for modelling purposes, and engages with academics to undertake a longitudinal study on the impact of tax rate divergence across the Wales-England border.

Accept

A longitudinal study would require the development of a new income tax dataset. This would provide information on tax payers linked across years rather than the more commonly created single year cross-sectional datasets.

The Welsh Government, along with the Scottish Government, has engaged with HMRC on the potential need for a longitudinal data set, to enable more sophisticated research into the behavioural impact of income tax changes and potential differences within the UK. Potential options are being developed around this proposal. This is a technical piece of work which will need to take account of the potential uses for such a dataset to ensure it is in an appropriate form for it to be of maximum benefit for both government and non-government researchers. Such a dataset is likely to become more useful in the future, especially if income tax rates were to diverge between Wales and the rest of the UK. As a new complex analytical tool, the development work required to produce such a dataset is likely to take some time. The Welsh Government has made an early start in exploring the feasibility with HMRC.

Financial Implications – None. Any additional costs will be drawn from existing programme budgets.

Recommendation 3. The Committee recommends that the Welsh Government provides an update on the viability of undertaking surveys to improve Welsh-specific data, including the costs and timescales involved.

Accept

The development of new surveys and improving Welsh specific data generally requires considerable resources and usually has long lead times.

The Improving Economic Statistics budget is used to fund improvements in survey evidence on Wales' labour market and the wider economy. This budget, worth £1.2 million in 2020-21 is used to boost the Annual Population Survey and commission short term economic output indicators for Wales.

More recently, the Welsh Government has been working on improving trade statistics in line with the need identified in the *Trade Policy: The Issues for Wales* (2018) report. A new trade survey has been developed by the Welsh Government, the first results from which have recently been published as experimental statistics[1].

Boosting existing surveys and introducing new ones provides additional information to improve economic and labour market statistics. We will continue to explore the potential to boost other statistical surveys where they can add value to the evidence base. However, for tax-related analysis, surveys may not necessarily provide the most useful data source. The collection of accurate and comprehensive income information via statistical surveys is resource intensive. It is also very difficult to achieve adequate coverage of those at the top end of the income distribution. Furthermore, there is a tendency for very high income people not to report their income fully[2]. One of the few consistent messages from the evidence base on the behavioural impact of tax variations is that those on high incomes are most likely to be affected. A small number of very high income tax taxpayers also contribute a large share of income tax revenue, so their behaviour is of particular interest in this context.

For the reasons set out above, administrative data tend to be more useful for studying the impact of income tax variations. The most useful data source in the UK is the Survey of Personal Income (SPI) provided by HMRC. This is a sample of administrative tax data, combining people's tax information from the pay-as-you-earn and Self-Assessment systems, to provide a large, anonymised representative sample of the income tax base. This dataset, along with the Welsh rates of income tax outturn, will be the key pieces of Welsh-specific income tax data. The SPI will be improved when it covers 2019-20 and subsequent years, as it will include the Welsh flag to identify those tax payers who paid the Welsh rates. The SPI for 2019-20 is expected in summer 2022.

The Welsh Government is already working with HMRC on the methodology and format for the first Welsh rates of income tax outturn publication, due in the summer of 2021. There is also a regular working group with HMRC, the Scottish Government, the Scottish Fiscal Commission, and the Office for Budget Responsibility to progress improvements to income tax datasets and the dissemination of statistics.

<u>Financial Implications</u> – None. Any additional costs will be drawn from existing programme budgets.

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[1] For more details see; https://gov.wales/trade-survey-wales-2018

[2] See for example Burkhauser, Richard V. and Hérault, Nicolas and Jenkins, Stephen P. and Wilkins, Roger (2017) Survey under-coverage of top incomes and estimation of inequality: what is the role of the UK's SPI adjustment? Fiscal Studies. ISSN 0143-5671

Recommendation 4. The Committee recommends that the Welsh Government continues to press HMRC to improve taxpayer identification and closely monitors the tax coding error rate to ensure that cross-border migration is detected in a timely manner and accurate tax revenues are returned.

Accept

Maintaining the accuracy of the Welsh taxpayer population is fundamental to the administration of WRIT. The Service Level Agreement between Welsh Government and HMRC includes performance measures designed to ensure there is a continued focus on identifying and maintaining an accurate and robust record of the Welsh taxpayer population. The SLA includes a planned regular cycle of activity, including HMRC data scans, to ensure the accuracy of the data.

However, it is important to be clear there is no definitive dataset of Welsh taxpayers against which to judge identification. The C code scan, which is the basis of the tax coding error rate referenced in the recommendation is not the most effective assurance activity in relation to the identification of taxpayers moving across the border. The C code scan checks whether employers are correctly applying the C code issued, rather than whether HMRC has identified Welsh taxpayers and cross border movement correctly. For a C code to have been issued, the individual would have to have been identified as a Welsh taxpayer. The latest C code scan indicated an error rate of under 3%.

A process whereby HMRC undertakes a comparison exercise between Welsh tax records and third party data sources provides a better tool for corroborating HMRC's identification of Welsh taxpayers, and providing additional assurance that the address details HMRC holds are up-to-date. This exercise was run ahead of the implementation of WRIT, and enabled corroboration of the addresses held for 98-99% of the population with external sources. Further exercises will continue to be undertaken on a regular basis. The 1-2% of addresses that were not corroborated in this exercise are also not necessarily "wrong". The differences simply highlight where the address records are uncorroborated by third party data sets. In some cases, the address record held by HMRC may be more up to date that the third party data.

It is also important to highlight these activities are audited by the National Audit Office to ensure the adequacy of HMRC's rules and procedures put in place, in consequence of the Welsh rates provisions, for the purpose of ensuring the proper assessment and collection of income tax charged at rates determined under those provisions.

<u>Financial Implications</u> – None. Any additional costs will be drawn from existing programme budgets.

Recommendation 5. The Committee recommends that the Welsh Government's framework for developing new policies, and reviewing existing policies, should consider whether its policies will grow the economy and maximise tax revenues.

Accept

The Welsh Government sets out in its Tax Policy Framework, its approach to developing its tax policies within the delivery of the Welsh Government wider policy agenda, shaped by the following principles:

- Raise revenue to fund public services as fairly as possible;
- Deliver Welsh Government policy objectives, in particular supporting jobs and growth;
- Be clear, stable and simple;
- Be developed through collaboration and involvement;
- Contribute directly to the Well Being of Future Generations Act goal of creating a more equal Wales.

Through this Welsh Government aims to grow the economy and maximise tax revenues balanced with consideration of the impact on tax payers and the use of taxes as a lever to advance fairness and equality.

Financial Implications – None. Any additional costs will be drawn from existing programme budgets.

Recommendation 6. The Committee recommends that the Welsh Government develops policy options to attract the most responsive groups to Wales, such as high income earners and young graduates, to boost tax revenues.

Accept in principle.

As with recommendation 5, the embedding of the consideration of devolved tax levers within the framework for future policy development is a key element of the Welsh Government's tax policy framework. Considerations around targeting certain groups to boost tax revenues needs to be considered within the wider objectives of making Wales a fair and inclusive nation that delivers for all of its current and future citizens.

Financial Implications – None. Any additional costs will be drawn from existing programme budgets.

Recommendation 7. The Committee heard evidence of how influential non-tax factors are on the behavioural response of taxpayers and recommends that such factors must be considered as part of any future Welsh Government research relating to the impact of income tax variations across the Wales-England border.

Accept.

The influence of non-tax factors, and in particular any changes to these, will be considered by the Welsh Government when undertaking research on the behavioural response of taxpayers which result from income tax variations across the Wales-England border.

Financial Implications – None. Any additional costs will be drawn from existing programme budgets.

Recommendation 8. The Committee recommends that the Welsh Government considers the mechanism by which the Welsh Rates of Income Tax operates and how it promotes a bias towards increasing income tax rates.

Accept

Each of the UK income tax rates in Wales has been reduced by 10 pence, providing room for the Welsh Government to set a Welsh rate in each band. This enables the Welsh Government to vary the three rates individually while limiting its exposure to financial risk, as the tax base is still shared with the UK Government.

There is a different framework for income tax devolution in Scotland, which provides the Scottish Government with greater flexibility, but also exposes it to much greater financial risk. The whole of the non-savings non-dividend tax base is devolved and the Scottish Government can set its own rates and bands. As a consequence, the Scottish Government budget has greater exposure to variations in the Scottish tax base, including those arising from behavioural changes.

Given the way that income tax has been devolved in Wales, it does mean the Welsh Government's budget is less likely to be affected by behavioural impacts from rate changes than it would be under the Scottish model.

This issue applies in principle on a much wider basis. Changes to one tax can have an economic impact that affects revenues collected across a range of other taxes. As long as only certain taxes are devolved, or partially devolved, there will always be impacts from devolved tax changes which do not fall fully on devolved budgets. The same is true for non-devolved tax changes and non-devolved budgets. For example, a land transaction tax reduction may increase the number of property transactions and thereby increase spending in the economy. In that case, VAT receipts would increase in Wales but the additional revenues would accrue to the UK Government. In practice, the impact of these asymmetries on fiscal incentives is likely to be small.

Income tax devolution is still a very recent feature of the UK fiscal landscape. The recent outturn and projected outturn for Scotland has shown that there are potentially big differences in revenue growth between different parts of the UK. The differences between Scotland and the rest of the UK to date have been concentrated at the top end of the income distribution. The risk arising from this is reduced for the Welsh Government as it is only exposed to 10 pence of the 45 pence rate for additional rate payers and has a separate block grant adjustment for this element.

The Welsh Government will continue to assess how the current arrangements in Wales perform ensuring an appropriate balance between devolved tax levers and exposure to fiscal risk.

Financial Implications – None. Any additional costs will be drawn from existing programme budgets.

Recommendation 9. The Committee recommends that the Welsh Government considers policy options for utilising its Welsh Rate of Income Tax powers to deal with adverse economic conditions and cuts in public spending.

Accept

As with recommendations 5 and 6, the Welsh Government's Tax Strategy includes the key principle to "deliver Welsh Government policy objectives, in particular supporting jobs and growth". The balance between investment in public services, the competitiveness of the Welsh economy and the impact on tax payers will be at the forefront of decisions, just as we use taxes as a lever to advance fairness and equality, enabling us to tackle social issues, including justice and economic security.

Financial Implications – None. Any additional costs will be drawn from existing programme budgets.

Recommendation 10. The Committee recommends that the Welsh Government commissions research into the impact of mitigating personal income tax through incorporation and changing forms of income.

Accept in principle

HMRC models for forecasting income tax, which underpin the Office for Budget Responsibility's forecasts, already include adjustments to take account of the incentives to incorporate provided by differential tax rates. These adjustments are applied to the forecasts of the Welsh rates of income tax published by the Office for Budget Responsibility. Welsh Government analysts are involved in the meetings to discuss these adjustments and other elements of the income tax forecast. Any additional work on the potential impact of tax-motivated incorporation would most likely be commissioned through HMRC. The detailed data sets required and issues relating to tax payer confidentiality would make it difficult for other organisations to conduct research effectively in this area.

Financial Implications – None. Any additional costs will be drawn from existing programme budgets.

Recommendation 11. The Committee recommends that the Welsh Government gives further consideration to seeking the devolution of savings and dividend income to Wales and assesses the benefits and risks of securing this power.

Accept

While it would be appropriate to give further consideration to this issue it should be recognised that now is not the appropriate time. Income tax devolution in Wales is still very new, having only just completed its first operational year (2019-20). Due to the deadlines allowed for tax returns, the outturn from the first year of the Welsh rates of income tax is not due until next summer. From that the Welsh Government and UK Government will understand further how the current system is operating. As a result, discussions to date with the UK Government over income tax devolution have focused on ensuring the current arrangements are working appropriately.

Devolving this aspect of income tax would provide the devolved governments the opportunity to reduce the difference between the tax rates on different forms of income. However, doing so would create a difference in the rate of tax on dividend income between England and Wales. This is considered to be a relatively more mobile form of income, compared to the types of income tax which have already been devolved to Wales.

Financial Implications – None. Any additional costs will be drawn from existing programme budgets.

Recommendation 12. The Committee recommends that future Welsh Government research should consider potential spill-over effects of Welsh Rates of Income Tax policy on disadvantaged people, such as low income earners and individuals paying income tax whilst in receipt of Universal Credit.

Accept

The Welsh Tax Strategy Framework includes a requirement to raise revenue “as fairly as possible” and contribute directly to the Well Being of Future Generations Act goal of creating a more equal Wales.

In addition, from 31 March 2021 the Socio-Economic duty will come into force in Wales. This duty is aimed at delivering better outcomes for those who experience socio-economic disadvantage. This is will cover low income individuals and those on income related benefits, such as universal credit.

The Socio-Economic Duty will ensure that any future tax strategies or policy decisions take account of the evidence and potential impacts on those who suffer socio-economic disadvantage. This information can then be used to design policy accordingly and help take actions which could mitigate any potential negative impacts.

Ahead of the duty coming into force, the Welsh Government already considers how its policies, particular tax, affect those on the lowest incomes in society. One of its aims is to make tax more progressive, ensuring those with the broadest shoulders pay relatively more tax than those who are less fortunate in society and have lower incomes. The Welsh Government already has analytical models to help improve the evidence and measure the likely impacts to aid decisions on that basis. These will be of even greater importance following this duty.

Financial Implications – None. Any additional costs will be drawn from existing programme budgets.