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What if the Welsh Government raises or cuts taxes? Implications for revenues and behaviour

David Phillips

Background

- Tax devolution is not just about power to change rates and rules
  - Also provides Welsh Government with a more direct financial stake in performance of Welsh economy
- But government may want to change rates
  - To raise more revenue to spend on public services
  - To reduce taxes in an effort to boost competitiveness
  - To shift the burden of taxation between taxes and between people
- When developing strategy and specific policies understanding effects of policy changes will be key
  - Will a tax increase be offset by people leaving Wales or reducing taxable incomes?
  - Will a tax cut pay for itself by boosting economic activity?

(Almost) hot off the press…

ITV REPORT 24 September 2016 at 11:09am

Report claims Welsh tax cuts could boost revenues

Credit: Joe Giddens/PA Wire

A new report by Cardiff University says that the Welsh Government could increase revenue by cutting taxes - once the powers are devolved to Wales.

The report, by Professor James Foreman-Peck and Dr Peng Zhou, argues that cuts to the higher or additional rates would increase tax revenue over the long-term.

A cut would lead to lower tax receipts in the short term but the report says that a cut of the higher rate of income tax from 40% to 30% would bring in an additional £500m extra a year after 10 years.

Authors of the report also state an increase in the higher rate of income tax could see revenues fall. They say that an increase to 42.5% from 40% could reduce tax revenue by £240 million annually after 10 years.

- Unlikely to be the case
- This report looked at all revenues raised in Wales
- Doing this gives a misleading picture of cost/benefit of tax rate changes to Welsh Govt
  - Not all taxes devolved to Welsh Government
  - UK Government plans to keep most income tax, NICs, VAT, corporation tax, excise duties, etc.

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Remember plans are to devolve

- Stamp duty land tax (land transactions tax)
- Landfill tax (land disposals tax)
- (Potentially) part of income tax
  - 10 percentage points of the basic rate (UK rate = 20 – 10 = 10%)
  - 10 ppt of the higher rate (UK rate = 40 – 10 = 30%)
  - 10 ppt of the additional rate (UK rate = 45 – 10 = 35%)
- And Wales already has council tax and business rates

Imagine an income tax cut (I)

- Welsh Govt bears the full "mechanical" effect of the lower tax rate
  - e.g. 1 ppt cut in all income tax rates cost ~ £200 million
- If this leads to more people to move to Wales, or people in Wales to earn and declare more income, or spend more…
  - Welsh Govt gets any tax from its (now) 11% income tax rate
  - Stamp Duty, business rates, council tax
- Remaining revenues from this extra income accrue to UK Govt
  - Rest of income tax revenues
  - NICs, VAT, Duties, CGT, Corporation tax, etc..

Imagine an income tax cut (II)

- So from a Welsh perspective a tax cut is less likely to pay for itself
  - Some of the extra revenues in Wales go to Westminster
- New “Fiscal Framework” may give scope for Welsh Govt to negotiate with UK Govt to get some of this money
  - But difficult to calculate what any transfer ‘should’ be
  - And default likely to be no transfer
- Is it ‘unfair’ Welsh Govt does not reap all these behavioural rewards?
  - If a large part of response is a result of people or businesses moving to Wales then these rewards come at cost elsewhere in UK
  - Might reduce potential for tax competition to drive down tax rates and revenues across the UK

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Imagine an income tax increase

- Welsh Govt gains full “mechanical” effect of a higher tax rate
  - e.g. 1 ppt increase in all income tax rates raises ~ £200 million
- Welsh government only bears part of any behavioural cost of this
  - Its income tax, council tax, business rates, etc.
  - UK Govt picks up tab of lower NICs, VAT, etc.
- A tax rise is less likely to be counterproductive from a revenue perspective than if Welsh Govt bore full effects
  - Might this skew Welsh Govt decisions towards tax rises?
  - Need to consider wider economic impacts of policies

A few thoughts on behavioural response

- Unlike Scottish/English border, Welsh/English border is quite densely populated
  - Does that mean more scope for movement in response to tax differences?
- Welsh income tax will not apply to savings and dividends
  - Owner-managers dividends most responsive to tax policy, and employment income less responsive
  - Ability to swap corporate forms and income between sources in response to tax differences
- More of Wales' high earners are in the public sector
  - A less responsive group?

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Summary

- Welsh Govt will not have control of all Welsh Revenues
- So any economic boost less likely to “pay for” tax cuts
- And any economic hit less likely to “undermine” tax increases
- Benefit is less potential for tax competition that reduces revenues everywhere
- Potential cost is skew towards tax increases
- Important tax strategy keeps in mind wider economic and social objectives and interests of Wales