Welsh Parliament
Finance Committee

Inquiry into the implementation of the Wales Act 2014 and operation of the Fiscal Framework

February 2021

www.senedd.wales

The Welsh Parliament is the democratically elected body that represents the interests of Wales and its people. Commonly known as the Senedd, it makes laws for Wales, agrees Welsh taxes and holds the Welsh Government to account.

An electronic copy of this document can be found on the Welsh Parliament website: **www.senedd.wales/SeneddFinance**

Copies of this document can also be obtained in accessible formats including Braille, large print, audio or hard copy from:

Finance Committee
Welsh Parliament
Cardiff Bay
CF99 1SN

Tel: **0300 200 6565**
Email: **SeneddFinance@senedd.wales**
Twitter: **@SeneddFinance**

Welsh Parliament
Finance Committee

Inquiry into the implementation of the Wales Act 2014 and operation of the Fiscal Framework

February 2021

www.senedd.wales

About the Committee

The Committee was established on 22 June 2016. Its remit can be found at:
www.senedd.wales/SeneddFinance

Committee Chair:

Llyr Gruffydd MS
Plaid Cymru

Current Committee membership:

Alun Davies MS
Welsh Labour

Siân Gwenllian MS
Plaid Cymru

Mike Hedges MS
Welsh Labour

Mark Isherwood MS
Welsh Conservatives

Rhianon Passmore MS
Welsh Labour

Mark Reckless MS
Abolish the Welsh Assembly Party

The following Member attended as a substitute during this inquiry.

Mick Antoniw MS
Welsh Labour

The following Member was also a member of the Committee during this inquiry.

Nick Ramsay MS
Welsh Conservatives

Contents

Chair's foreword

In 2014 we saw one of the biggest changes to the Welsh devolution settlement for 800 years. The Wales Act 2014 provided for the devolution of tax powers including Welsh rates of income tax, Land Transaction Tax and Landfill Disposals Tax, as well as extending the Welsh Government's borrowing powers, with the fiscal powers being underpinned by the fiscal framework.

One of the Finance Committee's main functions is to scrutinise the Welsh Government's budget which is approximately £18 billion a year, primarily funded through the block grant. However, fiscal devolution has meant that approximately 20 per cent of the Welsh Government's spending is now funded from tax revenue increasing the accountability of the Welsh Government to the people of Wales.

As we approach the end of the Fifth Senedd term, Members of the Finance Committee felt it was important to reflect on the implementation of these powers and the effectiveness of the fiscal framework.

Evidence has shown that the administration of devolved taxes is working well, of particular note is the work of the Welsh Revenue Authority, who have played a vital role in the successful implementation of Welsh taxes.

However, the Committee firmly believe that evidence to the inquiry, alongside the real life issues experienced with the funding arrangements throughout the COVID-19 pandemic has shown that the funding mechanisms need to be urgently reviewed by the Welsh Government and the UK Government. The COVID-19 pandemic provided a prompt to consider the suitability of elements of the fiscal system, such as the Barnett formula – which has long been subject to calls for reform. The financial response to the pandemic has resulted in a significant amount of money being spent at UK level which has raised further issues on how the fiscal framework operates in Wales.

It is also apparent that the funding arrangements lack any form of independent arbitration – the UK Government acts as judge and jury and this is difficult for the Welsh Government in achieving clarity or challenging decisions, and the Committee considers this needs to be rectified.

The Wales Act 2014 is fundamental to the devolution settlement and the roles of the Welsh Government and the UK Government in delivering the Bill's objectives are intrinsically linked. Notwithstanding the wider issues happening during the course of this inquiry, it is disappointing that the Committee has had a lack of engagement with the UK Government. I hope that during the next Senedd this can be rectified and the further issues in this report can be explored with the UK Government and the Welsh Government.

Llyr Gruffydd,
Chair

Recommendations and Conclusions

Recommendation 1. The Committee recommends that the Welsh Government continues to build on the existing knowledge and awareness of Welsh taxes with the public, businesses and professionals to further improve awareness and engagement on fiscal devolution in Wales. .... Page 24

Recommendation 2. The Committee recommends that the Welsh Government and HMRC work closely to ensure an integrated and complementary engagement strategy on the Welsh Rates of Income Tax............ Page 24

Recommendation 3. The Senedd also has a role in educating, engaging, and informing the Welsh public on fiscal devolution and the Committee recommends that the Senedd Commission considers how it can contribute to this in the Sixth Senedd............ Page 24

Recommendation 4. The Committee recommends that the Welsh Government provides an update on how it is progressing considerations around targeting certain groups to boost tax revenues with the wider objectives of making Wales a fair and inclusive nation that delivers for all of its current and future citizens. .... Page 24

Recommendation 5. The Committee believes that the Welsh Government should have the legislative powers to respond quicky to tax policy changes but recommends that any future primary legislation underpinning these powers provides that the powers are only used in appropriate circumstances, such as to avoid distorting behaviour or when new avoidance or evasion opportunities need to be addressed immediately. .... Page 30

Recommendation 6. The Committee recommends that the Welsh Government provides an update on its work exploring the feasibility and impact of replacing council tax and Non Domestic Rates with a local land value tax. Recognising the impact COVID-19 may have had on this work, this should be provided to the Finance Committee of the Sixth Senedd .... Page 40

Recommendation 7. The Committee recommends that the Welsh Government responds with its view on the feasibility of the devolution of a capital gains tax and whether this could replace the need to seek competence on the vacant land tax. .... Page 40

1. Introduction

Background

1. The Wales Act 2014 (2014 Act) provided the legislative framework to devolve tax and borrowing powers to the National Assembly for Wales[1] and the Welsh Government. These powers provided the Welsh Government with further tools to vary the level of tax and spending in Wales, thereby increasing its accountability to the people of Wales.

2. In December 2016, the Welsh Government and the UK Government agreed a new Fiscal Framework. This agreement enabled the powers in the 2014 Act – and any further powers devolved under the Wales Act 2017 – to be implemented. In particular, it supported the devolution of Stamp Duty Land Tax – now Land Transaction Tax (LTT), Landfill Tax – now Landfill Disposals Tax (LDT) and the creation of Welsh Rates of Income Tax (WRIT).

3. The Fiscal Framework also covers the Welsh Government's Block Grant Adjustment (BGA), borrowing limits, budget management tools, treatment of policy spill-over effects and implementation arrangements.

4. Under section 23 of the 2014 Act, Welsh Ministers and the Secretary of State for Wales are required to report every year about the implementation and operation of the provisions under Part 2 of the 2014 Act until the first anniversary after the final provisions have been implemented.

5. On 14 December 2020, the Welsh Government laid before the Senedd its Sixth annual report by Welsh Ministers about the implementation and operation of Part 2 (Finance of the Wales Act 2014.

6. On 18 December 2020, the Secretary of State for Wales laid before the UK Parliament and Senedd its Sixth Wales Act 2014 Section 23 Implementation Report.

7. There are a number of Memorandum of Understandings underpinning fiscal devolution, including:

[1] On 6 May 2020 the National Assembly for Wales became the Welsh Parliament, to be commonly known as the Senedd. As a result, references in this document reflect the change of name, referring to the institution as the 'Assembly' in a historic context (prior to 6 May) and 'Senedd' thereafter.

- Memorandum of Understanding between HM Revenue and Customs (HMRC) and Welsh Government for the implementation of the Welsh Rate of Income Tax

- Arrangements between the Welsh Government and the Department for Work and Pensions for the Welsh Rates of Income Tax

- Agreement between the Welsh Government and Welsh Revenue Authority

- Terms of Reference between the Welsh Government and OBR - December 2020

Terms of reference

8. Given that the 2014 Act has been in operation for five years, the Committee felt it was a pertinent time to consider the 2014 Act and the operation and effectiveness of the Fiscal Framework.

9. The terms of reference for the inquiry were to look at:

Taxation

- The Welsh Government's tax principles, whether these have been met and whether the current tax regime and proposed new taxes align with these principles;

- How successful the administration of Welsh taxes and the Welsh Rates of Income Tax has been;

- What possible future tax changes could look like and what scope there is for a different approach to taxation in Wales;

- How the mechanism for devolving powers for new Welsh taxes has been performing.

The Fiscal Framework

- Consider the fiscal framework processes and how funding is allocated to the Welsh block grant;

- Examine the application of the Barnett Formula and the criteria for excluding specific funding from the formula;

- Consider the block grant adjustment mechanism and the effectiveness of the adjustment model;
- Review the suitability of the budget management tools such as the Wales Reserve, and the ability to borrow;
- Evaluate the treatment of spill-over effects and the mechanism for agreeing these effects;
- Draw comparisons between Wales and other international fiscal frameworks.

Context

10. Evidence for the inquiry has been taken during an unprecedented time, with the situation relating to the COVID-19 pandemic changing rapidly from day-to-day and the uncertainty over EU transition. The financial response to the COVID-19 pandemic has resulted in a significant amount of money being spent at UK level, which has raised further issues on how the Fiscal Framework operates in Wales. During the period of this inquiry, the Committee has conducted scrutiny of other fiscal matters which have been considered as part of this inquiry, including the Committee's work on the financial response to the COVID-19 pandemic, the funding announcement made as part of the Chancellor's Summer Economic Update, scrutiny of the UK Spending Review 2020 and the Welsh Government's Second Supplementary Budget 2020-21.

11. This report has been published in early 2021, during the Committee's consideration of the Welsh Government's draft Budget 2021-22 and shortly before the publication of the Welsh Government's Third Supplementary Budget 2020-21. The consideration of both are likely to raise further issues with the fiscal settlement not covered in this report.

Evidence

12. From 1 July 2020 to 4 September 2020, the Committee undertook a public consultation, receiving nine responses from a range of organisations and academics.

13. In addition, the Committee conducted a digital campaign during the autumn term. The campaign's objective was to identify public understanding, knowledge and opinion of fiscal devolution and taxation in Wales. A digital approach was implemented to ensure the Committee could engage with a substantial audience, while ensuring that the inquiry was accessible during a time of shifting COVID-19 restrictions. A summary note and infographic are provided.

14. The Committee took evidence from stakeholders and the Minister for Finance and Trefnydd (the Minister) between September 2020 and December 2020 (see Annex A).

15. The Committee invited the Secretary of State for Wales (Secretary of State) and the Chief Secretary to the Treasury (Chief Secretary) to give evidence to the inquiry. Unfortunately, due to the timing of the evidence session and the UK Spending Review the invitations were declined.

16. Given the Secretary of State's role in ensuring that the devolution settlement delivers a clear and strong settlement for Wales and that the economic interests of Wales are promoted, and the Chief Secretary's responsibility for treasury interest in devolution to Wales, the Committee felt it was vital to hear from them.

17. This report identifies a number of areas where further information is needed from the UK Government. In order to gather this information before dissolution of the Fifth Senedd, the Committee invited the Secretary of State and the Chief Secretary to provide evidence following the publication of this report but before a Plenary debate is held in March 2021. The Secretary of State is scheduled to provide evidence in March 2021. The Chief Secretary declined the invitation.

18. The Department for Work and Pensions (DWP) declined the Committee's invitation to provide oral evidence on the inquiry. The Committee wrote to the Secretary of State for Work and Pensions to express its disappointment that she would not give her permission for officials to attend.

19. Whilst recognising the constraints on the time of UK Government and the relevant officials, it is disappointing that the Chief Secretary and DWP have not engaged with this inquiry. The Wales Act 2014 was a fundamental piece of legislation in the devolution settlement and the role of the Welsh Government in delivering successfully is intrinsically linked with the UK Government, and the value of the scrutiny process is undermined by the lack of engagement from the UK Government.

20. The Committee would like to thank all those who have contributed to this inquiry.

2. Tax devolution

Background

21. The Wales Act 2014 legislated to devolve tax powers to Wales for the first time in almost 800 years. It enabled the Welsh Government to legislate in respect of areas to which Stamp Duty Land Tax and Landfill Tax previously applied. The Act also legislated for the partial devolution of income tax to Wales which was replaced by Welsh Rates of Income Tax (WRIT).

22. The Tax Collection and Management (Wales) Act 2016 put in place the legal framework necessary for the future collection and management of devolved taxes in Wales. In particular, the Act provided for the establishment of the Welsh Revenue Authority (WRA) whose main function is to collect and manage devolved taxes.

23. Specific information on the progression of these Welsh taxes can be found in the next chapter.

Tax principles

24. In 2017, the Welsh Government published its tax policy framework, which outlined the following principles for Welsh taxes:

- 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.

25. In September 2020, the Welsh Government published its latest Tax Policy Work Plan 2020-21, setting out its programme of work on devolved taxes. The work plan includes areas where the Welsh Government intends to focus on through to the end of the current Senedd.

26. The Welsh Government noted in its consultation response that its tax strategy has ensured that the taxes it has developed are fair to the businesses and individuals who pay them; which are simple, with clear rules, aiming to minimise the costs of compliance and administration.[2]

27. The Federation of Small Businesses (FSB) Wales agreed that the Welsh Government's main aims, such as a clear and stable tax system and a degree of involvement in tax policy, have been achieved throughout the development of Welsh taxes and that devolved taxes have on the whole been well managed.[3]

28. Dr Ed Poole of the Wales Governance Centre (WGC), said the tax principles are "very good principles on which to organise".[4] However, he added:

> "I would say at the moment—and this perhaps comes into the question about changing the legislation in order to be a bit more reactive to changes in tax policy that have been made in Westminster—the big changes in land transaction tax have been made very, very rapidly, and in some form they've actually scrambled to respond to tax decisions that have been made in Westminster. That's not a criticism—it's just saying that the time frame for working out changes to tax policy has been dictated by this process rather than by the budget cycle or by the tax cycle that you'd normally expect for decisions like this to be made."[5]

29. Professor Holtham felt the Welsh taxes were fair but there was some complexity to LTT:

> "Well, I think they're fair. I don't know how simple the changes are to the tax on housing transactions. They've made an effort to be fair at the cost of a little bit of complexity, I think, but I don't think they've done anything that I would want to criticise at this point."[6]

30. David Phillips of the Institute for Fiscal Studies (IFS) said that tax policy has been "pretty stable" and when policy has changed rapidly, such as LTT, there have been good reasons for it.[7]

31. Following the publication draft budget 2021-22 and The Land Transaction Tax (Tax Bands and Tax Rates) (Wales) (Amendment) Regulations 2020, the National

---

[2] Consultation Response: FFWA 05 Welsh Government

[3] Consultation Response: FFWA 03 Federation of Small Businesses

[4] Record of Proceedings (RoP), paragraph 8, 12 October 2020

[5] RoP, paragraph 8, 12 October 2020

[6] RoP, paragraph 6, 9 November 2020

[7] RoP, paragraph 5, 16 November 2020

Residential Landlord Association (NRLA) shared correspondence it had sent to the Minister with the Committee. The NRLA said:

> "The Welsh Government's own Budget Narrative document states in paragraph 3.10 that the move the unwind the lifting of the LTT threshold – "is consistent with the Welsh taxes principles of being clear and stable enabling citizens and business to plan with certainty". This move is not in keeping with the Government's own taxation principles, nor has there been any impact assessment carried out. While government can and do change taxes at short notices as part of a budget process, businesses and consumers are well aware that such changes may take effect from the date set for the budget. It is most unusual for such changes to be implemented immediately months ahead of such a budget in a draft set of proposals."[8]

32. The Committee asked the Minister how the changes to LTT rates announced on 21 December 2020 fit in with the Welsh Government's stated tax principles. The Minister said "It is important to recognise that, in terms of our principles, these rates do remain progressive"[9] and it was "desirable, where possible" to make announcements relating to tax as part of the draft budget because they are linked to the spending commitments that are made in the budget[10].

33. The Minister acknowledged that the timing of the draft budget "wasn't ideal" but said that was a reflection "that there was the cancellation of another planned UK budget in the autumn."[11] She added:

> "We have the one-year spending review, rather than the comprehensive spending review that we had been expecting. And of course we had to fashion, then, our budget within a four-week period. So, none of this really is ideal in terms of timing."[12]

---

[8] National Residential Landlords Association: Letter to Minister for Finance and Trefnydd, 5 January 2021

[9] RoP, paragraph 42, 8 January 2021

[10] RoP, paragraph 45, 8 January 2021

[11] RoP, paragraph 46, 8 January 2021

[12] RoP, paragraph 45, 8 January 2021

Awareness of taxation in Wales

34. In February 2020, the Welsh Government published Public understanding of tax devolution: update report 2020. The main findings of the report were:

- The majority of respondents said the UK Government has the most control over the taxes they pay in Wales.
- Most respondents did not know that the Welsh Government has been able to set some taxes in Wales since April 2018.
- There was a significant increase in awareness that the Welsh Government is able to set different Income Tax rates in Wales.
- Respondents were less likely to correctly identify who has responsibility for setting levels of tax you pay when you buy a house in Wales and tax on waste that is sent to landfill compared with other taxes.

> "Helping the public to understand more about devolved taxes should hopefully increase public awareness of the work of devolved institutions and why they should vote in Senedd elections"
>
> Committee digital engagement exercise

35. In 2018, the FSB in partnership with Bangor University conducted a survey[13] that was completed by small business owners and FSB members to review their awareness and understanding of the new devolved taxes. The FSB stated that its work, which included the opinions of business and professional services such as lawyers, found that:

> "FSB survey responses and solicitor interview data indicate there is a low level of public awareness about Welsh devolved taxes, including LTT."[14]

36. The consultation response from the Chartered Institute of Taxation (CIOT) and Low Incomes Tax Reform Group (LITRG) commended the approach of the Welsh Government in illustrating a link between taxes and spend on public services. However, the response raised concerns that:

[13] Funding Prosperity: Creating a new tax system in Wales

[14] Consultation Response: FFWA 03 Federation of Small Businesses

> "… awareness and understanding of the Welsh Rates of Income Tax by the public in Wales remains fairly low despite efforts to engage the public via the WRIT Communications Plan. We acknowledge the difficulty in generating interest when effective rates are unchanged."[15]

37. The Committee's digital campaign showed that more than half of the respondents were not aware that LTT, LDT and Non-Domestic Rates are the responsibility of the Welsh Government. With only 62 per cent of respondents aware that the Welsh Government is responsible for WRIT.

38. Respondents to the Committee's digital campaign said:

> "It should state clearly in payslips the tax that is paid as Welsh tax"
>
> "I wasn't aware if this. I have lived in Wales for 2.5 years. Is this applied automatically by HMRC?"
>
> "I don't think all the people of Wales fully know and understand the role and power of the Welsh Government and how our actual tax is spent"
>
> Committee digital engagement exercise

39. When asked about the awareness of WRIT, the Minister said:

> "… the baseline measurement awareness levels were taken ahead of its introduction in 2019, and I'm really pleased that we have seen a significant increase in awareness, of 14 per cent, by then, and I think that that is particularly positive, given the fact that rates haven't changed. You could imagine that were rates to change, the level of awareness would be much greater. But I'm seeking, really, to use the budget to set the context for the role that Welsh rates of income tax plays and to give it a greater profile as we continue to try and engage with individuals on this particular agenda.
>
> And as I mentioned previously, we're developing an interactive Welsh rates of income tax calculator, and that will illustrate for people how their Welsh rates of income tax are being spent on key public services in Wales. A link to that tool will be included with every individual's

[15] Consultation Response: FFWA 08 Chartered Institute of Taxation (CIOT) & Low Incomes Tax Reform Group (LITRG)

> annual tax summary in order for them to go online and investigate further, really, how their money is being spent."[16]

Welsh tax base

40. The Welsh Government's tax policy work plan 2020 noted that a primary area of focus was "continuing to take action to support growth in the Welsh tax base, and develop the means to monitor progress".

41. The WGC published its report on the Welsh Tax Base which outlined the risks and opportunities after fiscal devolution. The report highlighted that the WRIT would be the largest source of devolved revenue for the Welsh Government and therefore represents the largest proportion of the tax base.

42. The Committee explored the impact of variations in national and sub-national income tax and reported in July 2020. As well as examining international and domestic studies on the responsiveness of taxpayers to cross-border tax variations and the availability of Welsh-specific data to support academic modelling, the inquiry considered the Welsh tax base, income profiles and approaches to mitigating personal income tax. With 44 per cent of the Welsh population paying income tax (compared with 47 per cent of the UK's population), the Committee concluded that the Welsh Government must consider ways to develop the Welsh income tax base and maximise tax revenues.

43. When asked what policies could be implemented to grow the tax base in Wales, there was a consensus that policies should focus on attracting highly skilled and highly paid jobs to Wales. The WGC emphasised:

> "…the long-term way to improve the Welsh tax base is through highly skilled and highly paid jobs. That all takes a great deal of time, and it's working through mechanisms that aren't necessarily directly related to tax policy. Tax policy is one of them, but it's also to do with some of the competences that have been held by the Welsh Government since day one—so in terms of skills policy, in terms of infrastructure."[17]

44. David Phillips highlighted that Wales' output per person is lower than the UK as a whole. The biggest factor responsible for this is lower productivity, which

[16] RoP, paragraph 53 & 54, 30 November 2020

[17] RoP, paragraph 15, 12 October 2020

suggests focusing on attracting and retaining higher-skilled people and higher-productivity employers.[18] He said:

> "I think that means a focus on factors that could appeal to both sides. So, that means amenities and quality of life. I think we can't forget things like that—transport and digital infrastructure, good-quality public services. I don't think it's just about skills, or just about business support. It's about things that can address both sides of that equation."[19]

45. Professor Holtham, felt that the Welsh Government does not have all of the tools to grow the tax base:

> "They certainly don't have the tools to ensure it, they don't have the tools to mandate a growth in the economy—that's certainly the case. They have a few tools that could be used to encourage the growth of the economy, but it's not going to be an easy job."[20]

46. This view was supported by David Phillips, who felt that while the Welsh Government had powers in some areas, the UK Government had control of other areas, such as macroeconomic management and labour market regulations.[21]

47. The Minister noted that the Welsh Government is utilising key determinants to measure changes to the Welsh tax base, such as employment rates, wage growth, land construction and property market trends.[22]

48. The Minister added:

> "… one of the places where you'll see some of that work come together now is the national development framework—the national plan 2040—and that plan aims to support the growth in the tax base by identifying where housing and employment should be growing in future, and the kind of services and infrastructure that we would need to locate to support that as well. So, I think that that is one of the key areas of work where we're trying to support the increase of the tax base."[23]

[18] RoP, paragraph 16, 16 November 2020

[19] RoP, paragraph 17, 16 November 2020

[20] RoP, paragraph 15, 9 November 2020

[21] RoP, paragraph 12, 16 November 2020

[22] RoP, paragraph 12, 30 November 2020

[23] RoP, paragraph 13, 30 November 2020

49. When asked how the Welsh Government is developing policies to increase productivity in Wales by attracting highly-skilled jobs and increasing wage growth, the Minister used the Welsh Government's support in creating skilled jobs in the cyber sector as an example. She continued:

> "Wales is getting an increasingly good reputation, globally, as a leader in the cyber sector, and those jobs are really good jobs and they pay well, but then other challenges come with that, because we know that women and girls are less inclined to go into that sector as well. So, as well as putting that focus on cyber, then we need to surround that with the mechanisms to ensure that we also have that diverse workforce as well."[24]

Impact of COVID-19 on Welsh taxes

50. When asked how the pandemic could impact the tax base in Wales, David Phillips commented:

> "I think COVID will clearly reduce the tax take in the short term, although much less than it otherwise would have if we didn't have the furlough or the self-employment income support scheme, because tax will be paid on those, and it has prevented the loss of even more jobs. I think it's also likely to reduce the tax take in the medium term."[25]

51. This was supported by Professor Holtham, who published an article on the impact of the COVID-19 pandemic on the Welsh economy. He highlighted that business rates would decline and Wales' share of income tax receipts would fall by around £300 million if UK GDP contracted by 13 per cent as forecast.

52. However, Professor Holtham and David Phillips also agreed that a fall in Welsh tax receipts may be compensated by adjustments made to the Welsh block grant. David Phillips noted:

> "What actually matters for Wales and the revenues of the Welsh Government, though, is not just the absolute level of the Welsh tax revenues; it's how they've changed compared to revenues elsewhere in the UK, and that's because of the operation of the fiscal framework. If

[24] RoP, paragraph 15, 30 November 2020

[25] RoP, paragraph 21, 16 November 2020

> revenues elsewhere in the UK fall, the block grant adjustment is smaller."[26]

53. He further commented:

> "I actually think there are some reasons to expect overall the tax base and tax revenues in Wales to fall somewhat less than in the rest of the UK. So, financially, in the medium term at least, the Welsh Government could potentially be a bit better off…"[27]

54. The Minister highlighted the "huge challenge of COVID" and what that means for employment in Wales. She said:

> "… the immediate interventions that you've been seeing that we've been trying to introduce in order to save jobs in the first instance to ensure that those kind of scarring effects on the economy are minimised as much as we possibly can."[28]

Committee view

55. The Welsh Government implemented a set of tax principles at the initial stages of fiscal devolution and the evidence suggests that stakeholders view the principles as fair, and most feel that the Welsh Government has adhered to the principles.

56. The Committee notes that the Welsh Government's timeframe for making changes to LTT in summer 2020 was dictated by changes made in Westminster, following the UK Government's temporary stamp duty "holiday" rather than by the budget cycle or by the tax cycle. However, the Committee notes that recent changes to LTT have been made as part of the draft budget and it welcomes this approach, given that tax changes are linked to the Welsh Government's spending commitments.

57. The Committee recognises that taxation changes such as LTT often need to be implemented immediately to avoid distorting behaviour, however, this could be viewed as contradictory to the tax principle of enabling stakeholders to plan with certainty.

---

[26] RoP, paragraph 22, 16 November 2020

[27] RoP, paragraph 22, 16 November 2020

[28] RoP, paragraph 16, 30 November 2020

58. Whilst awareness of fiscal devolution is increasing in Wales, it is concerning to hear that the awareness of devolved taxes amongst businesses, professionals and other stakeholders is low. Whilst recognising that the digital engagement exercise undertaken by the Committee was limited in scope, as the sample was self-selecting and not based on a representative sample of the population, it does provide an interesting snap shot of views and it is disappointing that awareness of devolved taxes amongst the general public is relatively low – particularly WRIT - which most people pay regularly.

59. The fact that 27 per cent of participants skipped the question about taxation and borrowing in the Committee's digital engagement exercise could indicate that more needs to be done by both Welsh Government and this Senedd to raise awareness amongst the public of fiscal devolution in Wales.

60. The Welsh Government's approach of raising awareness by linking Welsh taxes to funding public services is commendable, but it is clear that knowledge of Welsh taxes needs improving. If the onus is on individuals to inform HMRC of movement between Wales and England, taxpayers need to be aware of this requirement.

61. The Committee reiterates the conclusions made in its recent report on the impact of variations in national and sub-national income tax, regarding the need for innovative strategies to develop the Welsh tax base. This must include implementing policies to increase productivity in Wales, which is deemed integral to growing the tax base, through areas such as the creation of highly skilled jobs and attracting high productivity employers.

62. In response to a specific recommendation in that report on attracting "the most responsive groups to Wales, such as high-income earners and young graduates, to boost tax revenues", the Welsh Government said "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."

63. The challenge of responding to COVID-19 is something the Committee has reflected on in all aspects of its work since March 2020. The pandemic will clearly reduce the tax revenue in Wales in the short to medium term and Professor Holtham's predictions on reductions in business rates and the Welsh share of income tax receipts is worrying. Whilst recognising that some of this may be compensated by adjustments to the block grant – this is not clear and this lack of clarity is concerning. The block grant adjustment process is considered further in chapter 6.

Conclusion 1. The Committee considers that on the whole the Welsh Government's tax strategy has ensured that the taxes it has developed are fair to the businesses and individuals who pay them.

Recommendation 1. The Committee recommends that the Welsh Government continues to build on the existing knowledge and awareness of Welsh taxes with the public, businesses and professionals to further improve awareness and engagement on fiscal devolution in Wales.

Recommendation 2. The Committee recommends that the Welsh Government and HMRC work closely to ensure an integrated and complementary engagement strategy on the Welsh Rates of Income Tax.

Recommendation 3. The Senedd also has a role in educating, engaging, and informing the Welsh public on fiscal devolution and the Committee recommends that the Senedd Commission considers how it can contribute to this in the Sixth Senedd.

Recommendation 4. The Committee recommends that the Welsh Government provides an update on how it is progressing considerations around targeting certain groups to boost tax revenues with the wider objectives of making Wales a fair and inclusive nation that delivers for all of its current and future citizens.

3. Welsh taxes

Land Transaction Tax

64. The Land Transaction Tax and Anti-avoidance of Devolved Taxes (Wales) Act 2017 introduced Land Transaction Tax (LTT) to replace the UK Stamp Duty Land Tax in Wales from April 2018. The Act also included measures to tackle the avoidance of devolved taxes.

65. LTT is a tax payable when purchasing property in Wales. There are different LTT rates and bands for different types of property. The rates and bands are set by Welsh Ministers and approved by the Welsh Parliament.

66. Until recently, the LTT rates and bands established in April 2018 have remained the same, including the additional tax imposed on the purchase of second homes and buy-to-let properties (the higher residential rates).

67. On 14 July 2020, following the announcement of a UK Stamp Duty holiday as a temporary measure intended to stimulate the housing market after the COVID-19 lockdown, the Welsh Government announced that it was bringing the rate payable for residential properties valued at between £180,000 and £250,000 down from 3.5 per cent to nil from 27 July 2020 until the end of March 2021.

68. Coinciding with the publication of the Welsh Government's Draft Budget 2021-22 on 21 December 2020, the Minister announced the following LTT changes from 22 December 2020:

- Increasing all higher residential rates bands by 1 per cent;
- Increasing the zero-rate band of the tax charged for lease premiums and assignments, and freehold property transfers from £150,000 to £225,000;
- Increasing the zero-rate band of the tax charged on the rent element of non-residential leases from £150,000 to £225,000.

69. The announcement also set out the Welsh Government's intention to increase the "relevant rent" amount for the annual rent element of non-residential rents from £9,000 to £13,500 in February 2021 and confirmed that the temporary increase to the nil rate band for residential property transactions will end on 31 March 2021.

Landfill Disposals Tax

70. The Landfill Disposals Tax (Wales) Act 2017 introduced Landfill Disposal Tax (LDT) to replace Landfill Tax from April 2018.

71. LDT is a tax payable on the disposal of material as waste to landfill. It is charged by weight and is payable by landfill site operators. The three LDT rates are set by the Welsh Government and approved by the Welsh Parliament.

	2018-19	2019-20	2020-21
Standard rate	£88.95 per tonne	£91.35 per tonne	£94.15 per tonne
Lower rate	£2.80 per tonne	£2.90 per tonne	£3.00 per tonne
Unauthorised disposals rate	£133.45 per tonne	£137.00 per tonne	£141.20 per tonne

72. Alongside the publication of the draft budget in December 2020, the Minister announced that LDT rates for 2021-22 will increase to:

- Standard rate – £96.70 per tonne;
- Lower rate – £3.10 per tonne;
- Unauthorised disposals rate - £145.05 per tonne.

73. To date, the standard and lower rates have remained consistent with UK landfill tax rates (there is no UK unauthorised disposals rate). This is also true of the rates proposed for 2021-22.

Administering Land Transaction Tax & Land Disposal Tax

74. LTT and LDT are collected by the Welsh Revenue Authority (WRA).

75. The WRA said its decision to be "100 per cent cloud based" from the beginning of its establishment has been very important, particularly over the last year during the pandemic.[29] The WRA said its digital services "make it easy for our taxpayers and their representatives to get their taxes right".[30]

76. The WRA stated that 98 per cent of tax payers file online and 87 per cent of transactions do not require manual intervention. It added:

[29] RoP, paragraph 97, 16 November 2020

[30] RoP, paragraph 97, 16 November 2020

> "… that's really allowed us two things. Firstly, it allows us to be really efficient, because we reduce the amount of manual processing, and secondly, because we've got such a high take-up, we're able to use the digital tax return as a really effective tool to help reduce tax risk and help people get it right the first time more often."[31]

77. Generally respondents felt that the administration of LTT and LDT was a positive experience. The Auditor General for Wales (AGW) has published three reports on the development and implementation of the Act and the AGW noted that:

> "In summary, all three of those reports were very positive, so our conclusion was that the WRA had operated effectively in terms of administration of the devolved taxes…"[32]

78. The CIOT and LITRG response noted that "its members indicated the administration of LTT and LDT was robust and successful. The WRA has developed effective guidance and digital systems. The WRA's guidance is well-developed with regular updates and includes meaningful examples and illustrations."[33]

79. FSB Wales developed a survey with Bangor University to look at how effectively devolved taxes had been administered in Wales. The findings demonstrated that the WRA has performed well in its administration of LTT.

Future changes to Welsh tax legislation

80. The Welsh Government undertook a consultation seeking stakeholders' views on what the right tools are to ensure that Welsh Ministers can make changes to the "Welsh Tax Acts" at short notice in the following circumstances:

- To stop avoidance or evasion of the devolved Welsh taxes;
- To comply with international obligations;
- In situations of exceptional need (such as in response to a tribunal or higher courts decision);

[31] RoP, paragraph 104, 16 November 2020

[32] RoP, paragraph 88, 28 September 2020

[33] Consultation response: FFWA 08 Chartered Institute of Taxation & Low Incomes Tax Reform Group

- In specific circumstances where Welsh Ministers consider it in the public interest to do so. In particular, in response to tax policy changes made by the UK government.

81. When asked whether such legislation would be necessary, the WGC used the recent changes to the LTT threshold in response to UK Government changes as an example:

> "I would say at the moment—and this perhaps comes into the question about changing the legislation in order to be a bit more reactive to changes in tax policy that have been made in Westminster—the big changes in land transaction tax have been made very, very rapidly, and in some form they've actually scrambled to respond to tax decisions that have been made in Westminster."[34]

82. Consequently, the WGC felt that the legislation would be beneficial:

> "Anything that would improve the flexibility of the Welsh Government's response to these overnight changes to tax rates and frameworks in England would be, on the face of it, a good thing. This has been a long-standing principle that the Westminster Government has had secrecy over its finance Bills and over its budget."[35]

83. David Phillips noted that "there are circumstances where you need to act rapidly", such as to address new avoidance or evasion opportunities immediately before tax revenues are lost or to limit the potential for UK Government tax policy changes distorting economic activity if the Welsh Government delayed responding to such changes.[36]

84. David Phillips also commented on the need for the Senedd to hold the Welsh Government to account when using these powers:

> "… I think what will be very important is to make sure these powers are used only in the limited and appropriate circumstances the Welsh Government has set out. So, there's a very important role for the Assembly, and, I guess, this committee, to make sure the Welsh Government is keeping its commitment to only use these powers in

[34] RoP, paragraph 8, 12 October 2020

[35] RoP, paragraph 10, 12 October 2020

[36] RoP, paragraph 8, 16 November 2020

> exceptional circumstances, not as part of the day-to-day tax policy making".[37]

85. The Minister said that the proposed legislation would provide Welsh Ministers with powers to make regulations in relation to the Welsh Tax Acts, using the provisional or made-affirmative procedure in specific circumstances. This would mean that the effect of such regulations can come into force immediately.[38]

86. The Minister continued:

> "the impact of not being able to make any immediate changes for things such as avoidance activity, for example, would be that that activity would continue until such time as the law changes. So, the proposed legislation would give us that ability to act quickly and in a very agile way. I think that's also important, because the UK Government sometimes undertakes measures and takes decisions that have a direct impact on our devolved taxes, and consequently on our budget.
>
> So, for example, where the UK Government makes changes to our predecessor taxes and those changes are introduced with immediate effect at a budget or shortly thereafter, then it could, for example, result in the greater tax effort being made by individuals across the border, and then, obviously, that would have an impact on our block grant adjustment, increasing the block grant adjustment and reducing the resources available to us. And, of course, the contrary would be the case if the UK Government took the opposite decision. So, clearly, there would be a need to operate and move very quickly in terms of our response, because there could be an impact directly on the Welsh Government's budget, and we might want to take decisions that are in the same field as well."[39]

Committee View

87. The Committee has regularly recognised the role the WRA has played in the successful implementation of LTT and LDT and it is reassuring that the WRA has continued to operate effectively in the administration of devolved taxes.

[37] RoP, paragraph 9, 16 November 2020

[38] RoP, paragraph 6, 30 November 2020

[39] RoP, paragraphs 7 & 8, 30 November 2020

88. The Committee is pleased that the WRA's investment into cloud based services has enabled it to continue working effectively through the pandemic. It is clear that the WRA's investment in technology has resulted in a sustained level of high service.

89. The Committee notes the Welsh Government's consultation on enabling changes to Welsh Tax legislation. The Committee believes that the Welsh Government should have the flexibility to respond quickly to tax policy changes that are made in Westminster. However, these powers should only be used in appropriate circumstances, such as where UK Government tax policy changes could distort economic activity if the Welsh Government were unable to respond quickly, or when it is apparent that there is a need to address avoidance or evasion opportunities immediately to prevent a loss of tax revenues.

90. Any legislation enabling changes to tax legislation will likely be considered by the next Finance Committee in the Sixth Senedd and it will be important that adequate time is allocated to scrutiny of the primary legislation and any subsequent secondary legislation.

Conclusion 2. The Committee has regularly recognised the key role the Welsh Revenue Authority has played in the successful implementation of devolved taxes, and continues to commend the organisation's innovative approaches and the commitment of its staff.

Recommendation 5. The Committee believes that the Welsh Government should have the legislative powers to respond quicky to tax policy changes but recommends that any future primary legislation underpinning these powers provides that the powers are only used in appropriate circumstances, such as to avoid distorting behaviour or when new avoidance or evasion opportunities need to be addressed immediately.

4. Future tax changes

91. Whilst the main fiscal levers used by the Welsh Government have been LTT, LDT and WRIT, evidence from this inquiry covered other options available such as property taxation and reforming council tax which are explored further in this chapter, along with the possibility of new taxes in Wales.

Property taxation

92. There were a range of views on implementing tax reform in Wales. The majority of evidence focused on property taxation given that the Welsh Government has comprehensive powers over these taxes. David Phillips stated:

> "One of the things I would like to see, actually, going forward is some more radical proposals for reform in one area, and that is property taxation. Wales has comprehensive powers over property taxation, and it has opportunities to make that fairer and more efficient, and I think the Welsh Government is considering that issue at the moment."[40]

93. Professor Holtham said that LTT was not a "great tax" as it's a tax "on turning over the housing stock…it's not a tax on the stock itself".[41]

94. When presenting the draft Budget 2021-22 to Committee, the Minister said of the changes to LTT:

> "… those people who are buying those more expensive properties will continue to pay more tax and at higher rates. The increase in the higher residential rates also increased the differential between, broadly speaking, people who are buying that home to live in and people who are acquiring second or further residential properties."[42]

Council tax

"I'd encourage Welsh Government to investigate alternatives to the current Council Tax system, whether those are piecemeal changes to the banding system or something more radical"

Committee digital engagement exercise

[40] RoP, paragraph 6, 16 November 2020

[41] RoP, paragraph 17, 9 November 2020

[42] RoP, paragraph 45, 8 January 2021

95. Witnesses suggested that the Welsh Government should focus on reforming council tax. It was highlighted by the WGC that although this tax is under the control of local government, the Welsh Government has the power to design a different taxation system in this area.[43]

96. The FSB considered that "the next Welsh Government could look to introduce local property indices instead [of council tax] which would be regularly updated and maintained by the VOA in Wales and would remove the need for a revaluation process".[44]

97. Professor Holtham was critical of council tax, saying it was highly regressive and should be proportionate to the value of the property:

> "So, someone in the Valleys with a £50,000 house is paying 2 per cent of the capital value in tax, whereas somebody in a £1 million house in Cyncoed, or somewhere, is probably paying, I don't know, 0.5 per cent… and if, say, everybody pays 1 per cent, you would halve the tax rate on houses at the bottom and you would probably multiply it by three or four at the top, which would be very unpopular, but that would be one way that you could make it fairer, and it would be a tax on wealth, on property, not on income, and wouldn't have such a discouraging effect on activity."[45]

98. This view was supported by the WGC who noted that "a more progressive system would ensure that higher level house prices would mean higher levels or higher percentages of council tax".[46]

99. The CIOT and LITRG reflected on a possible "local land tax" and suggested that council tax is unpopular:

> "Council tax tends to be unpopular in part because it is a 'dry' tax charge, that is, it is levied when no monies are generated with which to meet the liability, and in part because of its visibility; it is administered by regular demands for payment in contrast to less obtrusive income or national insurance taxes. The same would be to some extent true of a local land tax although there may be alternative means of collection for both council tax or a local land tax that could be considered, such as

[43] RoP, paragraph 28, 12 October 2020

[44] Consultation response: FFWA 03 Federation of small businesses

[45] RoP, paragraph 19, 9 November 2020

[46] RoP, paragraph 29, 12 October 2020

> the approach in Ireland of providing an option to have local property tax withheld from pay or pensions."[47]

100. In March 2020, the Welsh Government published its technical assessment on a local land value tax (LVT). It found that implementing LVT in Wales could raise sufficient revenues to replace current local taxes such as council tax and non-domestic rates.

101. The Minister commented that the Welsh Government had commissioned the Institute for Fiscal Studies to examine how revaluation and reform of council tax in Wales would affect the tax base and household incomes in order to make council tax fairer and more progressive.[48]

Non-Domestic Rates

102. FSB Wales noted in its consultation response that Non-Domestic Rates (NDR) also needed reform:

> "The general consensus is that the current system is unfit for purpose, but a complete abolition would cost too much. Abolition could also create a very imbalanced landscape across the UK. Options therefore focus on either replacing or reforming the current regime. Welsh Government has itself commissioned work from Bangor University into a Land Value Tax and has committed to reviewing both of those options in the medium term."[49]

103. FSB Wales' evidence included changes to the current NDR tax system, which it believed could "facilitate a more enterprising tax policy".[50]

Tax expenditure

104. Professor Holtham published an IWA article on Tax devolution post Brexit. He noted that Wales would potentially lose out on funding once EU structural funds are lost:

> "The UK government has spoken of a Prosperity Fund for the regions of the UK but the size is unknown and Wales will have to share it with the

[47] Consultation response: FFWA 08 Chartered Institute of Taxation & Low Incomes Tax Reform Group

[48] RoP, paragraph 20, 30 November 2020

[49] Consultation response: FFWA 03 FSB Wales

[50] Consultation response: FFWA 03 FSB Wales

> regions of England as well as the other devolved countries. The chances that Wales will get as much as it has been getting from the EU is somewhere between a dog's chance and no chance."[51]

105. To compensate for the loss of structural funds, he noted that the Welsh Government could seek tax expenditures:

> "Instead of just receiving cash grants it could demand tax expenditures i.e. arrangements whereby [the UK Government] provides tax incentives at some cost to its own revenue. For example, a proposal in the Holtham Commission report could be revived, namely that devolved countries could levy a lower rate of corporation tax."[52]

106. Professor Holtham further highlighted that the reduction would be limited according to how far the devolved country's Gross Value Added (GVA) per head fell below the UK average.[53] He said:

> "Wales, for example, has a GVA some 30 per cent lower than the UK average. It should therefore be able to reduce corporation tax by 30 percent from 19 per cent to 13 per cent, initially for a five-year period."[54]

Capital gains tax on property transactions

107. Professor Holtham's article 'Tax Devolution Post Brexit' referred to the devolution of capital gains tax on property to Wales:

> "We couldn't currently take income tax over, for example, whereas if—one of the things that has been talked about—you were to devolve capital gains tax on property, for example, I can see no reason why that shouldn't be administered in Wales in the same way as the property transfer tax is being administered."[55]

108. Professor Holtham noted that "capital gains tax is payable on houses other than a principal residence". In some parts of Wales, second homes or buy-to-lets are a significant part of the total housing stock.[56]

---

[51] IWA: Tax devolution post Brexit, 25 June 2019

[52] IWA: Tax devolution post Brexit, 25 June 2019

[53] IWA: Tax devolution post Brexit, 25 June 2019

[54] IWA: Tax devolution post Brexit, 25 June 2019

[55] IWA: Tax devolution post Brexit, 25 June 2019

[56] IWA: Tax devolution post Brexit, 25 June 2019

109. Professor Holtham said the tax is also payable by businesses on their physical assets – though they may get roll-over relief if they use proceeds to buy other assets for an ongoing business. He further emphasised that if this tax was devolved then the Welsh Government may not need to introduce a vacant land tax:

> "If Wales were able to set capital gains tax rates on sales of land holdings there would be less point in investigating a vacant land tax, as the Welsh government is currently doing – certainly if the point of the latter tax is to discourage speculative land banks held by developers. The administrative and valuation difficulties involved in introducing such a tax, in any case, seem disproportionate to the problem it seeks to address. Vacant land is a relatively small problem and the tax could be like using a road roller to crack a nut."[57]

Tax devolution mechanism

> "Bring in a tourism tax. They are common in many countries. Use revenue to protect the environment, mountains, beaches, rivers of Wales"
>
> "Wales should introduce a city visitor tax along the lines of Italy, the money should be spend locally on street cleaning, etc. This should include all holiday lets whether caravans, airbnb, hotel rooms or other"
>
> "I would suggest that all Welsh Councils charge normal C/Tax levels to their residents and charge other taxes for say a visitors tax as they do in Europe which would raise more money and this would be fair. Everyone who visited Wales as a non-householder, would pay the visitors tax"
>
> Committee digital engagement exercise

110. The Welsh Government highlighted in its consultation response that it was "continuing to work with the UK Government to secure the devolvement of tax competence in respect of vacant land".[58]

111. The Minister published a written statement which provided an update on the mechanism for devolving tax powers. It stated:

> "The experience of moving through the process has been protracted and challenging, with HM Treasury continually requesting detail related

[57] IWA: Tax devolution post Brexit, 25 June 2019

[58] Consultation Response: FFWA 05 Welsh Government

> to the specific operation of the proposed tax – a matter for Wales - rather than information related to devolving competence for legislation in a new area of taxation."[59]

112. The statement concluded:

> "It has become clear the agreed process for devolution of further tax competence to Wales is not fit for purpose, and in practice bears a striking similarity to the previous process of Legislative Competence Orders... The failure of this mechanism significantly impacts the ability of this government and future governments to use tax as a lever to influence behaviour or support public spending to meet the needs of the people of Wales."[60]

113. Professor Holtham agreed that the procedures for achieving consensus between both Welsh and UK Governments on what taxes, in principle, could be devolved, are not as clear as they might be.[61] He added:

> "the ability to acquire new taxes in Wales does depend on the consent of the British Government, and there's a very general principle that says things shouldn't be to the disadvantage of other parts of the United Kingdom. But there's not much case law, as it were, or much detail about how that's assessed. So, I think we're in the position that you could make an application, and the judge and the jury and the witnesses are all the same person, and so it's a little unclear how to proceed. If the British Government says 'no', what do you do then, even if your request is perfectly reasonable? So, I think it is something, like a lot of things in the British constitution, that would benefit from a little more clarity and perhaps a little more codification of what counts as damage and what's permissible."[62]

114. When asked whether the mechanism for introducing new taxes is fit for purpose, the Minister stated:

[59] Written Statement: Update on Welsh Government's formal request to UK Government for devolution of further tax competence to Senedd Cymru, 8 September 2020

[60] Written Statement: Update on Welsh Government's formal request to UK Government for devolution of further tax competence to Senedd Cymru, 8 September 2020

[61] RoP, paragraph 40, 9 November 2020

[62] RoP, paragraph 33, 9 November 2020

> "… the mechanism is set out in law in terms of the steps that Welsh Government would need to take in order to see the devolution of further tax powers, and we have, in really good faith, engaged with the UK Government for more than two a half years on this agenda within the context of a vacant land tax. My most recent meeting was in person with the Financial Secretary to the Treasury back in March of this year, and, at that point, I thought we had made some decent progress and that the next step then would be for him to write around to his colleagues in the UK Government to ascertain their views. But, unfortunately, in August we did receive a really disappointing letter that just sought to reopen the whole series of questions and debates that I thought had already been answered in previous negotiations. So, in that sense, the mechanism just hasn't proved fit for purpose."[63]

115. The Minister said the "crux of the problem" is that the UK Government "is the final arbiter on whether enough information has been provided to support a proposal".[64] She said:

> "I think that's one of the areas that we really need to review, because UK Government can, quite rightly, take a view on the competency issues, but then the policy issues really are for Welsh Government and the Senedd to be determining."[65]

116. The UK Government's Sixth Annual Report on the Implementation and Operation of Part 2 (Finance) of the Wales Act 2014, referred to the power to create new taxes and specifically in relation to the proposed Vacant Land Tax said HM Treasury was committed to working alongside the Welsh Government and:

> "… the Welsh Government and HM Treasury have been working to agree a draft Order and supplementary information so that it can be assessed, notably according to criteria set out in the Command Paper published alongside the Wales Bill in 2014.
>
> To allow the UK Government to assess a change to the UK tax system of this nature, a well-developed account of the tax envisaged is needed, including more information on the impact of the proposed tax and the

[63] RoP, paragraph 30, 30 November 2020

[64] RoP, paragraph 31, 30 November 2020

[65] RoP, paragraph 31, 30 November 2020

> interactions with devolved and reserved taxes and the wider effects for the UK tax system.
>
> This will allow the UK Government to make an initial assessment of, and subsequently undertake a consultation upon, the impacts on the UK tax system from devolving this power and to allow those likely to be affected to engage meaningfully with that consultation."[66]

117. The sixth annual report by Welsh Ministers about the implementation and operation of Part 2 (Finance) of the Wales Act 2014 addresses the progress made on devolving competence to introduce a vacant land tax:

> "The Welsh Government's experience of moving through the process has been protracted and challenging, with HM Treasury continually requesting detail relating to the specific operation of the proposed tax - which is a matter for Wales - rather than information related to devolving competence for legislation in a new area of taxation. It has become apparent there are serious flaws in the agreed process for devolution of further tax competence. As the process currently stands, it is difficult to envision a scenario whereby the Welsh Government could successfully make the case for further tax competence. The process needs urgent review and reform."[67]

118. The Minister expanded on this when giving evidence on the draft budget 2021-22, referring to the process as "extremely painful" and, whilst there were good relationships at official level, the Minister believed it to be a political decision to not progress vacant land tax devolution.[68]

119. The Minister continued:

> "We're currently considering whether there is a case now for some kind of third-party assessment of the information that we provide to support a proposal for the devolution of tax powers, to have that kind of independent view and oversight of it, because the situation at the moment feels very, very lopsided towards the UK Government in terms of the devolution of further taxes. It's very difficult to see how we would

[66] The UK Governments Sixth Annual Report on the Implementation and Operation of Part 2 (Finance) of the Wales Act 2014: December 2020

[67] Welsh Government: The sixth annual report by Welsh Ministers about the implementation and operation of Part 2 (Finance) of the Wales Act 2014, December 2020

[68] RoP, paragraph 87, 8 January 2021

> get anywhere at the moment, and this is a fairly non-controversial area of tax. So, we're considering whether that kind of third-party view would be helpful, and also exploring with colleagues in Scotland as to whether or not that's the kind of proposal that they would also think would be helpful and would support. So, I think that that will potentially be our next step, if you like, to push for that kind of independent view on whether or not we've provided the information as set out in the Act, which we believe that we have."[69]

Committee view

120. The Committee notes the evidence that council tax is seen as regressive and more progressive tax systems should be considered. The inquiry also raised issues with NDR, which was considered not fit for purpose by some respondents.

121. The Committee welcomes the Welsh Government's work to explore the feasibility of replacing both council tax and NDR with a local land value tax and its commitment to examining how revaluation and reform of council tax in Wales would affect the tax base and household incomes in order to make council tax fairer and more progressive.

122. The Committee received evidence that seeking devolution of capital gains tax on property transactions could negate the need to investigate a vacant land tax. The Committee understands it is possible for the Welsh Government to seek competence for a devolved version of capital gains tax an Order in Council under via section 116C of the Government of Wales Act 2006.

123. The Committee would like to determine whether the Welsh Government has considered the devolution of capital gains tax, as an alternative to the proposed vacant land tax, and whether the devolution of an existing tax may result in a shorter process than the establishment of new tax. The Committee will consider the possibility of the devolution of capital gains tax further with the Secretary of State.

124. The Committee is disappointed that there has not been further progress in the devolution of powers to enable a tax on vacant land to be introduced in Wales. This is a relatively uncontroversial tax and, notwithstanding the first attempt at seeking competence for a new tax taking longer to iron out the process, the Committee considers it unlikely that the intention was that the

[69] RoP, paragraph 88, 8 January 2021

process would take such a long time when the powers to create new taxes were included in the Wales Act.

125. In devolving a new tax it is clear that there are differing views from both Governments on the level of detail that needs to be provided and the UK Government has the ability to hold up the Welsh Government's proposals. The Committee will explore the process for the creation of new taxes further with the Secretary of State.

Recommendation 6. The Committee recommends that the Welsh Government provides an update on its work exploring the feasibility and impact of replacing council tax and Non Domestic Rates with a local land value tax. Recognising the impact COVID-19 may have had on this work, this should be provided to the Finance Committee of the Sixth Senedd

Recommendation 7. The Committee recommends that the Welsh Government responds with its view on the feasibility of the devolution of a capital gains tax and whether this could replace the need to seek competence on the vacant land tax.

5. Welsh Rates of Income Tax

Background

126. From April 2019, the Welsh Government has been responsible for setting the Welsh Rates of Income Tax (WRIT) that apply to non-savings and non-dividend income for Welsh taxpayers (wages, profits from self-employment, rental profits, pension income and taxable benefits), subject to the approval of the Welsh Parliament. Welsh taxpayers' taxable savings income, such as bank interest, or taxable dividend income, remains subject to the main UK rates of income tax for those types of income.

127. In April 2019, the UK Government reduced the three rates of non-savings and non-dividend income tax paid by Welsh taxpayers by 10 per cent:

- Basic rate from 20 per cent to 10 per cent;
- Higher rate from 40 per cent to 30 per cent;
- Additional rate from 45 per cent to 35 per cent.

128. The Welsh Government then decides the WRIT to be added to the reduced UK rates. To date, the Welsh Government has set the Welsh rates at the same level as in England and Northern Ireland, in line with its commitment to not increase income tax rates during the Fifth Senedd[70].

129. When outlining the draft budget for 2021-22, the Minister confirmed that the WRIT will remain at 10 pence for 2021-22.

130. HM Revenue and Customs (HMRC) administers WRIT through existing Pay As You Earn (PAYE) and Self-Assessment processes. HMRC is responsible for collecting and managing WRIT.

131. The Department for Work and Pensions (DWP) also plays a role in in WRIT. The tax and benefits systems are inter-dependent and the introduction of WRIT has consequential impacts for the DWP. DWP declined the invitation to provide oral evidence to this inquiry.

[70] Welsh Government, Welsh Tax Policy Report 2019, paragraph 12

132. The Comptroller and Auditor General (C&AG), is required to report annually on administration of WRIT, the report for 2019-20 was laid before the Senedd on 21 January 2021.

Identifying Welsh taxpayers

133. HMRC noted that, in order to effectively administer WRIT, it must identify and maintain an accurate and robust record of the Welsh taxpayer population.[71] It emphasised:

> "…for the arrangements to operate as they need to, it is of critical importance that we hold the correct addresses for Welsh taxpayers so that we can identify them as being Welsh taxpayers, and so, before the Welsh rates of income tax went live, we did a major exercise to cleanse our data, to corroborate that data with third parties, to achieve a high level of accuracy."[72]

134. However, HMRC acknowledged there have been challenges with employers failing to apply the right tax code:

> "Having done that, we then put a 'C' to identify all Welsh taxpayers and shared those tax codes with employers. We are then reliant on employers to operate those tax codes correctly, and, as we have been discussing, there have been some challenges with that, but, as Jackie outlined, we've made really significant progress since last April."[73]

135. HMRC concluded that:

> "HMRC's identification of Welsh taxpayers was correct in 98-99% of cases. This gave HMRC confidence that it correctly identified the vast majority of Welsh taxpayers."[74]

136. HMRC discovered that some Welsh taxpayers were incorrectly paying Scottish Rates of Income Tax (SRIT) when WRIT was implemented in April 2019. It found that 10.4 per cent of employers were not correctly applying the 'C' code to identify Welsh taxpayers, which was in part due to issues with payroll software used by some employers:

---

[71] Consultation response: FFWA 07 HM Revenue and Customs

[72] RoP, paragraph 121, 9 November 2020

[73] RoP, paragraph 121, 9 November 2020

[74] Consultation response: FFWA 07, HMRC

> "As soon as we identified this problem, we worked very closely and quickly with employers and with the software providers to put it right. So, that was a transitional issue. It's regrettable, but it has now been sorted out."[75]

137. HMRC commented that "the most recent scan, carried out in June 2020, showed that the percentage of employers failing to correctly apply the 'C' codes had reduced to 2.9%".[76]

138. HMRC said that keeping the database as accurate as possible, requires continuous monitoring and updating:

> "We will be running another exercise, similar to one run in 2018, where we compare our address data with a third party, and look at where there are discrepancies, writing or trying to contact the taxpayer and ask them about that to confirm their correct address, so that we can corroborate addresses where we can."[77]

139. The Welsh Government's consultation response stated:

> "Maintaining the accuracy of the Welsh taxpayer population is fundamental to the administration of WRIT. The Service Level Agreement (SLA) 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 regular cycle of activity, including HMRC data scans, to ensure the accuracy of the data. One of the key requirements is for HMRC to report annually on its delivery of the agreed services."[78]

140. The NAO in its annual report on the administration of Welsh income tax noted that the pandemic had delayed the scanning of taxpayer records:

> "HMRC scans taxpayer records to identify missing or invalid postcodes which would result in an incorrect residency status being applied. This was last performed in July 2019. The corresponding exercise was due to

[75] RoP, paragraph 122, 9 November 2020

[76] Consultation response: FFWA 07 HM Revenue and Customs

[77] RoP, paragraph 124, 9 November 2020

[78] Consultation response: FFWA 05 Welsh Government

> be undertaken in July 2020 but was delayed as a result of COVID-19 resourcing pressures on HMRC."[79]

141. The NAO further reported that if this process is not completed within the required timescales then there is a risk of misidentifying Welsh taxpayers:

> "HMRC is in the process of undertaking this work, with the intention that addresses will be corrected prior to the annual tax code exercise in early 2021. If the scans are not completed before tax codes are issued to employers, there is a risk that the tax codes will not correctly identify taxpayers as Welsh."[80]

142. The NAO also noted in its report that to ensure the taxpayer information HMRC holds is accurate and complete, a comparison is undertaken between its record of addresses and third-party data. However, the report highlighted that this exercise was not carried out in 2019-20 with HMRC proposing to run the data comparison exercise every two years from 2020-21.

143. In response to how confident the Minister was that HMRC has implemented appropriate processes for identifying taxpayers responsible for paying WRIT, she said:

> "We've got a really good relationships with HMRC in terms of how we are working with them on this particular agenda. We've got a service level agreement between Welsh Government and HMRC, and that includes some performance measures designed to ensure that there's a continued focus on ensuring that we have identified and maintained an accurate and robust record of taxpayer population here in Wales. There's a regular cycle of activity included in that service level agreement, including the HMRC data scans, for example, to ensure that the data is accurate. So, I do think the system that we have is working well there."[81]

144. The Minister's official added that HMRC uses a variety of techniques to identify if a person is a Welsh taxpayer:

> "…for example, one of the things that they do is something called the data clash, where they take their own database of Welsh rate taxpayers

[79] National Audit Office: Administration of Welsh income tax 2019-20, 21 January 2021

[80] National Audit Office: Administration of Welsh income tax 2019-20, 21 January 2021

[81] RoP, paragraph 35, 30 November 2020

> and they compare that to other data sources that may be relevant—electoral registers, a variety of other data sources. And where there's a mismatch between the two things, then they will correspond with the taxpayer and give them an opportunity to correct things if they've been incorrectly attributed as a Welsh rate of income tax payer or the other way around. None of these things are entirely perfect, but there are some methods that can be used to try to whittle down the number of mistakes in the system."[82]

145. The Minister said HMRC is "making constant improvements" and confirmed that the latest HMRC scan showed a 2.9 per cent error rate which was down from 3.3 per cent earlier that year.[83]

WRIT awareness

> *"When it came to WRIT, 57% of respondents knew that Welsh Government had 'some' control over income tax rates. With 62% of respondents saying that they were aware that Welsh Government is able to vary the rates of income tax paid by Welsh taxpayers. Also 66% of respondents correctly identified that 10 pence in every £1 of income tax goes directly to Welsh Government."*
>
> Committee digital engagement exercise

146. HMRC noted that it had communicated with Welsh taxpayers ahead of the introduction of WRIT to inform them of the upcoming changes to the tax system. In November 2018, a bilingual letter was sent to 2.01 million HMRC customers identified as being resident in Wales and a "range of communications activity supported this letter, targeting employers, software providers, pension providers, tax professionals, and others".[84]

147. When asked how effective its communications strategy has been, HMRC reported:

> "It's certainly the case that, when we launched the Welsh rates of income tax project, when it went live at the beginning of the last tax year, there was a very, very strong communications push. I know this for a fact because it was all over all of my social media feeds, which was

[82] RoP, paragraph 43, 30 November 2020

[83] RoP, paragraph 45, 35 November 2020

[84] Consultation response: FFWA 07 HM Revenue and Customs

> absolutely fantastic to see, in both English and in Welsh. As you say, at the moment, with the rates being the same, possibly not everybody focuses on it as much as they might."[85]

148. HMRC said a key part of its communications approach is to continue "reminding people of the critical importance of keeping their address details up to date… to make sure that the whole system is operating as we need it to".[86]

149. HMRC confirmed that it monitors the success of its communications strategy by tracking the number of people contacting it with queries or any confusion about the arrangements. HMRC commented:

> "And those levels of contact and confusion are very, very low indeed, which suggest to us that we've got the approach right for now. Obviously, as and when issues arise, Welsh Government officials raise those with us and we work those through."[87]

150. However, CIOT & LITRG, in its joint consultation response, were concerned about the awareness and understanding of WRIT by the public in Wales, which anecdotally remains fairly low despite efforts to engage the public via the WRIT Communications Plan. They did acknowledge the difficulty in generating interest when effective rates are unchanged.[88]

151. The Committee's digital campaign showed that only 62 per cent of 692 respondents were aware that the Welsh Government is responsible for WRIT.

152. The Minister highlighted the importance that "individuals understand that Welsh Government is now the beneficiary of part of the tax that they pay". She said the Welsh Government was making improvements in terms of raising awareness of WRIT through its annual tax summary which "will show a breakdown…of how their Welsh rates of income tax have been spent."[89]

153. The Minister also said that the Welsh Government was developing an interactive WRIT calculator that will illustrate for individuals how their WRIT is being spent on key public services in Wales. She said that "tool will be included

---

[85] RoP, paragraph 132, 9 November 2020

[86] RoP, paragraph 132, 9 November 2020

[87] RoP, paragraph 133, 9 November 2020

[88] Consultation response: FFWA 08 Chartered Institute of Taxation & Low Incomes Tax Reform Group

[89] RoP, paragraph 35, 30 November 2020

with every individual's annual tax summary in order for them to go online and investigate further".[90]

Welsh data

154. The Service Level Agreement between HMRC and the Welsh Government requires HMRC to:

- Provide the Welsh Government with sufficient relevant and timely information and data for rate-setting and forecasting for WRIT;
- Provide the Welsh Government with sufficient relevant and timely information and data to discharge its duties in respect of cash management due to any change between forecast and collected amounts of WRIT.

155. HMRC said that the key information it shares with the Welsh Government is real-time information data from the PAYE system on a monthly basis. It was noted that this "provides real-time information about employee liabilities, and provides, for example, a breakdown across the tax bands".[91]

156. However, this data does not provide the full picture with HMRC stating:

> "…we can never expect that to be 100 per cent accurate in real time, primarily because until the self-assessment returns are completed at the end of the year we won't have the full picture, and also, of course, there are ongoing in-year adjustments."[92]

157. HMRC also highlighted its project to deliver longitudinal data:

> "…we are also in discussion with both Welsh and Scottish colleagues on a new project to put in place a longitudinal data set to make sure that we can track the impacts of introducing devolved income taxes over time."[93]

158. The Minister reported that datasets have been improving due to the work of the analytical working group which was established to identify the most useful tax

---

[90] RoP, paragraph 54, 30 November 2020

[91] RoP, paragraph 138, 9 November 2020

[92] RoP, paragraph 138, 9 November 2020

[93] RoP, paragraph 142, 9 November 2020

data and includes officials from HMRC, Welsh Government and Scottish Government.[94] She said that:

> "information is now being provided more promptly and in greater detail than previously, which is also to be welcomed as well. I think that officials would also say that there are still opportunities for further improvements, but it is very much constraints around taxpayer confidentiality and the long lags in data due to the way that self-assessed tax data is collected."[95]

Committee view

159. The Committee has monitored the establishment and implementation of WRIT, and welcomes the successful working relationship that has developed between the Welsh Government and HMRC. It is disappointing that there have been issues with the identification of Welsh taxpayers, however, the Committee notes that the latest HMRC scan showed an improvement.

160. It is disappointing that levels of awareness of the WRIT are still low and, whilst appreciating that the levels of tax remain the same across England and Wales, there is little incentive for Welsh taxpayers to understand that part of their income tax goes directly to the Welsh Government. However, efforts should still be made to ensure an increased awareness of WRIT amongst Welsh taxpayers.

161. The Committee welcomes the development of an interactive WRIT calculator that will illustrate how an individual's WRIT is being spent on key public services in Wales. The Committee believes the inclusion of this tool in individuals annual tax summary will contribute to increased awareness.

162. Awareness raising for WRIT has primarily fallen to the Welsh Government and HMRC but there is a role for the Senedd in increasing knowledge of WRIT and fiscal devolution, and the Committee would like to see additional engagement activity in this area as mentioned in recommendation 3.

163. The Committee notes the requirements for HMRC to provide the Welsh Government with relevant and timely information for rate setting and forecasting and to enable the Welsh Government to manage its budget in respect of changes between forecasted and collected amounts of WRIT.

[94] RoP, paragraph 57, 30 November 2020

[95] RoP, paragraph 57, 30 November 2020

164. Whilst HMRC provides key information monthly to the Welsh Government, it is noted that this information is not 100 per cent accurate due to the ways data is collected. The Committee would hope that the accuracy of data improves as time passes.

165. The Committee notes the third-party comparison exercise to maintain an accurate and complete database would be undertaken every two years. The Committee consider this exercise should be conducted in a timely manner in order to maintain an accurate database, and would urge the Welsh Government and HMRC to ensure this happens as planned.

Recommendation 8. The Committee recognises the importance of tracking the impacts of WRIT over time and recommends that the project to deliver longitudinal data should be a key priority for the Welsh Government and HMRC.

Recommendation 9. The Committee recommends that the Welsh Government provides an update on how it is reviewing HMRC's activities to minimise coding errors and monitoring the database of Welsh taxpayers to identify migration across the Wales-England border throughout the year.

6. Money allocated by the UK Government

166. Wales receives a budget allocation determined by the UK government in accordance with the 'Statement of Funding Policy'; the 'block grant'. Adjustments to the block grant are determined using the Barnett formula.

167. The Barnett formula is used to calculate changes to the block grant based on increases or decreases in UK Government spending in areas where public service provision in Wales has been devolved.

Spending reviews

168. Due to the 2019 UK General Election there were issues with the timing of the UK Budget for 2020-21, and this impacted on the timing of the Welsh Government draft Budget for 2020-21. These issues are covered in the Committee's report 'Scrutiny of the Welsh Government Draft Budget 2020-2021'.

169. In June 2020, the Chair of the Committee sent a joint letter with his counterpart in the Scottish Parliament and the Northern Ireland Assembly, stressing the need for an early UK Budget to ensure that devolved governments can plan and to allow for optimum scrutiny:

> "… the appropriate level of parliamentary scrutiny of the devolved governments' budgets has a dependence on the timing of the UK Budget - given the interplay between the block grant including the adjustments and reconciliations and the operation of the Fiscal Framework more widely. At the same time, the ongoing uncertainty arising from the impact of the COVID-19 Pandemic and the end of the transition period following Brexit inevitably means that this year's budget process will be more challenging for the Governments of all 4 nations across the UK. Therefore, you will understand that all of our Committees believe that the opportunity for robust parliamentary scrutiny is even more essential than normal."[96]

170. In Plenary on 6 October 2020, the Minister noted the Chancellor's decision to cancel the UK autumn budget, the uncertainty around the UK comprehensive spending review and the lack of information on replacement EU funding making the Welsh Government's "task harder".

[96] Correspondence to Rt Hon Steve Barclay MP, Chief Secretary to the Treasury; 29 June 2020

171. During scrutiny of the draft budget 2021-22, when asked about engagement with the Treasury leading up to the spending review the Minister said:

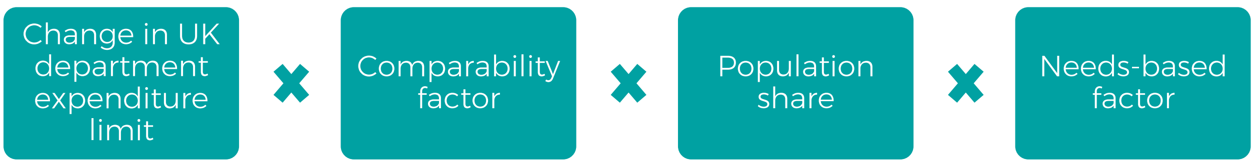
> "I've been in this portfolio since 2018 and this is my first spending review, and I was absolutely surprised at the lack of engagement that there was. I did think that there would be detailed meetings exploring these particular issues, especially in such an important year, when we're talking about replacement EU funding, and so on. But there were no meetings of that sort."[97]

The Barnett formula

> "Regardless of how much money we raise in Wales through taxes, we should still receive money as 'top up' from UK Govt, as we are a poorer area of the UK. Although, Barnett should be reformed so that more money com es to Wales"
>
> Committee digital engagement exercise

172. The Barnett formula was modified as part of the Welsh fiscal framework agreement to include a needs-based factor. This change represented the first major modification of the Barnett formula since its introduction in the late 1970s.

Figure 0.1. Modified Barnett formula



173. At the 2015 Spending Review, the UK Government introduced a "funding floor". This mechanism was designed to prevent per-capita funding for the Welsh Government from falling below 115 per cent of comparable spending per person in England for the duration of the current Parliament.

174. When the Fiscal Framework was agreed, the relative funding per head in Wales compared to England was over 115 per cent. The Fiscal Framework noted that as long as this remained above 115 per cent the factor would be set at 105 per cent. The WGC commented:

97 RoP, paragraph 95, 8 January 2021

> "…the very rapid growth in spending over the last two years has had some interesting consequences. First of all, the needs-based factor has resulted in a lot more additional funding than we would have expected when the agreement was signed in 2016. So, it's around £360 million of additional funding over the last three years for the Welsh Government, as a result of the needs-based factor being in place."[98]

Funding floor review

175. A report published by the IFS and WGC in February 2017, assessed the fiscal framework agreement. The report highlighted that "for the first time, the Barnett formula will include explicit recognition of the higher level of spending need in Wales".[99]

176. However, the report mentioned that the needs-based factor would require updating:

> "The absence of any commitment to reassess the level of relative need in Wales in the future is notable in the agreement. This could mean that the post-transitional period needs-based factor of 115% (which may not come into effect much earlier than 2040) will be based on an assessment of relative need from 2010, which in turn was based on much earlier data, including the 2001 census. Given different economic and demographic trajectories, the level of relative need for public spending in Wales compared with England is unlikely to remain unchanged."[100]

177. The report further noted:

> "If there is no intention to update the assessment of relative need (and hence the basis of the needs-based factor), then the Welsh Government will in effect bear the risks and rewards of its spending needs changing from this initial (and already out-of-date) level over the period of this agreement."[101]

---

[98] RoP, paragraph 50, 12 October 2020

[99] Wales Governance Centre: Fair Funding for Taxing Times? Assessing the Fiscal Framework Agreement, February 2017

[100] Wales Governance Centre: Fair Funding for Taxing Times? Assessing the Fiscal Framework Agreement, February 2017

[101] Wales Governance Centre: Fair Funding for Taxing Times? Assessing the Fiscal Framework Agreement, February 2017

178. Audit Wales suggested that the Committee may wish to explore with the Welsh Government how the new needs-based formula would work if the UK returned to a period of austerity in future.[102]

179. Audit Wales highlighted that the fiscal framework agreement mentioned "from 2018-19 and for the remainder of the current spending review period, all uplifts to Welsh Government DEL above the level in 2017-18 will attract the 105 per cent factor, while any reductions below the 2017-18 level will be applied without the additional factor".[103]

180. However, Audit Wales felt that the Committee might want to seek clarity on whether this would last beyond the current spending review period:

> "Given the current state of public finances and the possibility of a fiscal squeeze at some point, we just thought it was something that the committee may want to get clarity on, in terms of the Welsh Government's current understanding of that protection and whether or not it expects it to apply to future spending review periods."[104]

Needs-based formula

181. The Welsh Government's written evidence details:

> "The needs based factor has been applied to changes in the Welsh Government's block grant since 2018-19, compared to a 2017-18 baseline. It has delivered a total of around £360 million additional funding to date, with about half of that in relation to coronavirus funding in 2020-21."[105]

182. Professor Holtham highlighted previous work he had carried out in 2010[106] on a needs-based formula, which he suggested would be more suitable for tailoring the allocations to need:

> "I think many people would agree that it would be better if the Barnett formula explicitly contained elements that tailored the allocations to need, and it's quite a long time ago now—about 10 years ago—that we

[102] Consultation response: FFWA 01 Audit Wales

[103] Consultation response: FFWA 01 Audit Wales

[104] RoP, paragraph 137, 28 September 2020

[105] Consultation Response: FFWA 05 Welsh Government

[106] Independent Commission on Funding & Finance for Wales: Fairness and accountability: a new funding settlement for Wales, July 2010

> produced a formula that was quite simple, it only had four or five elements in it, but went quite a long way to showing how you could adjust the Barnett formula on a needs basis. And if that were the case, then expenditures currently in England would have a Barnett consequential that was adjusted for need."[107]

183. David Phillips recommended that the Committee looked at Professor Holtham's work from 2010 "to make sure whatever system is in place actually is delivering the appropriate level of funding for Wales".[108]

184. The Minister agreed that a needs-based funding system across the UK would be an appropriate approach to allocating funding to the devolved administrations, which has been proposed in the Welsh Government document for reforming UK funding and fiscal arrangements after Brexit.

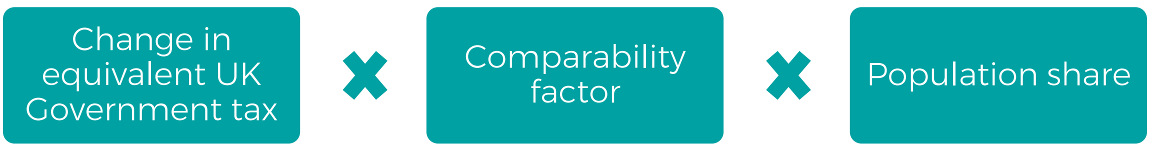
185. The Minister added:

> "But I think there are some benefits to the Barnett formula, and we've seen them through the COVID crisis in the sense that it allowed Welsh Government to receive funding in a very quick way. So, that kind of speed I think was really useful for us in terms of allowing us, then, to respond with speed to the challenges of COVID. So, while being far from ideal, it does at least allow the rapid allocation of resources to devolved administrations, and we've seen the benefit of that."[109]

Block grant adjustment

186. The comparable model, as set out in the Fiscal Framework, is used to calculate the block grant adjustment (BGA) for devolved taxes in Wales. The BGA is determined by a tax-capacity adjusted population share of the change in equivalent UK Government revenues in England and Northern Ireland.

Figure 2. Comparable model for calculating block grant adjustments



[107] RoP, paragraph 44, 9 November 2020

[108] RoP, paragraph 63, 30 November 2020

[109] RoP, paragraph 63, 30 November 2020

187. The comparability factor reflects tax per head in Wales as a proportion of the corresponding UK Government tax per head at the point of devolution. The population share is based on Wales' population as a proportion of the population of England.

188. When asked how the comparable model was performing, the WGC noted that the fiscal framework included applying the comparable model to each band of income tax, which would be important during the pandemic:

> "At the moment, although it's far too early to tell definitively, we're seeing an increase in income inequality, so you'd imagine that the basic rate tax payers will be affected more by the COVID-19 crisis, and the fact that that's relatively more important for the Welsh tax base as a whole, that separate block grant adjustment will be a positive thing for the Welsh Government to protect it against that increase in income inequality across the UK."[110]

189. However, Professor Holtham stated that the comparable model exposes the Welsh Government to population risk. He said that:

> "Even if revenue growth per head is the same in Wales and ENI [England and Northern Ireland] the Comparable Model will lead to the BGA deduction growing if Welsh population growth falls short of that in ENI – which is not true of the proportionate adjustment."[111]

190. A range of evidence was submitted linking the comparable model to the COVID-19 pandemic. The WGC noted that the pandemic would test the appropriateness of the model:

> "Yes, and I think COVID-19 probably will be a bit of a litmus test for this comparable model and for the principle of linking the block grant adjustments to comparable revenues in the rest of the UK."[112]

191. During evidence to the Welsh Affairs Committee, David Phillips stated that "one thing that could address the long-run impacts of a bigger hit to the Welsh economy [as a result of the pandemic] would be to update the block grant adjustments to account for changes in the relative size of the Welsh tax base. As it

[110] RoP, paragraph 64, 12 October 2020

[111] Additional Information following Professor Holtham's attendance on 9 November 2020: Block Grant Adjustment

[112] RoP, paragraph 63, 12 October 2020

stands, these block grant adjustments are set to be based on pre-coronavirus relativities indefinitely".[113]

192. He further explained:

> "Updating these fully or partially for future years would increase the Welsh Government's budget if its tax base is relatively smaller in future than it was when the BGAs were initially set (e.g. if the Welsh economy is hit harder on a long term basis); but would reduce the Welsh Government's budget if its tax base is relatively larger in future (e.g. if the Welsh economy is hit less hard on a long term basis)… Whether the Welsh economy will be hit harder or not is difficult to say."[114]

193. The Welsh Government said that it is difficult to assess the BGA for Wales at this stage because of the delay in out-turn information.[115] Furthermore the Welsh Government believed that:

> "The long lag before reconciliation adjustments are applied can clearly lead to budgetary issues in future years, as has recently been observed in Scotland.
>
> The differences between income tax devolution in Wales and Scotland are likely to mean that reconciliation issues are less severe in Wales. In Scotland, all income tax on non-savings non-dividend income is devolved. With just 10p of each tax rate devolved in Wales, the Welsh Government has less exposure to the risks associated with differential income tax revenue growth. The separate BGAs for each income tax band in Wales should also help to reduce this risk, by weighting the overall BGA in a way that more closely resembles the Welsh income tax base. Scotland has a single BGA for income tax.

194. The Minister said the Welsh Government's long-term aim is for a "much more needs-based funding system that operates consistently across the UK". She continued:

> "You'll have seen that set out in the two documents: 'Reforming UK funding and fiscal arrangements after Brexit: Securing Wales' Future',

[113] Written evidence submitted by David Phillips, Associate Director, Institute for Fiscal Studies (COV0028)

[114] Written evidence submitted by David Phillips, Associate Director, Institute for Fiscal Studies (COV0028)

[115] Consultation response: FFWA 05 Welsh Government

> and then also in the finance section of the 'Reforming our Union: Shared Governance in the UK' document. But I think there are some benefits to the Barnett formula, and we've seen them through the COVID crisis in the sense that it allowed Welsh Government to receive funding in a very quick way. So, that kind of speed I think was really useful for us in terms of allowing us, then, to respond with speed to the challenges of COVID. So, while being far from ideal, it does at least allow the rapid allocation of resources to devolved administrations, and we've seen the benefit of that."[116]

Transparency

195. The National Audit Office (NAO) published its report on the 'Investigation into devolved funding' in March 2019. The report covered:

- The way the UK government allocates funding to the devolved administrations and the adjustments that are required, particularly in light of devolution of tax and revenue-raising powers;
- The different UK government funding streams available to the devolved administrations and the mechanisms for calculating and allocating funding;
- The implications of changes in UK government spending plans and how these impact on the funding allocated to the devolved administrations.[117]

196. The report noted that, unlike UK government departments, the devolved administrations are not involved in direct negotiations with HM Treasury on their funding settlements. The devolved administrations told the NAO that, while they maintain their own records of UK Government spending announcements and estimate how much they expect to receive at fiscal events, they will not know the net impact on their budgets until HM Treasury has decided where the money will come from to fund changes to its spending plans.[118]

197. The NAO report also observed that, because the UK Government does not give advance notification of changes in its spending, finance staff at the devolved administrations need to be responsive to UK government spending

[116] RoP, paragraph 63, 30 November 2020

[117] National Audit Office, Investigation into devolved funding, March 2019

[118] National Audit Office, Investigation into devolved funding, March 2019

announcements to understand the potential impact on the funding available to support their spending plans.[119]

198. The NAO highlighted:

> "I think the scope for similar-looking spending programmes to be treated in quite different ways in terms of the impact on the funding for the devolved administrations is one of the points that struck us in that work."[120]

199. The NAO linked the lack of transparency of devolved funding with value for money:

> "We thought it was important in our role to be clear that the system was complex, lacked transparency, and crucially, I think, lacked predictability so that, in making spending decisions in Wales or other devolved administrations, it's very hard to have sufficient clarity and notice, and therefore with implications perhaps for value for money, because decisions that can't be planned a long way in advance are often—it's more difficult to ensure that they are value for money."[121]

200. In 2019, following the NAO's report, the UK Parliament's Public Accounts Committee (PAC) undertook an inquiry on the transparency of funding to devolved administrations.

201. Its report stated that "there is a lack of transparency about how these decisions are made and that a lack of detailed information makes it difficult for Parliament to properly examine them".[122]

202. The NAO commented that the PAC report:

> "…recommended that the Treasury should share timely information with the devolved administrations on how it was going to fund projects and programmes and be very clear on the basis for that in a timely way

[119] National Audit Office, Investigation into devolved funding, March 2019

[120] RoP, paragraph 202, 9 November 2020

[121] RoP, paragraph 193, 9 November 2020

[122] UK Parliament Public Accounts Committee Report: Funding for Scotland, Wales and Northern Ireland

to tackle the issue that we're discussing now. And the Treasury, in its response, did agree with that recommendation."[123]

203. The UK Parliament *Public Accounts Committee Report: Funding for Scotland, Wales and Northern Ireland* made a series of recommendations on the transparency of funding and HM Treasury response accepted these recommendations.

204. Following the Chancellor's delivery of the UK Government's Spending Review on 25 November 2020, the Committee held an evidence session with the Minister to scrutinise the funding announcement to Wales.

205. The Minister told the Committee that the level of engagement on the spending review between the UK Government and Welsh Government at a ministerial level had been "very poor".[124]

206. The Committee has previously raised the issue of transparency of funding decisions. In summer 2020, the Committee held evidence sessions with the SoS and the Minister on the financial response to the COVID-19 pandemic. There were differing views between the UK Government and Welsh Government on the calculation of the settlement to Wales announced by the Chancellor in the Summer Economic Update.

207. The Committee wrote to the Secretary of State requesting transparency in future funding announcements to Wales and clarifying whether any funding provided is "new money", and not funding which has already been previously detailed or announced. The Committee highlighted the importance of transparency in funding calculations, in line with the UK Government's guidance on Block Grant Transparency: July 2020.

208. In addition, the Committee has previously recommended in its report on the Welsh Government's First Supplementary Budget 2020-21 that the Welsh Government insists that the UK Government provides as much information as promptly as possible, on any UK Government announcement that affects Wales, its residents and/or the businesses that operate here.

209. In April 2020, the Welsh Affairs Committee launched an inquiry into the Welsh economy and the Covid-19 pandemic. David Phillips submitted written

[123] RoP, paragraph 197, 9 November 2020

[124] RoP, paragraph 14, 16 December 2020

evidence on the additional financial powers and budgetary flexibility that should be provided to Welsh Government in response to the pandemic.

210. David Phillips highlighted the possibility of bypassing the Barnett formula as a result of the pandemic:

> "The UK government should therefore consider bypassing the Barnett formula, especially if it is clear that the coronavirus is having very different impacts in different parts of the UK or the cost of particular policy responses will vary significantly."[125]

211. He further mentioned that any formula bypass should probably be temporary as "it is important not to rush into making new long-term fiscal arrangements in the midst of a crisis".[126] However, David Phillips concluded that:

> "…as may be the case in other areas of public policy, this crisis can be a prompt to consider the suitability of elements of the fiscal system, like the Barnett formula, that have long been subject to calls for reform."[127]

Exclusion of funding

212. The UK Government has previously allocated additional funding outside of the Barnett formula, and it has been argued that the funding was intended for areas of devolved policy.

213. For example, Northern Ireland received an additional £1 billion of funding from the UK Government in order to gain support from the Democratic Unionist Party (DUP) on votes in Parliament. However, this was not subject to the Barnett formula's spending rules as the UK Government claimed the DUP agreement did not involve any extra spending in England. This resulted in both Welsh and Scottish Governments triggering a 'formal dispute' over the deal.[128]

214. The NAO published a report investigating devolved funding. It highlighted the case of the High Speed 2 (HS2) rail project. Given that rail infrastructure is devolved to Scotland and Northern Ireland but not Wales, both nations would

[125] Written evidence submitted by David Phillips, Associate Director, Institute for Fiscal Studies (COV0028)

[126] Written evidence submitted by David Phillips, Associate Director, Institute for Fiscal Studies (COV0028)

[127] Written evidence submitted by David Phillips, Associate Director, Institute for Fiscal Studies (COV0028)

[128] www.bbc.co.uk/news/uk-wales-politics-51181641

receive additional funding but not Wales, even though the HS2 project would only benefit England.

215. The WGC noted that the HS2 project would also reduce the amount of funding Wales would receive in future years:

> "And then you do get some anomalies like the HS2 finance, which isn't part of rail spending in Wales, but it's classed as an England and Wales project. And I think two perverse factors that come from that decision is that the overall comparability factor for the department in the spending review, at this forthcoming spending review, will drop significantly for the transport department."[129]

216. The WGC concluded:

> "So, for every extra pound spent over the next five years via the Department for Transport, Wales will get a significant amount less because HS2 now accounts for a larger share of that Department for Transport budget. So, not only are we losing out directly on that additional funding from HS2, we also lose out from non-HS2 spending because that affects the overall comparability factor. So, it does strike me as pretty odd, that feature of the Barnett formula."[130]

217. However, the WGC further explained that the HS2 project would mean that more funding would be received by the UK Government's Department for Transport which Wales would receive as a Barnett consequential.[131]

218. The Spending Review 2020 raised further questions around how comparability factors are calculated and how decisions regarding how projects such as HS2 are agreed and could be challenged.

219. A change in the Statement of Funding Policy's comparability factor in relation to combining Network Rail and Transport formulae led to transport spending comparability reducing from 80.9 per cent (transport only) to 36.6 per cent, mainly as a result of the treatment of HS2 funding. The Minister said that there should be:

> "comparability with rail infrastructure programmes, particularly in the light of the transfer of the core Valleys lines, and also, the fact that in

[129] RoP, paragraph 57, 12 October 2020

[130] RoP, paragraph 57, 12 October 2020

[131] RoP, paragraph 58, 12 October 2020

> the aggregate, HS2 provides no benefit to Wales; in fact, UK Government's own analysis suggests it could come at a cost to Wales of £150 million a year, and most of that will be felt in south-west Wales, when areas beyond Bridgend, Swansea and so on become less attractive to investors. So, all of these issues provide us with cause to believe that it's just inappropriate, really, to reduce the factor to 36.6 per cent."[132]

220. The Minister noted:

> "One of the extremely disappointing things about the recent spending review was the determination by the UK Government that Wales should have zero comparability with either Network Rail or HS2 infrastructure programmes. That now means that we have a comparability factor of just 36.6 per cent with the Department for Transport, so we only receive a population share of around a third of changes to the DfT budget, and that compares to a comparability factor of more than 80 per cent in previous times."[133]

221. Referring to the way Wales is funded when giving evidence on the draft budget, the official accompanying the Minister said:

> "It just highlights how incredibly complex our funding system is at the best of times. I think this year has seen a level of in-year changes in funding levels—and not just volume, but lots and lots and lots of decisions contributing. It's not just one or two big changes. We're talking about, through the year, probably three figures of changes made to budgets and in consequential for us. I think the system has been under an incredible strain with all of that going on, and I think there are some important questions to be asked as to whether the system that we've got is robust enough to deal with the circumstances that we've been in this year. 'Probably not' is the answer to the question. Reforming the system in the current context probably is not a today thing, but I think it raises a lot of very important questions."[134]

[132] RoP, paragraph 94, 16 December 2020

[133] RoP, paragraph 74, 30 November 2020

[134] RoP, paragraph 40, 8 January 2021

Committee view

222. The Committee acknowledges the unprecedented level of uncertainty regarding the UK Government's budgets and Spending Review over the past few years relating to factors such as Brexit, the UK General Election and the COVID-19 pandemic. However, whilst the difficulties of providing multi-year settlements in the current circumstances are understood, the Committee is disappointed that for the past three years, the Welsh Government has had to produce a draft budget with only a one year revenue settlement, especially as some departments in England, such as health and education, have received multi-year settlements.

223. In our report on the Scrutiny of the Welsh Government Draft Budget 2020-2021, the Committee recommended that the Welsh Government seeks commitments from the UK Government that UK fiscal events will normally take place by a specified date to ensure devolved administrations have sufficient time to carry out meaningful budget setting and scrutiny.

224. The Committee notes the Minister's response that while the timing of UK fiscal events is a matter for the UK Government, the Welsh Government would continue to highlight to the UK Government the importance of providing the devolved administrations with greater certainty and clarity in relation to the timing of UK fiscal events, given the impact this has for respective budget procedures.

225. It is disappointing not to be able to discuss the timing of UK Fiscal events with the Chief Secretary but the Committee intends to consider these issues with the Secretary of State.

226. Furthermore, it is disappointing that the Minister has demonstrated a lack of engagement between the Welsh Government and the UK Government leading up to the spending review and this is also an area the Committee will want to explore with the Secretary of State.

227. It is clear from the evidence taken during this inquiry, and the various other evidence surrounding the Barnett formula, that the process for allocating funding to Wales needs to be reviewed.

228. There is clearly a lack of transparency over funding decisions. The system for funding Wales is complex and lacks transparency and predictability, making it difficult for the Welsh Government to make long term funding decisions. This is concerning in terms of how this impacts on both the ability to plan and achieve value for money from funding. The lack of transparency over funding decisions also makes effective scrutiny more difficult, as it is hard to achieve a clear understanding of the funding available to the Welsh Government.

229. The UK Parliament's Public Accounts Committee recommended that HM Treasury should address the lack of transparency over funding decisions, which the Treasury accepted. The Committee would welcome details on how the Welsh Government is monitoring the Treasury's delivery on this. This is also an area the Committee will explore with the Secretary of State.

230. Evidence suggested that the needs-based factor of the Barnett formula is based on outdated data. It was proposed that a periodic review of relative need in Wales would keep the needs-based factor up-to-date to ensure that Wales receives appropriate funding. The potential for reviewing the Barnett formula is an area the Committee intends to consider further with the Secretary of State.

231. The Committee noted the ambiguity in calculating comparability factors used to determine funding allocations through the Barnett formula and it is also concerned that the UK Government has the ability to determine whether funding relating to devolved areas can be excluded from the Barnett formula - resulting in no consequentials for devolved administrations. It is disappointed that the comparability factor for transport has received a significant downgrade due to the treatment of HS2 funding, which provides no benefit to Wales. This is an area the Committee will pursue with the Secretary of State.

Recommendation 10. Noting the Welsh Government's view that the timing of UK fiscal events is a matter for the UK Government, the Committee recommends the Welsh Government continues to address the need for greater certainty through multi-year funding allocations and clarity of the timing of UK fiscal events with the UK Government.

Recommendation 11. The Committee recommends that the Welsh Government provide an update as to how it is ensuring HM Treasury is delivering on the accepted recommendation by the UK Parliaments Public Accounts Committee that the lack of transparency over funding decisions is addressed.

Recommendation 12. The Committee recommends that the Welsh Government aides transparency of funding by publishing its calculations on consequentials from UK spending announcements.

7. Borrowing powers

Background

232. The Fiscal Framework provided the Welsh Government with new capital borrowing powers. The total borrowing limit was increased to £1 billion, which included an annual borrowing limit of £150 million.

233. The Welsh Government can borrow up to £200 million each year for resource purposes, with an overall cap of £500 million. If tax revenues are lower than forecast, repayments must be made within four years. The Welsh Government has not made use of this facility yet.

234. On 30 November 2018, Welsh Government gained new powers to issue bonds, which can be used as an alternative source for capital borrowing. However, any issuing of bonds will count towards the Welsh Government's borrowing cap.

235. The written evidence from the Welsh Government details:

> "It [the Welsh Government] borrowed £65m in 2018-19 but did not require the facility in 2019-20 due to the UK Government providing additional capital spending in-year, which to use at short notice meant the planned capital borrowing for that year was no longer required. The 2020-21 budget plans assume £125m of capital borrowing."[135]

236. During evidence on the draft budget 2021-22, the Minister highlighted the most up-to-date information on borrowing:

> "… tables 7.3 and 7.4 illustrate how the Welsh Government budgets for the debt associated with our planned capital borrowing, as well as the management and repayment of that debt, so both the principal and the interest. Those tables show the planned aggregate capital borrowing at 31 March 2022 as £341 million, with repayments of £6.9 million of principal and £3.6 million of interest due in 2021-22."[136]

[135] Consultation Response: FFWA 05 Welsh Government

[136] RoP paragraph 100, 8 January 2020

Borrowing limits

"The money presumably would not be lent if it could not be repaid. The decision as to whether it should be borrowed is entirely a Welsh affair"

"It will give the Welsh government more levers to react to crisis like the global pandemic. It can invest in infrastructure spending that could provide an overall boost for the economy"

"I feel as though a limit is incredibly restrictive, obviously, but prevents us from doing things we may need to do for the good of our people"

"If the Senedd sees it necessary to borrow more to improve the services and infrastructure here in Wales then it should be able to"

"I think as a nation it should have borrowing powers to a limit that would not put the country into financial trouble in the future, so it could be more than the £1B but not unrestricted"

Committee digital engagement exercise

237. The WGC noted that the nominal limits placed on capital and resource borrowing by the Welsh Government are arbitrary amounts which have not been updated over time, so they do not bear any relation to the fiscal capacity of the Welsh Government or changing economic circumstances.[137]

238. The WGC also proposed an approach to determining the Welsh Government's borrowing limits:

> "I think one practical solution, maybe, would be to look at the UK Government's own fiscal rules … So, the Conservative manifesto, for instance, said that the debt interest payments of the UK Government should not exceed 6 per cent of tax revenues. So, if you apply that principle to the Welsh Government budget, then the cap on Welsh Government borrowing would be the point at which debt interest payments reached £300 million a year, or something like that."[138]

239. The WGC felt that tying borrowing limits to tax revenues would reward the Welsh Government when its revenues increased and this approach would also

[137] RoP, paragraph 68, 12 October 2020

[138] RoP, paragraph 69, 12 October 2020

"increase the scope to borrow when interest rates are at a historic low, as they are at the moment, to be able to respond to economic crises".[139]

240. Professor Holtham agreed with this approach, feeling that the Welsh Government should be able to borrow between £2 billion to £3 billion:

> "…if you think, okay, we could raise £2 billion a year, let's say, from income tax, what leverage would you think would be appropriate on that £2 billion? Well, what I look at is what proportion of that revenue should you be able to consecrate to tax to service your borrowing? If you said, 'Okay, listen, we shouldn't be able to spend more than 5 per cent of that £2 billion on servicing the debt', you then have to look at what your annuity rate is, and then you multiply that up and you get what you get. And I think reasonable assumptions say you should be able to borrow £2 billion or £3 billion."[140]

241. During the Committee's inquiry into capital funding sources, the Minister commented that the Welsh Government would seek prudential borrowing:

> "I think that we would see an appropriate limit within the context of prudential borrowing. So, it should be for us to set that limit, but we would do so in discussion with the National Assembly… I think, putting an arbitrary number on what we would like to borrow is probably a bit of a sterile discussion; it needs to be a much richer one than that, which we would like to be in a position to have in the Chamber."[141]

242. The Minister said that "some of the issues relating to the framework that don't work as well as they could relate to the funding flexibilities".[142] The Minister confirmed that the Welsh Government has requested an increase in borrowing powers, both in terms of its annual and aggregate borrowing powers. However, the Minister had not received "a positive response to those requests".[143]

---

[139] RoP, paragraph 69, 12 October 2020

[140] RoP, paragraph 58, 9 November 2020

[141] RoP, paragraph 80, 17 July 2019

[142] RoP, paragraph 89, 30 November 2019

[143] RoP, paragraph 105, 30 November 2019

243. The Minister further commented that linking borrowing limits to Welsh tax revenue collected, as mentioned by the WGC and Professor Holtham, would be a more practical approach.[144] The Minister said:

> "the system that, actually, we have at the moment, in terms of the annual capital borrowing limit of £150 million and the aggregate ceiling of £1 billion, doesn't really have a concrete or understandable rationale behind that. So, I think that, certainly, one link to tax revenues would at least have a clear rationale behind it, which I think would be important."[145]

Impact of COVID-19

244. As discussed elsewhere in this report, and other Committee outputs since March 2020, the impact of COVID-19 on the Welsh Government's finances is vast and unprecedented.

245. The IFS has recognised that the current borrowing limits were not designed to deal with the situation currently faced, when:

- "There is a need to develop, cost and announce new measures very rapidly;
- There is the potential for the nations to be affected by coronavirus in very different ways."[146]

246. Expanding on this point, David Phillips said that borrowing rules do not allow borrowing to cover day-to-day costs of new policy measures, he continued:

> "Welsh Government, in terms of resource borrowing, can borrow for forecast errors; it can't borrow because it wants to announce new policy measures to tackle a pandemic. Now, I identify that as being a potential issue, given potential delays in being able to announce policies in the acute phase of the crisis, and if there's a need or just a desire to do things differently in the devolved Governments."[147]

---

[144] RoP, paragraph , 30 November 2019

[145] RoP, paragraph 107, 30 November 2020

[146] IFS: Devolved governments need more flexible funding and greater borrowing power to tackle coronavirus effectively, 25 March 2020

[147] ROP, paragraph 67, 16 November 2020

247. David Phillips suggested a temporary increase in borrowing limits, advising that it should be temporary "because you don't want to make permanent changes in the midst of a crisis that may end up creating different problems elsewhere or may not be appropriate for the long term."[148]

248. Responding to the suggestion that capital borrowing limits restrict the Welsh Government's ability to react to the pandemic and support economic recovery, the Minister said:

> "Well, the borrowing limits will be particularly challenging in the next financial year, given the very difficult and disappointing capital settlement that we had in the spending review. So, inevitably, it just limits and constrains our ability to be as ambitious as we would want to be in the next financial year, and that's a live example, really, of what the constraints are doing."[149]

Committee View

249. The borrowing limits placed on the Welsh Government do not appear to be linked to the fiscal capacity of the Welsh Government or changing economic circumstances in Wales.

250. The Committee believes that the long term borrowing limits should be increased in line with the suggestions heard during evidence.

251. However, in the short term the Committee considers that a temporary increase to borrowing should be implemented to support the Welsh Government in planning an effective recovery from COVID-19. The Committee recognises that there may be reasons why the UK Government would not wish to rush into making new long-term fiscal arrangements in the middle of a pandemic, and this is an area which will be explored further during evidence with the Secretary of State.

252. During the Committee's inquiry into the Welsh Government's capital funding sources, the Committee heard that the Welsh Government had made the case for an increase in borrowing to allow a rational approach to capital borrowing. The majority of Committee Members said they would support the Welsh Government's borrowing limits being increased to help deliver investment

[148] ROP, paragraph 69, 16 November 2020

[149] ROP, paragraph 112, 30 November 2020

priorities and agreed that the Welsh Government should continue to seek prudential borrowing powers.[150]

Conclusion 3. Whilst recognising that making long term fiscal changes during a global pandemic may not be desirable, the Committee considers that, ultimately, capital borrowing limits should be increased.

[150] Finance Committee report: Inquiry into the Welsh Government's capital funding sources, page 25

8. Budget management tools

253. The Fiscal Framework provides the Welsh Government with tools to help manage:

- Resource borrowing - the Welsh Government can borrow up to £200 million each year (within an overall £500 million cap) if tax revenues are lower than forecast. Repayments must be within four years.

- Wales Reserve - the Welsh Government can save surplus revenues into a cash reserve, which can be drawn down as required in future years. The reserve is capped at £350m. There are no annual limits for payments into the Wales Reserve but annual drawdowns are limited to £125m for resource and £50m for capital. Funds in the resource reserve may be drawn down to fund resource or capital spending but funds in the capital reserve may be drawn down to fund capital spending only.

Wales Reserve

254. In April 2020, the Welsh Government submitted evidence to the Welsh Affairs Committee's inquiry into the Welsh economy and COVID-19. It noted:

> "When there remain so many uncertainties about the duration of the pandemic, and the course of the recovery, additional budgetary flexibilities will be essential to enable the Welsh Government to manage its response in a timely and effective manner."[151]

255. The Welsh Government focused on the Wales Reserve:

> "In particular, we are calling for greater flexibility to use our Wales Reserve, as required, to respond to developments - both full access to the resources in the Reserve this year if required, and also the ability to carry forward more resource and capital in the Reserve at the end of the financial year, depending how the recovery progresses. The ability to switch funding between capital and revenue budgets would provide a further useful flexibility to aid budget management this year."[152]

256. It further noted the limitations in drawing down from the Wales Reserve:

[151] Written evidence submitted by the Welsh Government (COV0059)

[152] Written evidence submitted by the Welsh Government (COV0059)

> "The Welsh Government can deploy up to £150m of capital borrowing this year under the current rules. The capital plans in the final budget assumed that we would use £125m of that facility this year. We are calling for an increase in the annual limit and the aggregate £1bn ceiling to enable the Welsh Government to further support its capital programmes this year if necessary and to aid the economic recovery over the longer term. These additional flexibilities should be available to the Welsh Government as a matter of course and not require permission from the UK Government on a case by case basis. We note how, in other countries, the fiscal rules for sub national governments are being relaxed - for example in Spain and Germany."[153]

257. The WGC questioned the limitations of the Wales Reserve during the pandemic stating:

> "There are restrictions on the use of the Wales reserve and, as you said, the Welsh Government is already drawing down the maximum allowed from the Wales reserve this year, and that could potentially mean that there's around £150 million of unused resource spending in the Wales reserve that the Welsh Government won't be able to use this year. It seems like a weird year, given the crisis that we're in, to limit the Welsh Government's use of its own reserves."[154]

258. During an evidence session with the Minister on the Welsh Government Second Supplementary Budget 2020-21, she reiterated that dealing with the pandemic necessitates more flexibility regarding annual limits to accessing the Wales Reserve and also limits the Welsh Government's ability to carry funding between years.[155] She said:

> "We have had numerous discussions with the Chief Secretary to the Treasury about using the tools that we have better, and having access to more of the Wales reserve. That request was declined on the basis that we have established the guarantee with the UK Government in terms of additional funding. So, from their perspective, that wasn't needed at this time. And perhaps at this point in the financial year, that's reasonable, but as we move towards the end of the financial year, I think it's really important that we retain larger flexibility to draw down

[153] Written evidence submitted by the Welsh Government (COV0059)

[154] RoP, paragraph 72, 12 October 2020

[155] RoP, paragraph 126, 2 November 2020

> more if we need to, but also potentially to carry more over into the next financial year, because clearly we don't know where we're going to be in the spring, and managing the budget is quite difficult in the sense that you're planning for a wide range of scenarios, and I think that it would help us a great deal if we were able to plan on that basis, with the confidence that we could carry more over to next year without having to find ourselves in a position that nobody wants to be in in terms of returning money to the Treasury."

259. The Minister stressed that the ability to carry COVID-19 funding across financial years would be useful in supporting the Welsh Government to respond to the pandemic.[156]

260. During scrutiny of the Welsh Government's draft Budget 2021-22, the Minister added:

> "We've been asking to carry forward, potentially, if we need to, some of that additional COVID funding into the next financial year. That's one of the flexibilities that we've been seeking. We understand that we will have a decision from the Chief Secretary to the Treasury towards the end of this month on that, as part of the UK Government's supplementary estimates piece of work, so we look forward to that decision."[157]

Committee View

261. Reporting on the First Supplementary Budget 2020-21, the Committee made a number of recommendations relating to the funding flexibility of the Welsh Government.

262. This was further considered in the Committee's report on the Second Supplementary Budget 2020-21 stating:

> "… the Committee believes it would be prudent for the Welsh Government to have more flexibility in managing its end of year finances and cannot see the reason for the Treasury declining this in such exceptional circumstances."[158]

[156] RoP, paragraph 89, 30 November 2020

[157] RoP, paragraph 13, 8 January 2021

[158] Finance Committee: Scrutiny of Welsh Government's Second Supplementary Budget 2020-2021, November 2020

263. The Committee continues to support calls for flexibility around end of year reserves, to enable the Welsh Government to be more strategic in its long term planning. There is a general case to be made for this change. However, in the current global pandemic the case for this flexibility is even more pronounced. As has been evidenced throughout this report, the fiscal arrangements for Wales were not designed for a global pandemic and it is vital that consideration is given to how swift changes can be made to ensure appropriate responses from devolved governments.

264. The Committee notes that the Chief Secretary is expected to take a decision by the end of January 2021 on the Welsh Government's request to carry forward some of its additional COVID funding into the next financial year. This is an area the Committee will consider further with the Secretary of State.

Conclusion 4. The Committee fully supports the Welsh Government's request for greater flexibility in utilising the Wales Reserve, particularly during the pandemic, and encourages the Welsh Government to continue to engage with the UK Government on this.

9. Additional issues for consideration

265. As has been highlighted in this report, the Committee intended to conduct this inquiry prior to the COVID-19 pandemic. However, the implications of the pandemic have had an impact on the time available for the Committee to thoroughly review fiscal arrangements. This chapter briefly summaries the areas that the Committee feels require further consideration.

International fiscal frameworks

266. The Scottish Parliament Information Centre (SPICe) published a research briefing outlining comparative examples of fiscal devolution in Belgium, Australia, Germany, Spain, Switzerland and Canada. It noted:

> "These countries and their systems are extremely varied and they were selected as they provide an insight into a broad range of devolution arrangements. They show a number of different ways of dividing powers vertically between the central and sub-central governments. They also show different methods of fiscal equalisation – the redistribution of resources to address differences in revenue raising or fiscal capacity across sub-central governments."[159]

267. The briefing further highlighted:

> "Some countries with higher levels of decentralised taxes have relatively little control over these taxes. For example, Germany has relatively high sub-central tax revenues, but these are largely in the form of assigned revenues. On the other hand, in some countries the level of decentralised taxes is low, but sub-central governments have greater control over these taxes. For example, in Australia the states and territories have full discretion on the rates and bases of sub-central taxes."[160]

268. In 2018, the Welsh Government published Reforming UK funding and fiscal arrangements after Brexit: Securing Wales' Future, this paper states:

[159] Scottish Parliament Information Centre: Financial Scrutiny Unit Briefing Fiscal devolution – some comparative examples

[160] Scottish Parliament Information Centre: Financial Scrutiny Unit Briefing Fiscal devolution – some comparative examples

> "We believe the fiscal arrangements of the UK should enable all parts of the union to provide an equivalent level of services taking account of relative needs of the population and assuming equivalent tax effort. We recognise the wide range of different approaches to fiscal relations in different countries (Annex 1 includes some key examples) and no reasonable option should be off the table as we continue to discuss this."[161]

269. The Minister agreed that the Welsh Government could examine other international fiscal frameworks such as Australia, to explore how these have established independent oversight of the workings of the framework and the dispute resolution process.[162]

Relaxing fiscal rules

270. The OECD published COVID-19 and fiscal relations across levels of government which highlighted "during a time of crisis, it may be possible to relax such rules with a reduced risk of moral hazard problems emerging later. Relaxation may take the form of both formal escape clauses that can be triggered by prescribed circumstances and/or effective suspension of the rules in practice when it is unreasonable to expect sub-national governments to comply".[163]

Dispute resolution

271. The Committee asked the Minister about the process for challenging funding decisions taken by the UK Government. The Minister said that disputes can be escalated to Joint Ministerial Committees, however, "that's not a satisfactory way to do it, because the UK Government then, essentially, becomes the judge and jury on the issue."[164]

272. The Minister confirmed that the Welsh Government has set out its ambitions to have a more independent arbitrator of disagreements, which she felt would be an "improvement and a more appropriate way forward".[165]

[161] Welsh Government: Reforming UK funding and fiscal arrangements after Brexit: Securing Wales' Future

[162] RoP, paragraph 93, 30 November 2020

[163] OECD Policy Responses to Coronavirus (COVID-19): COVID-19 and fiscal relations across levels of government

[164] RoP, paragraph 87, 16 December 2020

[165] RoP, paragraph 87, 16 December 2020

273. The Committee wrote to the Chief Secretary on 8 January 2021 expressing its concerns about the mechanism used by the UK Government to make funding decisions and the Welsh Government's means of challenging such decisions.

Committee view

274. It is unfortunate that the pandemic and the approaching dissolution period has meant that time has not allowed for further consideration of the issues in this chapter. However, this is clearly an area of great importance and interest within Wales and the Committee hopes this would be pursued by the next Senedd/Welsh Government.

275. The Committee considers that it would be helpful for further consideration to be given to international decentralised fiscal arrangements relating to independent oversight, dispute resolution, borrowing limits, funding flexibilities, the approach to calculating devolved funding allocations and the process for devolving competence on new taxes.

276. The Committee is concerned about the mechanism used by the UK Government to make funding decisions and the Welsh Government's means of challenging such decisions. There needs to be transparency of funding decisions made by the UK Government, and the Committee believes that there needs to be an independent process for challenging these decisions - the current route of challenging decisions via the Joint Ministerial Committee is not satisfactory as it is not an independent adjudication. The Committee intends to address the independence of challenging funding decisions with the Secretary of State.

Conclusion 5. As well as the need for transparency in funding decisions made by the UK Government, the Committee believes that there needs to be an independent process for challenging these decisions.

Annex A: List of oral evidence sessions

The following witnesses provided oral evidence to the committee on the dates noted below. Transcripts of all oral evidence sessions can be viewed on the Committee's website.

Date	Name and organisation
28 September 2020	**Robert Chote, Chairman** Office of Budget Responsibility
28 September 2020	**Adrian Crompton, Auditor General for Wales** Audit Wales **Richard Harries, Audit Director** Audit Wales **Mark Jeffs, Audit Manager** Audit Wales
12 October 2020	**Dr Ed Poole, Senior Lecturer** Wales Governance Centre **Guto Ifan, Research Associate** Wales Governance Centre
9 November 2020	**Professor Gerry Holtham**
9 November 2020	**Ruth Stanier, Director General, Customer Strategy and Tax Design** HM Revenue & Customs **Jackie McGeehan, Deputy Director of Income Tax Policy** HM Revenue & Customs
9 November 2020	**Gareth Davies, Comptroller and Auditor General** National Audit Office **Darren Stewart, Director** National Audit Office **Ben Rodin, Audit Manager** National Audit Office **Lee Summerfield, Director** National Audit Office
16 November 2020	**David Phillips, Associate Director** Institute of Fiscal Studies
16 November 2020	**Dyfed Alsop, Chief Executive** Wales Revenue Authority **Rebecca Godfrey, Chief Strategy Officer** Wales Revenue Authority **Sam Cairns, Chief Operating Officer** Wales Revenue Authority

Date	Name and organisation
30 November 2020	**Rebecca Evans MS** Minister for Finance and Trefnydd **Andrew Jeffreys** Director, Welsh Treasury **Julian Revell** Head of Fiscal Analysis, Welsh Treasury

Annex B: List of written evidence

The following people and organisations provided written evidence to the Committee. All Consultation responses and additional written information can be viewed on the Committee's website.

Reference	Organisation
FFWA 01	Audit Wales
FFWA 02	Australian Parliamentary Budget Office
FFWA 03	FSB Wales
FFWA 04	Victorian Parliamentary Budget Office
FFWA 05	Welsh Government
FFWA 06	Department for Work and Pensions
FFWA 07	HM Revenue & Customs
FFWA 08	Chartered Institute of Taxation & Low Incomes Tax Reform Group

Additional information

Title	Date
Note from Prof. Gerry Holtham – Block Grant Adjustment for devolved taxes	13 November 2020