

# The Senedd Papers

#2

# Taxation in Wales

An IWA discussion paper by Gerald Holtham

iwa

# The Senedd Papers

## #2

### **About us**

The IWA is Wales' critical friend.

We aim to bring people together in a safe space, where ideas collide and solutions can be forged. Our role is to act as a catalyst to generate an intelligent debate about Wales' future.

We are an independent charity with a broad membership base. We discharge our mission by:

### *Generating ideas*

- Providing a platform for innovative ideas to improve Wales.
- Bringing together experts and practitioners to critically examine evidence in key areas and to suggest improvements.

### *Discussing*

- Providing a unique space to bring together the worlds of politics, business, public service, academia and the wider public.
- Testing and challenging ideas through a diverse range of activity across Wales.

### *Influencing*

- Working with policy makers from across the spectrum to translate these ideas into practice

We are a small think tank. We cannot achieve our charitable mission alone. We need your help.

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## Introduction to the Senedd Papers

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For democracy to work there needs to be an engaged electorate and civil society. One of the core objectives for the National Assembly for Wales's Commission during the Fourth Assembly is to increase engagement with the people of Wales.

That is, we aim to create an environment that encourages interest in the work of the Assembly and facilitates participation in the Assembly's roles of legislating, scrutiny and representation.

We aim to achieve this by engaging actively and widely, and ensure that the Assembly benefits from the creative energy generated by such engagement.

An important part of that process is working with partner organisations to facilitate debate amongst wider civic society and that's why the National Assembly is supporting the Institute of Welsh Affairs in launching The Senedd Papers.

The IWA plays an important role in Welsh civic life in terms of developing Wales's public policy landscape - and by anchoring this series of discussion papers to the seat of Welsh Governance, here in our iconic building, we are highlighting the central role that the National Assembly now plays in developing and scrutinising public policy in Wales.

### **Dame Rosemary Butler AM**

Presiding Officer of the National Assembly for Wales

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## IWA Foreword

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Just fifteen years after the establishment of an Assembly with executive powers Wales now has a Government, a Parliament, and will soon have tax raising powers.

The third Government of Wales Bill in a decade and a half, currently before Parliament, will give the National Assembly power over Stamp Duty Land Tax and Landfill Tax. The new powers follow some – though not all – of the recommendations of the Silk Commission on financial reform for Wales. The first report of the independent commission on devolution also recommended that powers to vary income tax should be given to the Assembly, subject to a Yes vote in a referendum. It unanimously agreed that the Aggregates Levy and Air Passenger Duty be devolved to the National Assembly, however, this was not accepted by the coalition Government.

For the UK Government the devolution of tax raising powers represents an important principle in making the Assembly more accountable for raising some of the money it spends. The sums that will be raised by these ‘small taxes’ are relatively trivial, but they do unlock a revenue stream to service some borrowing powers for the Welsh Government. To access more meaningful borrowing levels, however, a referendum will need to be won, and that seems like a very remote possibility at present.

Nonetheless, an important principle has been conceded and the Welsh Government now has to ready itself to perform a new role. Whilst some of the matters that need to be addressed are largely technical they mark the opening of an important new chapter in the development of democratic devolution to Wales.

In the second of our Senedd Papers series the highly respected economist, Gerald Holtham, sets out some initial thinking on the shape of a tax policy for the next Welsh Government. As with each of the papers in the series we have sought out an expert in their field to help policy makers come up with practical proposals to consider as they shape their manifestos for the next Assembly election. Gerry Holtham is not only the author of the acclaimed report on fairer funding for Wales (which bears his name), but has had a distinguished career in the City of London, the OECD and in think-tanks in the UK and the U.S.

In this typically stimulating paper, Holtham, a Fellow of the IWA, argues that the Welsh Government must think about those taxes it already controls as well any newly devolved ones in order to optimise tax policy. His proposals are rational and progressive, but present a range of problematic choices for politicians. But with the Wales Audit Office putting the funding gap

for Welsh public services at between £2.6 and £4.6 Billion by 2025<sup>1</sup>, our leaders have little option other than to be bold.

Once again I'd like to thank the Assembly Commission and the Presiding Officer, Dame Rosemary Butler, for their support for the Senedd Papers series.

**Lee Waters**

Director, Institute of Welsh Affairs

*May 2014*

1 Mark Jeffs, Future Pressures on Welsh Public Services, Wales Public Services 2025. 2013. ([www.walespublicservices2025.org.uk](http://www.walespublicservices2025.org.uk))

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## Starting to think about tax

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The Silk report has recommended the devolution of some taxes and that is embodied in the Wales Bill before Parliament. The Welsh government is ready to accept the devolution of a number of small taxes. They could be useful policy instruments and provide a moderate revenue stream that would underpin limited borrowing powers. The devolution of income tax which Silk suggested, is subject to a referendum and, at present, that looks a more remote possibility.

The Finance Minister has convened an advisory panel of tax academics and accountants and has also arranged a series of consultations on the right approach to stamp duty tax on land sales, one of the Silk taxes. (The other is landfill tax). Stamp duty is already been devolved to Scotland where it is to be reformed. In recent discussions, the Welsh construction industry and business organisations have said they want the tax devolved and reformed, and the Royal Institute of Chartered Surveyors has suggested a similar reform would also be popular in England.

There is general agreement that Wales needs to develop a stronger Treasury function before it takes on many more financial initiatives and taxation powers, both to consider tax policy and to improve project appraisal across the Welsh Government. Another function that has to be organised is tax collection and administration.

In considering tax policy, the Welsh Government must think about those taxes it already controls as well any newly devolved ones in order to optimise tax policy. The most considerable of current taxes is council tax, an important source of revenue for local authorities that raises over £1 1/4 billion in Wales. Most specialists accept that the tax is ill-structured and it is politically unpopular too. Consideration of this tax is something on which a developing Welsh Treasury should cut its teeth.

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# Council tax: it's a mess

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Council tax is the misbegotten offspring of political misjudgment and political cowardice. Local government used to be funded by domestic rates, a tax levied on rental values of property. That tax was unpopular with homeowners, as property taxes tend to be. The reason is that people get a relatively large demand for tax and it is not associated with any income flow or transaction. It sticks out and is resented. Yet land or property taxes are loved by economists because they have two excellent features – they are hard to avoid (you can't easily hide or move a house) and they don't distort economic activity as most taxes do.

Nonetheless Mrs Thatcher's Government in the 1980s decided to gratify homeowners whom it considered its natural supporters. It abolished the rates and introduced the poll tax. The rationale was that the tax paid for local services so everyone who enjoyed those should pay – and at the same rate. The poll tax was an act of political miscalculation and the tax was no more popular than it had been when levied in the 14th century, triggering the peasants' revolt. It helped to hasten Mrs Thatcher's departure and had to go. But John Major's Government, battered by public fury, did not have the nerve to levy a proper land or property tax so we got the community charge, tied to housing, with the tax varying depending on a series of arbitrary bands on house prices. The initial cowardice was subsequently repeated in England where the tax is levied on house values that have not been reformed since 1992.

Wales did better with a revaluation in 2005, based on 2003 values, and another band was added on the top of those existing in England. It caused some political pain for Rhodri Morgan's administration and though another revaluation is due before 2015, the nerve of Welsh politicians has failed after the fuss in 2005. Yet people in expensive houses could now be paying much more tax than they are in the existing situation if the old domestic rates tax had just been retained. Mansion taxes could merely restore a situation that existed until the 1980s.

At present Council tax is regressive in property values, going up more slowly than house prices across the range. In Wales in 2013 the average council tax on the lowest band, where properties are worth up to £44,000, amounts to nearly 1.9% of the value of the property. That falls to nearly 1.5% for properties in the range £44,000-£65,000 and it goes on falling for more expensive properties. For properties worth over £424,000, the tax is just over 0.5% of capital value.

The council tax could be reformed to make it fairer, more buoyant and less likely to give rise to political tantrums when revaluations occur.

Moreover, changes to the benefit system are now making reform urgent since the UK Government has abandoned responsibility for paying the council tax of people on income support, without giving the Welsh Government all the money necessary to do so. The Welsh Government is in a position to mend council tax now; it has all the powers it needs. Reform

could take the form of a radical restructuring or a range of more modest changes.

First step: acknowledge the council tax is two things: a charge for local services and a property tax. So first of all set the charge for local services, which all householders and tenants pay irrespective of the value of the property. Then have a schedule that raises the tax more or less proportionately with the value of the property. This can be done with present council tax bands though the progression could be made more precise by increasing the number of bands. Moreover, the tax banding should not stop with a single band for house prices above £424,000 as it does now but could reflect rising valuations beyond that.

If the authorities set the rates on this reformed tax so as to collect the same revenue as it does now, the effect would be to collect much more revenue on more expensive houses and less on those at the bottom of the market. In general that would reduce the tax on poorer people who tend to live in poorer houses.

In the days before changes to the welfare system, much of the council tax on the poor was paid by housing benefit, but the UK Government has just cut the resources available for that relief by 10%. The cost of the benefit is currently some £240 million and will evidently rise over time with inflation and council tax rates. The UK Government has given Wales £220 million, leaving a shortfall of some £20 million in Wales last year that must grow with time. So now making the tax more progressive would actually relieve the burden on poor people, or on the Welsh budget, and not just help the UK Treasury as formerly.

Currently council tax in Wales is set to realise the same revenue as a pure property tax on housing would if leveled at the rate of about 0.8% of capital value. There is a perfectly proper political discussion to be had in these times of squeeze on public services, especially at the local level, whether that could be more or less.

The Mirrlees Review of the British tax system, chaired by Nobel laureate James Mirrlees and sponsored by the Institute for Fiscal Studies noted:

“...there is also evidence that people just find the idea of a tax linked to the value of their property unfair. This seems to reflect the fact that perceptions of fairness in tax are more closely linked to the relationship of the tax to flows of income than to stocks of wealth. But, both because consumption of housing services is as legitimate a tax base as any other consumption, and because it is a good complement to current income as an indicator of lifetime income or ability to pay, this does not seem to us to be a good objection—at least not economically.”<sup>2</sup>

If residential property services were taxed at the same rate as other consumption, council tax would be over 1% of house values.

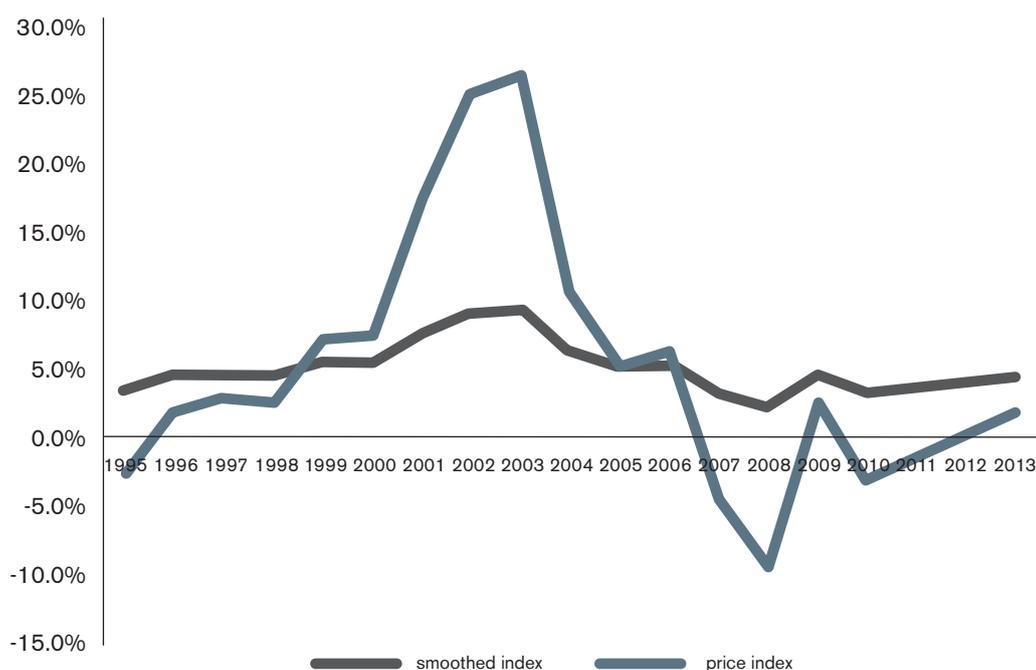
But in any case something should also be done to make the tax base more buoyant and the tax less unpopular. The first could be done by indexation. The tax base (the assessed value of houses) should rise each year with a local index of house prices. These are readily available. But the rise would need to be smoothed since house prices are volatile. The average annual rise in Wales since 1995 has been 4.9%, but in 2002 and 2003 prices rose by over 20%, and in 2007 and 2008 they fell by nearly 5% and 10% respectively.

2 *Dimensions of Tax Design: the Mirrlees Review, Oxford University Press: September 2011.*

There are various ways to smooth the indexation. One possibility would be to take a very long run average of price increases, say 20 years, and make the annual change equal to a proportion of that change and a proportion of the previous year's change. If the proportions were weighted in favour of the long-run change, the index would be quite smooth. The chart below compares the house price index for Wales with a smoothing with proportions of 0.8 and 0.2. Indexation is an approach followed in the United States and elsewhere. It leads to gradual change and does away with the ten-year fuss about whether to revalue. The process would be subject to an appeals mechanism, as is currently the case, where house values had been subject to specific factors and so did not follow the index. Indexation gives local government a buoyant tax base that rises with the costs, and means they don't necessarily have to announce changes in rates of tax just to keep revenues constant in real terms after adjusting for inflation.

Moreover, it might also help acceptability if the tax was announced as a rate and a weekly or monthly sum, which could be reduced somewhat for direct debit payments. It is the same approach that sellers of cars use – so much a week they tell you, rather than the price of the car.

### — House prices and indexation



One often-cited objection to property taxes is that they hit the asset-rich, income poor, like widows living on in the family home on a modest pension. The evidence is that this is a small-scale problem in reality. Anyway it can be ameliorated by allowing council tax to roll up in such circumstances and become a charge on the house when it is sold or when the widow is deceased. At a tax rate of 0.65% the widow could stay in the house for 153 years before all the equity was gone.

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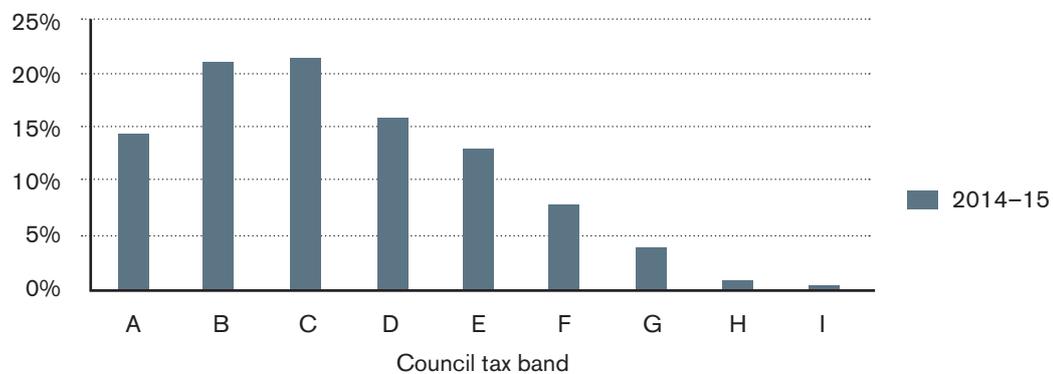
# An example of reform

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Data exist for the number of dwellings in Wales in each band (see chart below) and the average council tax payment. We also have data for the council tax benefits relating to each band. Currently band A properties pay an average £850 a year rising to £2970 for band I (Those are all-Wales averages; the tax is set by local authorities and varies from place to place but the relation between different bands is the same everywhere).

If all eligible properties paid tax at the full rate, Wales would collect about £1.8 billion annually, but just over one third of properties are eligible for a discount. People living alone get a discount of 25%. Some 4% of properties are exempt altogether, mainly empty properties and those occupied only by students. With a collection rate of just under 97%, council tax revenues were about £1.2 billion in 2011-12, and they are expected to hit £1.5 billion in 2014-15.

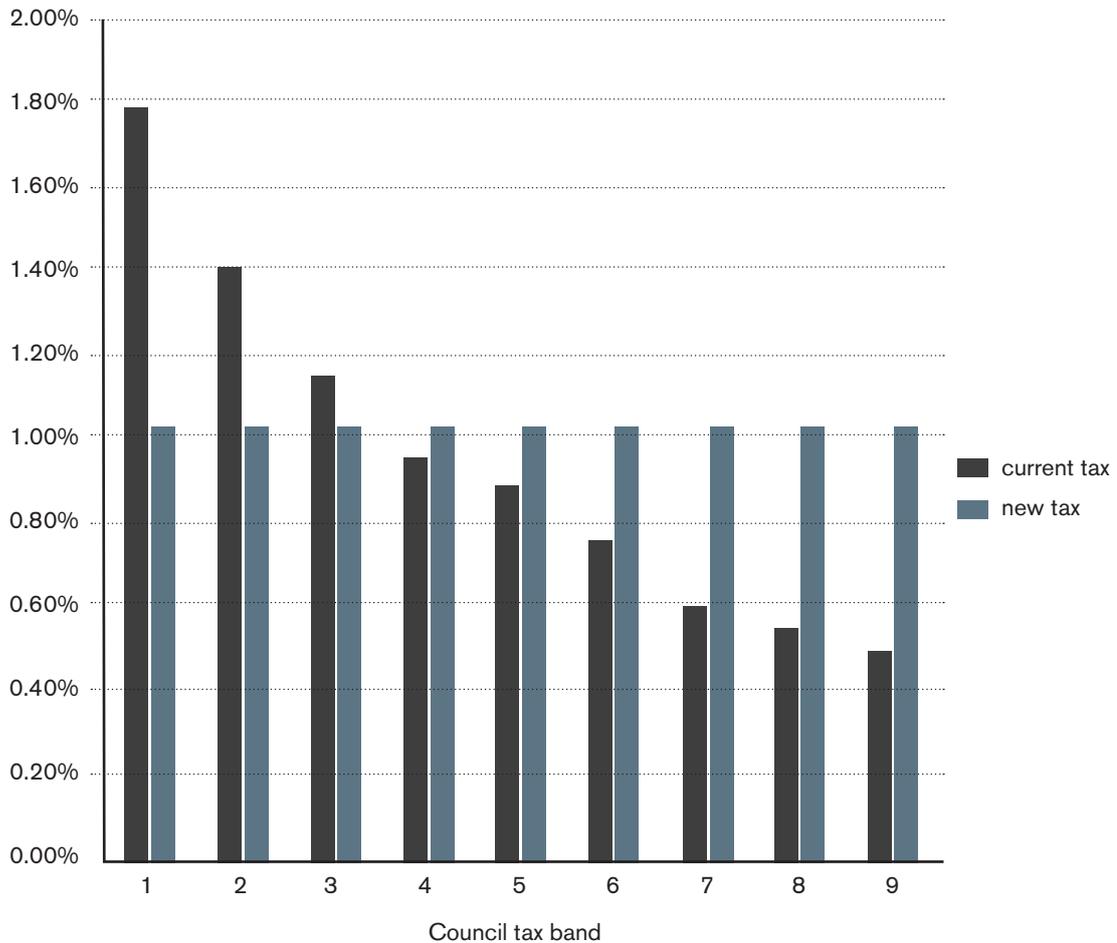
— Proportion of dwellings by council tax band



Suppose we replaced the current council tax with a payment equal to a flat sum plus a proportion of the value of the property minus a property 'allowance'. That could be done, even without reforming existing bands – although it would be better, and fairer, to increase the number of bands so that taxes more nearly reflected actual property values. However, for simplicity let's consider a reform based on current bands. For example there could be a flat payment of £350 a year plus 1.09% of the top-of-each-band property value, minus a fixed allowance of £34,000. That would yield similar revenue to the current tax.

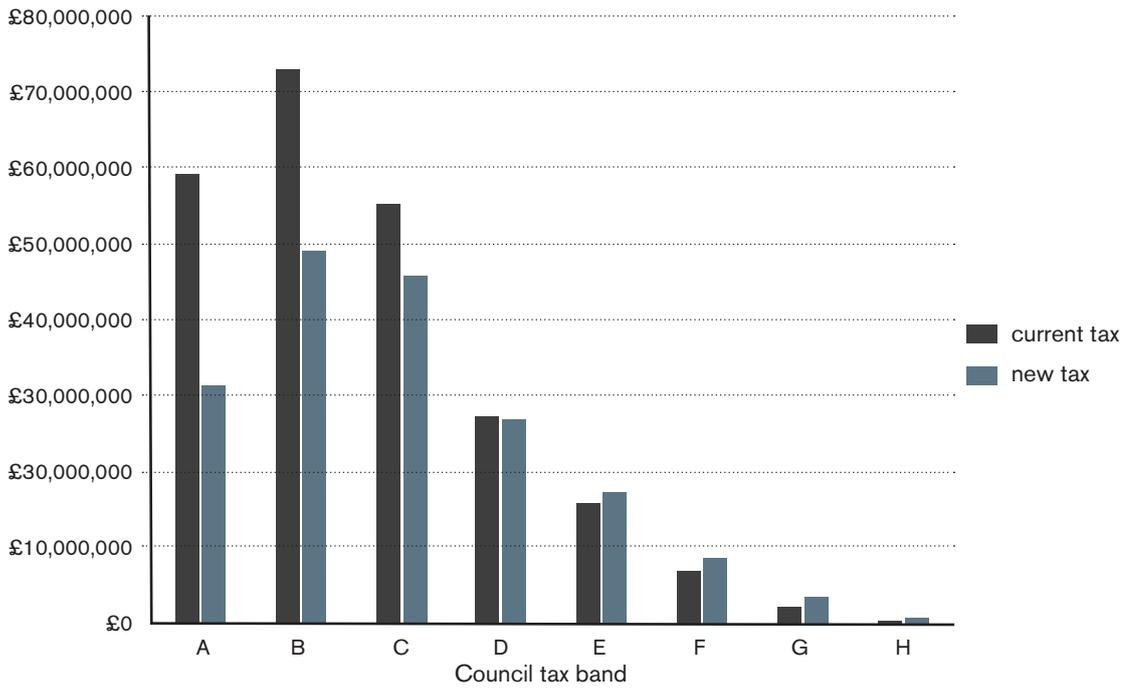
A tax “allowance” off property values combined with the fixed charge gives a strictly proportionate tax. Everyone eligible ends up paying a fraction over 1% of the band value unlike the current regressive system (*see the chart below*).

— Tax as proportion of property (band) value



Note, however, that property prices are up over 30% on average since the revaluation based on 2003, so this rate is no more than about 0.8% of current property values. Taxpayers in band D would pay a little more tax at £1318 a year instead of £1276, i.e. less than a pound a week more. But band A taxpayers would see their bills fall from £851 to £459. All the bands below D would pay less. The cost of Council Tax Benefit would therefore fall from £242 million a year to just over £190 million, a saving to the Welsh government of over £50 million a year (*see chart below*).

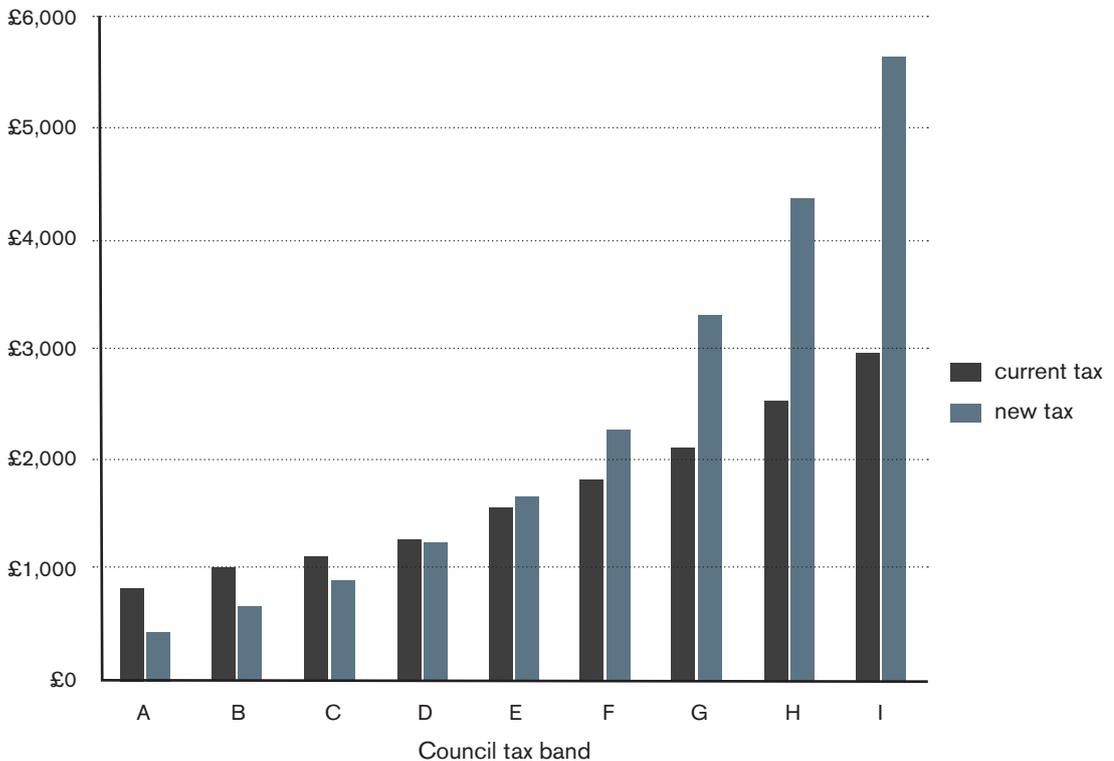
— Council tax benefit (annual sum payable by band)



The offset would come at the high end. Band H taxes would rise from £2452 to £4367. On properties worth £550,000 in band I, the bill could rise to £5565 from £2860 (see chart below).

Such large increases would certainly cause some political anguish, particularly as affluent

— Average tax per band



areas where they are most germane are often marginal political seats. They would have to be phased in over a number of years, though there are other possibilities for ameliorating the effect.

For example, there are a number of exemptions or discounts to council tax that, if removed or reduced, would yield revenue and enable somewhat lower rates to be levied overall. Authoritative analysts have criticised the single-occupant discount, for example, as unjustified. If that were phased out, another couple of hundred million pounds of tax revenue could accrue across Wales. Moreover, while discounts for second homes are allowed to local councils at their own discretion, they will soon be able to charge a premium. In Gwynedd, fully 10% of the entire housing stock consists of second homes. The Council is now to be allowed to charge a premium on second or holiday homes so it should be able to realise more revenue or reduce rates for local inhabitants. In most other parts of Wales, however, this is not likely to be a significant source of extra revenue.

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# An integrated tax policy

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If income tax is devolved eventually, with the freedom to vary individual tax bands as recommended by the Silk Commission but currently resisted by the UK Government, reforming council tax creates another important possibility for the longer run. With council tax more progressive we could reduce upper-band tax rates on incomes since well-to-do people would be paying more tax on property.

It is widely understood that Wales could gain economically by reducing higher rates of income tax but many are concerned that doing so would conflict with the Welsh public's sense of fairness. Taxing property wealth rather than income alleviates that concern because the better off are contributing, though in a different form. Taxing wealth not income is a better option economically since it does not discourage work and is less prone to evasion.

House prices historically have averaged about four times annual earnings, though currently they are around five times. Someone in a house worth £400,000 to £500,000 might be earning £100,000 a year and would be paying a 40% tax rate on some £60,000 of that. Reducing his or her tax rate to 37% would broadly compensate for the rise in council tax. Moreover over a number of years that could result in an increase in revenue. People earning £150,000 would be better off and that would be likely to influence location decisions for people moving near the border with England. A relatively small proportionate increase in the net number of wealthy incomers to east Wales would swell the Welsh tax base.

Note the importance of thinking about tax policy in an integrated manner.

Another example concerns stamp duty. Stamp duty is already been devolved to Scotland where it is to be reformed. The current tax is slab-sided in that when the house price passes a threshold, a higher rate of tax is charged on the entire price, not just on the portion of the price that exceeds the threshold. That leads to sharp jumps in tax liability at the threshold prices and distorts the market by causing prices to cluster just below thresholds.

In Scotland it is proposed to replace this structure with a proportional tax. In recent discussions, the Welsh construction industry and business organisations have said they want the tax devolved and reformed, and the Royal Institute of Chartered Surveyors has suggested a similar reform would also be popular in England. It will be very difficult, however, to reform that tax to remove its distorting effects without sacrificing revenue - or raising rates, which the public has not been led to expect. Rather than trying to square the circle it would be better to reform the tax to remove the slab-sides that cause the distortions and accept some loss of revenue. The loss could be recouped by minor changes to council tax. Indeed, since stamp duty raises about one tenth of the revenue from council tax one could phase it out altogether if one were prepared to raise council tax receipts by 10%. That may be too radical but removing or reducing the single-occupant discount on council tax, for example, would finance a substantial reform of stamp duty.

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# Tax administration

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The only bodies in Wales that currently have experience of tax collection and administration are local authorities. It therefore makes sense to use that experience in collecting the smaller taxes that are to be devolved, landfill and stamp duty. Both are easy to collect with conveyancing solicitors doing much of the work for stamp duty. It would make sense for them to send the money to the local authority finance department to administer. Stamp duty and landfill could be treated like business rates, collected by local authorities, pooled centrally and then redistributed among local authorities according to a Welsh government formula. That need not imply any overall increase in their funding if the Welsh government reduced the revenue support grant accordingly but it would mean more local authority spending was financed by their own tax collection. It would surely make sense if these new responsibilities were accompanied by a consolidation of tax administrations among local authorities. Local authorities may be consolidated in the near future but even if they are not it makes sense to pool certain functions. There are only some ten local authority pension funds, for example, shared among the 22 local authorities. A smaller number of tax administrations operating regionally would be appropriate and these could administer the new taxes. The Welsh Government would require a tax policy unit but would not need to create a tax administration. It would be a good story if additional Welsh tax powers were accompanied by a reduction, not an increase in the administrative overhead.

If income tax is ever partly devolved on the lines recommended by the Silk Commission, it would surely continue to be collected by HMRC. The Revenue would then transmit to the Wales the proceeds of the Welsh income tax and they would charge a fee for doing so to cover the extra costs of discriminating between Welsh and English residents for tax purposes. It is very important that the relationship between the Welsh Government and HMRC be put on a firm contractual basis with the responsibilities of each party spelled out. It will be rather easy for many people to avoid tax if English and Welsh rates differ by claiming to be in the lower-tax jurisdiction. Policing would be expensive. There is a case for ensuring HMRC is incentivised to administer the system appropriately. Perhaps instead of a fixed fee, the Welsh Government should offer a fee with an element proportionate to the taxes collected.

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# Conclusion

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Up to now the Welsh Government has not had to give any thought to taxation, just spending its block grant. It could lead on the reform of council tax, making it less regressive. It could use changes in council tax to fund a necessary reform of Stamp Duty on landed transactions. It could improve tax collection in co-operation with local authorities and could pioneer the development of a new contractual relationship between HMRC and devolved administrations.

In general, Wales has the opportunity to improve its own tax system and blaze a trail for the rest of the UK.



**Gerald Holtham:**

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## Forward Thinking for Wales

The Institute of Welsh Affairs is an independent, membership-based, think tank dedicated to making Wales better.

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