Welsh Parliament
Finance Committee

Impact of variations in national and sub-national income tax

July 2020

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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

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Plaid Cymru

Mike Hedges MS
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Welsh Labour

Nick Ramsay MS
Welsh Conservatives

Mark Reckless MS
Brexit Party

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Chair's foreword

As Wales approaches the third year of partial devolution of income tax in April 2021, and the final year of the current Welsh Government's commitment to not raise Welsh Rates of Income Tax, we felt it was an appropriate time to examine the possible impact of different income tax rates across the Wales-England border. A border that is densely populated – with 17 million people living within 50 miles of it.

Though drawing direct comparisons with other national and sub-national tax systems may be limited, we believe that international evidence offers valuable insights into potential behavioural responses of taxpayers.

For example, international studies show that high income earners are particularly responsive to tax rates; that some high-earning professions are more mobile than others; and that the stage of an individual's career can influence their ability to relocate. Wales needs to attract and retain these influential groups.

But we also know that tax considerations are not the sole determinants of migration. The influence of non-tax factors, for example, wages, family, house prices and quality of life cannot be underestimated and must form part of future Welsh Government research on the impact of tax divergence across the Wales-England border.

To fully understand the Welsh tax base and support further research development on taxpayers' responses to income tax divergence, it is clear that Welsh-specific data, such as data on the different income bands of households, needs to be unlocked.

With 44 per cent of the Welsh population paying income tax (compared with 47 per cent of the UK's population), it is apparent that the Welsh Government must consider ways to develop the Welsh income tax base and maximise tax revenues.

On the issue of maximising tax revenues, we also call for research to examine taxpayers' response to mitigating personal income tax, such as self-employed individuals incorporating their business to benefit from a lower rate of UK corporation tax on their profits, rather than paying Welsh Rates of Income Tax on their earnings.

Though we concluded our evidence gathering for this inquiry before the true extent of the COVID-19 pandemic was realised, it is clear that difficult decisions on taxation will need to be made in order to aid economic recovery. We urge the

Welsh Government to start considering tax policies and looking at contingencies to ensure that all the fiscal levers are available to aid Wales's recovery from the global pandemic.

Llyr Gruffydd MS
Chair of the Finance Committee

Recommendations

Recommendation 9. The Committee recommends that the Welsh Government considers policy options for utilising its Welsh Rate of Income Tax powers to deal with adverse economic conditions and cuts in public spending. ....Page 37

Recommendation 10. The Committee recommends that the Welsh Government commissions research into the impact of mitigating personal income tax through incorporation and changing forms of income. ....Page 42

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Recommendation 12. The Committee recommends that future Welsh Government research should consider potential spill-over effects of Welsh Rates of Income Tax policy on disadvantaged people, such as low income earners and individuals paying income tax whilst in receipt of Universal Credit. .... Page 46

1. Background to the inquiry

1. The Welsh Government has responsibility for some of the taxes paid in Wales, including responsibility to set 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). If Welsh taxpayers have taxable savings income, such as bank interest, or taxable dividend income, this remains subject to the main UK rates of income tax for those types of income.

2. 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.

3. The Welsh Government then decided 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.

4. In light of these new taxation powers and the concentration of people living close to the border, the Finance Committee (the Committee) decided to undertake an inquiry into the potential effects of different income tax rates across the Wales-England border.

5. There is a significant population flow between Wales and England due to the length and porous nature of the border between the two countries. The Welsh Government noted that nearly 7 million people live within 25 miles of the Wales-England border and over 17 million people live within 50 miles of the border.[1]

6. The Welsh Government estimates that 98,500 people commuted daily from Wales to England and 42,700 commuted from England to Wales in 2019.[2]

7. There is potential for the number of commuters to increase, particularly around the south east, following the removal of tolls on the Severn and Prince of Wales bridges in December 2018.

[1] Written evidence: NSIT 04: Welsh Government
[2] Welsh Government, Commuting patterns in Wales by measure and year

8. The Welsh Government's evidence shows that the position is very different in Scotland, where only 6 per cent (around 3.7 million) of the combined population of Scotland and England live within 50 miles of the Scotland-England border.[3]

9. The Committee's terms of reference for the inquiry were:

- to examine the effects of sub-national income tax variations in international tax systems on the behaviour of low, medium and high income earners, particularly migration and tax avoidance.
- to understand how low, medium and high income earners may respond to income tax rate divergence for each tax band between Wales and England.
- to understand the level of divergence in income tax rates that could trigger a behavioural change in low, medium and high income earners in Wales and England.
- to assess the monetary impact on WRIT revenue with varying levels of tax rate divergence.

10. From 14 October 2019 to 15 January 2020 the Committee undertook a public consultation, receiving seven responses from a range of organisations and academics. The Committee took evidence from stakeholders and the Minister for Finance and Trefnydd (the Minister) between 27 February and 12 March 2020.

11. The Committee would like to thank all those who have contributed to its work.

[3] Written evidence: NSIT 04: Welsh Government

2. Review of literature

12. Evidence gathered during the inquiry found that, whilst the responsiveness of taxpayers in other jurisdictions to changes in and variation in national and sub-national income taxes could not be simply translated to the Wales-England border, Wales could learn lessons from international studies.

13. David Phillips, Associate Director at the Institute for Fiscal Studies (IFS) noted that findings in international studies on cross-border tax variations were mixed, highlighting:

> "Some studies find relatively little effect of variations in sub-national taxes on behaviour and hence tax bases…[whilst] a number of other studies find larger responses – especially for subsets of the population."[4]

14. In terms of the impact that tax variations have on migration, David Phillips indicated:

> "…there is some evidence that migration is a bigger thing when there are smaller distances. So, where there are differences in tax rates between small areas, like Swiss cantons or Swedish municipalities, migration seems to be more of an issue there than it is across US states or across countries. So, I think that is a really important point with the densely populated Welsh border. I think something like 8 per cent of the Welsh tax base comes from people working in England. Those people, you might think, would be particularly mobile as well."[5]

15. The Organisation for Economic Co-operation and Development (OECD) has conducted a range of work in the area of taxation and published an article on 'Tax Competition Between Sub-Central Governments'. The article examines the strategic interaction of tax policy between sub-central governments with the objective to attract and retain the mobile tax base, and found that:

- tax competition is widespread and occurs in most countries;
- taxes on capital income are most prone to tax base mobility followed by personal income taxes;

[4] Written evidence: NSIT 06: Institute for Fiscal Studies
[5] Finance Committee, Record of Proceedings, 27 February 2020, paragraph 63

- other factors also affect tax competition and tax base mobility such as house prices, spending on public services etc.;
- tax competition tended to converge and increase rather than decrease;
- high tax raising capacity is associated with low tax rates.[6]

16. The research body 'Wales Fiscal Analysis' (WFA) referred to there being "some evidence that differences in tax rates within a country can encourage taxpayers to relocate or shift their income between jurisdictions", but added:

> "However, migration responses are likely to be very context-specific, and Wales' particular circumstances make it hard to draw conclusions from other countries and tax jurisdictions."[7]

17. The Welsh Government noted that it "has undertaken extensive research into the potential migration effects arising from different income tax rates in Wales and England", a summary of which was published in the Tax Policy Report 2018[8].[9]

18. The Welsh Government also highlighted that a review of the literature found that there is no study from which results can be readily applied to estimate intra-UK migration as a result of changes to the devolved rates of income tax. It noted that "the literature generally confirms that there is a relationship between tax rate changes and migration" with the size of the effect generally found to be small.[10]

19. The Minister told the Committee:

> "It's really important that we take account of the best available evidence, and that's one of the reasons why we're trying to expand the base of evidence that we have, and also expand the expertise that we have in Wales… So, the information isn't there at the moment because, as I say, we're in early days but we're keen to learn from other places, although…things aren't easily applicable to Wales."[11]

20. In terms of drawing conclusions from international studies, the Welsh Government official accompanying the Minister agreed that behavioural effects

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[6] OECD, Tax Competition Between Sub-Central Governments
[7] Written evidence: NSIT 07: Wales Fiscal Analysis
[8] Welsh Government, Welsh Tax Policy Report 2018
[9] Written evidence: NSIT 04: Welsh Government
[10] Written evidence: NSIT 04: Welsh Government
[11] Finance Committee, Record of Proceedings, 12 March 2020, paragraph 152

are highly uncertain. However, the official did refer to general findings from the literature:

> "…there are some general things: if tax goes up, then people are more likely to migrate out, and vice versa. So, I think that's the general finding, and I think that's not an unsurprising one. But these effects aren't very large, particularly for the general tax base. They're very hard to actually identify and actually find in the data. But they are larger at the top end of the income distribution. For the real top earners, then they are more likely to move, and I think this is something that really does come strong from the data."[12]

Wales-England border research

Wales Fiscal Analysis

21. WFA is an ongoing research project within the Wales Governance Centre and part funded by the Welsh Government. WFA responds to fiscal events and generates research on all aspects of Government expenditure in Wales.

22. WFA's evidence to the inquiry draws upon its report 'The Welsh Tax Base' published in July 2018.[13] It stressed that, if the Welsh Government was to change income tax rates in Wales, there would likely be some behavioural response from Welsh taxpayers. Whilst it anticipates the extent and effect of behavioural change to be highly uncertain, possible behavioural responses include:

- greater use of tax planning,
- tax avoidance or evasion,
- individuals seeking different jobs or changing the number of hours worked, and/or
- migration into and out of Wales.[14]

23. WFA stated that an obvious factor would be the already large migration flows across the Welsh-English border, noting the possibility that the decisions of those already planning on moving may be influenced by income tax differentials:

[12] Finance Committee, Record of Proceedings, 12 March 2020, paragraph 157
[13] The Welsh Tax Base, Risks and Opportunities after Fiscal Devolution, July 2018
[14] Written evidence: NSIT 07: Wales Fiscal Analysis

> "With several large English cities within commutable distances of the Welsh border, individuals who do not have to change jobs after moving may have a greater incentive to migrate to Wales to take advantage of lower tax rates. There are also a significant number of second homes in Wales and England which are owned by residents of the other country. Changing their primary residence to these addresses may allow some taxpayers to take advantage of lower income tax rates, without incurring the costs of relocation."[15]

Professor James Foreman-Peck and Dr Peng Zhou, Cardiff University

24. Professor James Foreman-Peck and Dr Peng Zhou published an article 'A Welsh tax haven?' in February 2017, analysing the extent of possible tax-induced mobility by looking at migration between local authority areas in Wales and England. They used a model based on the Welsh economy to isolate the effect of council tax rates that can differ substantially between local authority pairs.[16]

25. The research found that:

- changes in the Basic Rate of income tax had little effect on migration and tax yields, due to the lack of incentive to warrant relocating,
- changes in the Additional and Higher income tax rates would have significant impacts,
- the migration and revenue effects become stronger over a longer period, with a reduction in the Additional Rate from 45 per cent to 40 per cent increasing Welsh tax revenue by an annual rate of £55 million after ten years,
- a Higher Rate differential between Wales and the rest of the UK would have the greatest impact on Welsh tax revenue because it affects both the middle income and the high income groups,
- a tax cut would reduce government spending and impact household well-being, but suggested that this is perhaps partly or more than counterbalanced by greater spending on private goods and services, and

[15] Written evidence: NSIT 07: Wales Fiscal Analysis
[16] A Welsh tax haven?, February 2017

- the net effect of changes in the composition of the labour force through tax-induced migration is that tax cuts always increase output per capita but they do not always increase total tax yield.[17]

26. They later published a paper 'Devolving fiscal policy: migration and tax yields' in 2019. The paper developed an indirect approach to establishing revenue impacts of possible devolved tax changes by allowing for tax-induced migration.[18]

27. The results suggested that limited tax devolution, such as that conferred on Wales by the Wales Act 2014, could trigger substantial tax revenue and gross value added (GVA) spill-overs from migration on the devolved economy.

Dr Long Zhou, Professor Kent Matthews and Professor Max Munday, Cardiff Business School

28. Cardiff Business School's evidence noted that the Welsh Government sponsored a research programme in 2014 to develop more complex economic models of the Welsh economy through which to understand the potential effects of changes in taxation at a regional level. The evidence outlined the approach to building its models and provided an example of the model's outputs for a given scenario (a 5p tax cut across all bands).[19]

29. As part of the research, Cardiff Business School developed a Computable General Equilibrium (CGE) model which captures the inter-dependencies between sectors and markets, enabling analysis of how a policy change or shock targeted in one part of the economy will affect the rest of the economy. The evidence noted that the key advantage of this model is its ability to simulate the impacts of policies and events, both regional and national, at the regional level. The model considers the impact of income tax increases and cuts on both the private and public sector.[20]

30. To illustrate how the model works, Cardiff Business School's evidence included a simulation of a 5p-per-pound cut of income tax revenue. Table 1 shows how this tax cut would impact on the Welsh Government and the Welsh economy:

[17] A Welsh tax haven?, February 2017
[18] Devolving fiscal policy: migration and tax yields, May 2019
[19] Written evidence: NSIT 01: Cardiff Business School
[20] Written evidence: NSIT 01: Cardiff Business School

Table 1. Effects of a 5p cut in income tax (percentage change in revenues)

Major variables: Income tax (-5 per cent)	Short run	Medium run	Long run
Devolved Government Revenue	-3.90	-3.87	-3.79
Income tax revenue	-5.07	-5.05	-4.94
Welsh Government spending	-1.24	-1.23	-1.20
Gross value added (GVA)	-0.09	0.03	0.13
Household consumption	0.47	0.49	0.61
Gross fixed capital formation	0.56	0.89	0.95
Total labour factor income	0.37	0.33	0.35
Employment	0.00	0.00	0.35

Source: Written evidence: NSIT 01: Cardiff Business School

31. The evidence notes that:

- the 5p reduction in income tax causes devolved government revenue to decrease by around 4 per cent in the short, medium and long run – mainly because of the weak recoupment of the income tax revenue collected in Wales.

- the income tax revenue initially falls by slightly more than the scale of the 5p tax cut but recovers a little in the long run falling by 4.94 per cent. The small scale of the recoupment implies that the tax cut does not boost the private sector enough to substantially offset the contractionary effect from the public spending cut.

- the Welsh Government's spending decreases by 1.24 per cent in the short run and 1.20 per cent in the long run. The scale of the government spending cut is less than that of the devolved government tax revenue due to the existence of fiscal transfers from central government.

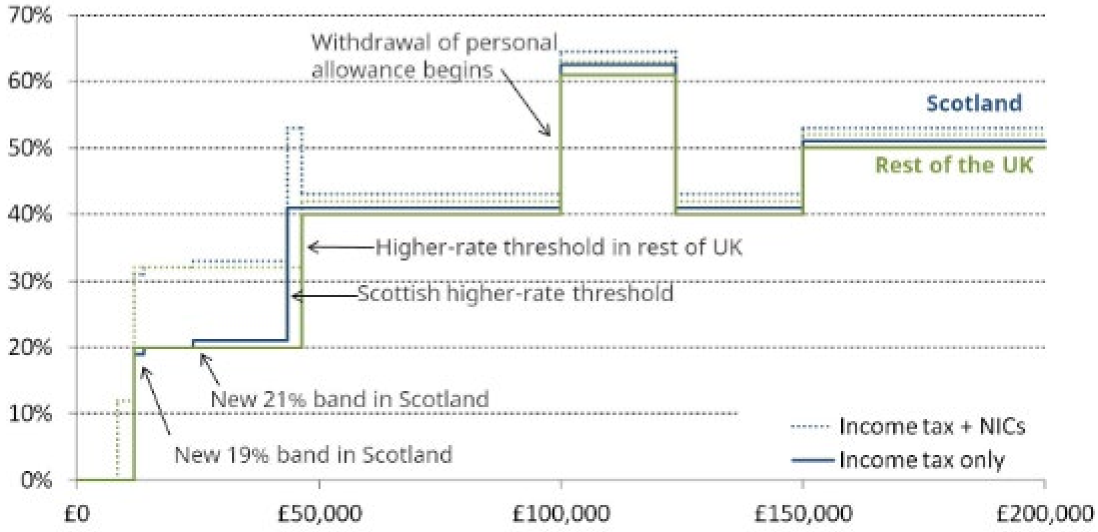
- major macroeconomic variables, including GVA and household consumption, have generally weak positive responses to the tax change. The initial fall of GVA is a result of the contractionary effect from the government spending cut. In the medium to the long run, however, the stimulation to the private sector starts to emerge and covers the negative effects from the spending cut.

- the increase of labour income in the long run is fully linked with the rise of employment which may come from inactive labour in Wales or migration from outside of Wales. If it was assumed that total full time equivalent in Wales was around 1.2 million people, then the tax cut might be connected with around 4,000 more full-time equivalent (FTE) jobs in the long run.[21]

Scottish Rates of Income Tax

32. In April 2018, the IFS published an observation paper[22] on the divergence of the Scottish Rates of Income Tax (SRIT) from the rest of the UK, to raise more from high income earners.[23]

Figure 1. Marginal tax rate schedule on earned income, Scotland and the rest of the UK, 2018-19



Source: Institute for Fiscal Studies, Scottish income tax diverges further from rest of UK to raise more from high earners, April 2018

33. The paper noted:

> "One risk would be that these individuals migrate south of the border into England. While genuine migration is costly, it may be easier for those with multiple properties to change their tax residence within the UK. The OBR [Office for Budget Responsibility] assumes no response in terms of genuine migration, but estimates that changes in reported tax residence as a result of this year's changes will lead to revenue losses to

[21] Written evidence: NSIT 01: Cardiff Business School
[22] Institute for Fiscal Studies, Scottish income tax diverges further from rest of UK to raise more from high earners, April 2018
[23] SRIT 2018-19: Starter Rate: 19 per cent; Basic Rate: 20 per cent; Intermediate Rate: 21 per cent; Higher Rate: 41 per cent; Top Rate: 46 per cent.

> the Scottish Government of around £20 million – almost 10% of the predicted yield."[24]

34. The IFS stated that an effect of this magnitude would require only a small number of additional rate taxpayers (fewer than 20) to switch their residence.[25]

35. In terms of the lessons that Wales could learn from the different income tax rates in Scotland, contributors to the inquiry agreed that the Scotland-England border was fundamentally different to the Wales-England border.

36. The Welsh Government noted:

> "Even once income tax data is available which covers the recent changes in Scotland, careful consideration will need to be given to how applicable any lessons learned are to Wales. The Wales-England border is much longer than the Scotland-England border and the border area is much more heavily populated… Therefore migration between Scotland and England is more likely to require a change of job and social networks than migration between Wales and England."[26]

37. David Phillips told the Committee that it was too early to assess the impact of the Scottish tax rate divergence, as it takes a while for HMRC to process the data.[27]

38. The Minister indicated that "it will probably be a year or two before useful data comes from Scotland in terms of being able to help us understand the issues" and recognised that "the evidence from Scotland will be one more interesting piece in the puzzle rather than a definitive guide to what we can understand might happen in Wales".[28]

39. The Minister's official went on to explain that the "frictionless borders" in the UK makes economic modelling difficult, and relies on conducting surveys that can be quite onerous on businesses:

> "Scotland have done it to some degree, but, by assumption, they've assumed that trade between Scotland and England is not massive. I

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[24] Institute for Fiscal Studies, Scottish income tax diverges further from rest of UK to raise more from high earners, April 2018
[25] Institute for Fiscal Studies, Scottish income tax diverges further from rest of UK to raise more from high earners, April 2018
[26] Written evidence: NSIT 04: Welsh Government
[27] Finance Committee, Record of Proceedings, 27 February 2020, paragraph 68
[28] Finance Committee, Record of Proceedings, 12 March 2020, paragraphs 169 and 283

don't think we can make that assumption in Wales; I think we have to assume almost the opposite."[29]

40. In contrast to the Scottish devolved tax system, WFA highlighted that:

> "…the UK government will not be able to respond in kind to a decision to cut income tax by the Welsh Government. Because any UK government tax cut will also apply in Wales (to the reserved portion of income tax), any differential between income tax rate in Wales and the rUK [rest of the UK] cannot close unless the Welsh Government so chooses."[30]

Committee view

41. Whilst the substantial body of literature examining taxpayers' responsiveness to variations in sub-national income tax offers useful guiding principles, the Committee acknowledges that trying to draw conclusions and predict behavioural responses in Wales from the various effects of tax changes in other countries and tax jurisdictions could be difficult.

42. The Committee welcomes the research being undertaken to develop Welsh specific models and recognises the ongoing nature of this work. The Welsh Government's relationship with these research programmes is crucial, not only in funding further research development but also in terms of collecting and disseminating data to inform this work.

43. The Committee accepts that future data on the impact of income tax rate divergence in Scotland will provide a UK evidence base and offer further insight into taxpayers' responsiveness, but shares the views of contributors that drawing comparisons with Scotland should be approached cautiously given the distinct differences in the composition of the Wales-England border.

[29] Finance Committee, Record of Proceedings, 12 March 2020, paragraph 175
[30] Written evidence: NSIT 07: Wales Fiscal Analysis

3. Welsh-specific data

44. A key theme throughout the inquiry was the lack of Welsh-specific data available to support academics in modelling the impact of behavioural responses to income tax rate divergence on the tax yield and Welsh economy.

45. When questioned about the most appropriate data needed to better inform the relationship between tax rate variations and behavioural responses, WFA stressed:

> "…this [lack of clarity of behavioural effects] is just going to need a lot of work over a period of years. It's not something, in terms of data collection, that we can do overnight. This is going to be something that HMRC particularly, as the tax collection authority, are going to have to monitor over some years."[31]

46. In terms of embarking on a longitudinal study, David Phillips highlighted the need for research on the impact of WRIT policy decisions:

> "Whether it's an ongoing research project, I'm not sure. I think one thing that HMRC would do in what's called KAI—the knowledge analysis and intelligence division—they do a lot of research on an ongoing basis, and I don't know whether they're doing that for the Welsh Government as well as doing it for the UK Government. If they're not, maybe that's what I'd investigate to find out, actually, are they doing this investigation specifically for the Welsh, and if not, why not?"[32]

47. The Minister agreed that there are gaps in the Welsh evidence base:

> "…there's also lots of appetite, I think, for more data to gain a more complete understanding of how the Welsh economy works in terms of those cross-border business flows between Wales and England. Again, that's an area where there is a gap in evidence. Work is under way to understand how feasible it would be to get a greater understanding there. So, we're aware of these gaps in evidence and we're exploring ways to close them."[33]

48. Addressing the continuous appetite for more data, the Minister's official said:

[31] Finance Committee, Record of Proceedings, 27 February, paragraph 146
[32] Finance Committee, Record of Proceedings, 27 February, paragraph 40
[33] Finance Committee, Record of Proceedings, 12 March 2020, paragraph 171

> "…there's already been a survey in the field to try and—a one-off survey to see how viable this is to do…So, you have to go out on surveys, and that can be quite onerous on businesses. Some businesses don't even know that [cross-border business flows between Wales and England]. And so, this has always been a major restriction for this type of economic modelling in Wales… Whether it's viable, what the cost of that is and the burden on business is stuff that we are actively exploring, and we're going to learn more, I think, in the next few months, hopefully. But that is something that the Welsh Government is very conscious of."[34]

Modelling

49. Cardiff Business School explained that the main constraint in constructing its model was data availability:

> "…this model was conducted based on a single level of households, it does not consider the different income bands of the households. So, one of the reasons we chose to do this was because of the lack of data, because currently the Welsh data for the household—there is only one type of household and there is only one type of consumption pattern, in terms of different consumption groups."[35]

50. In terms of whether the necessary data was available to populate the model, Professor Kent Matthews said that, whilst he thinks the data does exist, it's a question of confidentiality in accessing such data.[36]

51. The issue of data confidentiality was also raised by the Minister's official who explained:

> "There is a lot of data there, but, as I say, it's tax sensitive. The best data is the tax data, because what you're really interested in is those top payers, the high-end payers, the additional-rate payers. You only really identify those not from surveys necessarily, but from tax data.
>
> So, yes, we are actively working with HMRC to improve the data, because it's not just important for us to have access to it, it's also important for researchers, like Kent Matthews himself, for them to do studies on, and for transparency in itself. So, that is something that

[34] Finance Committee, Record of Proceedings, 12 March 2020, paragraphs 173 and 175
[35] Finance Committee, Record of Proceedings, 12 March 2020, paragraph 37
[36] Finance Committee, Record of Proceedings, 12 March 2020, paragraph 134

we're trying to—. Even though there are long lags in the data, as the Minister says—we're many years off having the really good data for Wales—it's putting those steps in place so that, once it is available, it's then in an appropriate form and it can be shared appropriately."[37]

52. When asked how the Welsh Government could assist in obtaining data to refine the model, Professor Kent Matthews indicated:

"…I believe the trade survey is on its way and that will be of great value. At this moment, I'm thinking very much about what kind of information you have about income structure and tax paying and migration. These are the most important at the moment. Labour economists will be able to give you a much more definitive answer to this, in terms of micro studies, because you can't—. Wales is never going to have the kind of data that we have in the United Kingdom to build an econometric model, but we can build bits of it and that will be very important, and labour studies are important. So, I do believe that the sort of information you're getting in the general household survey on a regional basis would be interesting."[38]

Taxpayer identification

53. Reflecting on the Scottish experience, the Institute of Chartered Accountants of Scotland (ICAS) said it should not be assumed that Welsh taxpayers "have been correctly identified to the lowest possible margin of error" and encouraged the development of better data to support the analysis of taxpayers' behaviours:

"HMRC's identification of Scottish and Welsh taxpayers is a basic example of an area where accurate and comprehensive information flow is essential to the Scottish and Welsh governments. Clearly, the information flow should be barrier free and mutually recognised as beneficial, to ensure that tax revenues on both sides can be optimised and any potential loopholes identified and resolved expeditiously."[39]

54. In relation to the administration of taxpayers and the correct coding of addresses, WFA told the Committee:

"This is going to be something that needs continual monitoring, because, as taxpayers move out from England to Wales, are they being

[37] Finance Committee, Record of Proceedings, 12 March 2020, paragraphs 287-288
[38] Finance Committee, Record of Proceedings, 12 March 2020, paragraph 128
[39] Written evidence: NSIT 03: Institute of Chartered Accountants of Scotland

> picked up as soon as they move in? People particularly with no fixed address or with multiple addresses in the year: is HMRC mobile and flexible enough to pick up these small changes? It doesn't really matter right now, because the block grant adjustment in the first year equalled the offset tax, but, as we go forward, and particularly if we're looking at changes to tax rates, administration is going to be really, really key, I think, given the Welsh Government's contract with HMRC over tax collection. I think that's a role for both the Welsh Government and the Senedd to participate in."[40]

55. Addressing how effectively taxpayers moving across the border are being identified, the Minister indicated that 97 per cent of taxpayers are now using the correct C code prefix but acknowledged that there is still more work to do. The Minister explained that HMRC has an ongoing education and compliance programme in place and is working with employers to seek improvements.[41]

Committee view

56. The lack of Welsh-specific data is a recurring challenge in the context of fiscal devolution and the Committee acknowledges the constraints this places on supporting research and refining Welsh-specific modelling. Whilst recognising the sensitivities surrounding the disclosure of tax data on income structure in particular, improving Welsh data collection and dissemination is crucial to understanding the composition of the Welsh tax base.

57. The Committee notes that the Welsh Government has undertaken a one-off trade survey to gain Welsh-specific data collection and supports further exploration of the feasibility of this approach to address the gaps in the Welsh evidence base identified by stakeholders.

58. The issue of cross-border migration and taxpayer identification is discussed regularly with the Minister, as part of the Committee's scrutiny of the progress of the devolution of fiscal powers to Wales and the Welsh Government's budgets. Whilst the Minister detailed the work undertaken by HMRC to reduce coding errors, the Committee believes that greater confidence over the completeness and accuracy of the Welsh tax base is required.

Recommendation 1. The Committee recommends greater collaboration between the Welsh Government and HMRC to improve Welsh data collection and dissemination, and urges the Welsh Government to explore how HMRC's

[40] Finance Committee, Record of Proceedings, 27 February 2020, paragraph 233
[41] Finance Committee, Record of Proceedings, 12 March 2020, paragraphs 274 and 276

Knowledge, Analysis and Intelligence division can be utilised to support research into tax divergence.

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

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

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

4. Behavioural responses

Welsh tax base

59. The likelihood of being an income taxpayer is lower in Wales than it is in the UK as a whole, according to the OBR report on Welsh Taxes Outlook. It stated that, according to the 2016-17 Survey of Personal Incomes (SPI), 44 per cent of the Welsh population were income taxpayers, compared to 47 per cent of the UK's population, adding:

> "The most important reason for the gap between UK and Welsh tax per person as recorded in the SPI is that Welsh taxpayers had lower average incomes."[42]

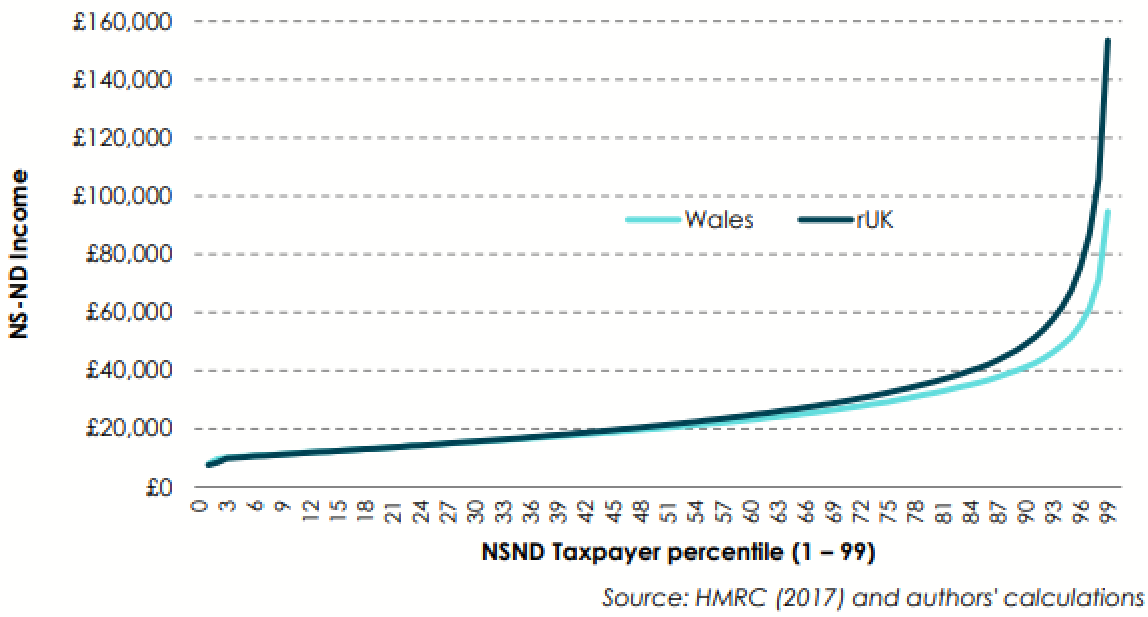
60. The OBR also cited two other factors likely to contribute to the lower proportion of taxpayers in Wales:

- employment rates being lower in Wales; and
- successive rises in the tax-free personal allowance taking proportionately more Welsh residents out of income tax altogether.[43]

61. WFA's report on the Welsh Tax Base noted that mean taxpayer non-savings, non-dividend (NSND) income in Wales in 2014-15 (£24,900) was significantly below that of the rest of the UK (£29,900). The report also stated that differences between Welsh and the rest of the UK taxpayer incomes are particularly apparent at the upper end of the income distribution: income at the 99th percentile was £94,600 in Wales but £153,400 in the rest of the UK.[44]

[42] Office for Budget Responsibility, Welsh Taxes Outlook, December 2019, paragraphs 2.17 and 2.20
[43] Office for Budget Responsibility, Welsh Taxes Outlook, December 2019, paragraphs 2.18-2.19
[44] The Welsh Tax Base, Risks and Opportunities after Fiscal Devolution, July 2018, page 7

Figure 2. Distribution of taxpayer non-savings, non-dividend (NSND) incomes in Wales and the rest of the UK 2014-15



Source: The Welsh Tax Base, Risks and Opportunities after Fiscal Devolution, July 2018 (Figure 2.3)

Income profiles

62. David Phillips agreed with the conclusions formed by the majority of international literature, that migration and other behavioural responses such as tax avoidance are likely to be greater for high income individuals.[45]

63. Elaborating on this he explained:

> “That looks like it’s to do with the fact they have greater scope to make use of various tax planning and tax avoidance things—perfectly legally, I should add—also to migrate to other jurisdictions—it’s easier to migrate if you’re a millionaire than if you’re someone on an ordinary salary—and also perhaps greater award of effort and performance. So, if you’re a top executive, maybe you can really push the boat out a bit more. Your earnings will depend a bit more on your performance—although not always—than someone on a more regular salary. So, high income taxpayers tend to be more responsive.”[46]

[45] Written evidence: NSIT 06: Institute for Fiscal Studies
[46] Finance Committee, Record of Proceedings, 27 February 2020, paragraph 5

64. He noted that evidence suggests responsiveness to tax divergence is weakened due to the significant costs of reacting to tax changes, especially in the short term. He identified that for migration responses:

> "…these costs include the physical cost of moving (e.g. costs of buying/selling houses), information costs (e.g. on where taxes are lower, on where and which jobs are available), and psychological costs (e.g. missing family and friends)."[47]

65. In terms of tax avoidance, David Phillips also highlighted the cost of seeking professional advice and suggested that "it may only be worth making the effort to respond at all once tax changes/differentials are of a sufficient size".[48]

66. WFA noted that "high income earners are assumed to be the most responsive to income tax rate changes because they have the largest incentive and the greatest means to change their behaviour in response to tax policy".[49]

67. Whilst acknowledging that Wales is less dependent on the incomes of the very highest earners, WFA stated that the Welsh tax take will be heavily influenced by their income:

> "The top one per cent of taxpayers in Wales will contribute over 10 per cent of devolved income tax revenue (more than the lowest-earning 40 per cent of taxpayers), and the top 10% will contribute more than the lowest-earning 70 per cent."[50]

68. WFA's evidence, which presented estimates of the migration levels required for the revenue effect of a tax change to reverse, found that migration by additional rate taxpayers has the highest likelihood of materially affecting the revenue effects of Welsh Government tax rate changes.[51]

69. WFA's modelling, which suggested that abolishing the additional rate in Wales (by implementing a 5p cut) would cost the Welsh Government approximately £27 million in 2020-21, projected that:

[47] Written evidence: NSIT 06: Institute for Fiscal Studies
[48] Written evidence: NSIT 06: Institute for Fiscal Studies
[49] Written evidence: NSIT 07: Wales Fiscal Analysis
[50] Written evidence: NSIT 07: Wales Fiscal Analysis
[51] Written evidence: NSIT 07: Wales Fiscal Analysis

- the cost of the tax cut would fall to £17 million, if around 407 additional rate taxpayers migrated to Wales (0.1 per cent of additional rate taxpayers in the rest of the UK);
- the cost of the tax cut would be offset, if 1,100 average additional rate taxpayers migrated;
- the Welsh Government's budget would increase by £129 million, if over 6,000 additional rate taxpayers migrated.[52]

Table 2. Modelling a 5p cut in the additional rate in Wales: revenue effects of varying migratory responses from additional rate (AR) taxpayers from the rest of the UK (rUK)

Share of rUK AR taxpayers migrating to Wales	Number of AR taxpayers migrating to Wales	Number of AR taxpayers in Wales	Welsh share of all UK AR taxpayers	Budget effect of migratory response (£ million)	Budget change after tax cut (£ million)
0.0%	0	6,000	1.4%	0	-27
0.1%	407	6,407	1.5%	10	-17
0.5%	2,035	8,035	1.8%	52	25
1.0%	4,070	10,070	2.3%	104	77
1.5%	6,105	12,105	2.8%	156	129
2.0%	8,140	14,140	3.3%	208	181
2.5%	10,175	16,175	3.7%	260	233
3.0%	12,210	18,210	4.2%	312	285

Source: Written evidence: NSIT 07: Wales Fiscal Analysis, (Figure 3)

70. WFA explained that a 5p cut in the additional rate would represent a £10,500 tax cut each year, adding:

> "If your intention is to increase the size of the Welsh budget by attracting higher earners you'd need around 6,000 additional rate taxpayers to move to Wales to raise £129 million for the Welsh budget. That would be a doubling of the amount of additional rate taxpayers in Wales…In considering the differences in housing costs and living costs already present across the border, that would represent a substantial migration response. How likely that is to recur—you could probably be

[52] Written evidence: NSIT 07: Wales Fiscal Analysis

> quite sceptical about that sort of response taking place after a tax cut."[53]

71. Conversely, if the higher rate was increased by 5p (costing the average higher rate taxpayer in Wales £1,067), the WFA's modelling showed that more than 17,000 higher rate taxpayers would need to migrate to offset the additional £118 million raised.[54]

72. On the responsiveness of low and medium income taxpayers, David Phillips said:

> "I should say that the strong evidence is these people are a lot less responsive to changes in income tax, but because there are far, far more of them, a small change can turn into a bigger cash amount. So, I wouldn't say that you should ignore the effects. In pounds millions, it could be bigger, actually; it's just a much smaller percentage of the revenue you get from them."[55]

73. However, David Phillips noted that responsiveness can be high for particular sub-sets such as young graduates, inventors, professional sports people, those approaching retirement and non-UK citizens.[56] Expanding on the more responsive groups, he explained:

> "…if you look at the evidence about who is most responsive, it could be people with childcare responsibilities, who seem to be a bit more responsive to differences in tax rates and benefit policy—so, mothers with young children. There's some evidence that when people move to retire that can be a factor there, and there's some evidence, although this is a bit unclear—some say it's fine, some don't—that young graduates can be a bit more mobile, because they haven't set up their families and their careers yet.
>
> …I know the Welsh Government's been thinking more generally about what to do with young graduates who come to Wales to study, or leave Wales, and there's a bit of an in-flow of older people and an out-flow of young graduates. It could have an impact there, but probably relatively small."[57]

[53] Finance Committee, Record of Proceedings, 27 February 2020, paragraphs 211-212
[54] Written evidence: NSIT 07: Wales Fiscal Analysis
[55] Finance Committee, Record of Proceedings, 27 February 2020, paragraph 42
[56] Written evidence: NSIT 06: Institute for Fiscal Studies
[57] Finance Committee, Record of Proceedings, 27 February 2020, paragraphs 43-44

74. The OECD emphasised the need to consider the interactions between the tax and social security contribution system:

> "…labour market activity is not just about tax, there are many other considerations, and these approaches should be considered in that broader policy context as well. But, we would certainly see that ensuring that particularly the interaction between any benefits that might be available through other spending channels and the tax system, we try to reduce any of the disincentives that you might be creating. That's an incredibly complicated set of assessments to make."[58]

75. Furthermore, the OECD cautioned giving too much weight to some of the mobility threats:

> "In the end, the environment in a post-partial devolution context is no different to what every jurisdiction faces, and tax rates impact the extent to which people work, the amount that they work, their willingness to work and getting the rates right to get the right responses is the first set of questions that you should be asking. We do think that it's obviously important to take behavioural responses into account, but we think there is a danger that you could over-emphasise the impact of those."[59]

76. The OECD also raised the challenges of Wales's ageing population and the need to consider the impact of fewer people being active in the labour market on personal income tax revenues.[60]

77. The Minister told the Committee that she accepted that higher earners are more susceptible to behavioural changes in response to income tax in particular:

> "In terms of influencing policy, there's a real tension, isn't there, in terms of seeking to encourage high earners to come and live in Wales, but, at the same time, maintaining our very progressive approach to policy and tax policy."[61]

[58] Finance Committee, Record of Proceedings, 27 February 2020, paragraph 167
[59] Finance Committee, Record of Proceedings, 27 February 2020, paragraph 187
[60] Finance Committee, Record of Proceedings, 27 February 2020, paragraph 169
[61] Finance Committee, Record of Proceedings, 12 March 2020, paragraph 178

Non-tax factors

78. The joint response from the Chartered Institute of Taxation (CIOT) and Low Incomes Tax Reform Group (LITRG) suggested that there are a number of non-tax factors that would be greater influencers on where an individual lives, rather than small income tax variations, such as:

- Cost of housing (buying or renting)
- Availability of work (and travel links to work)
- Cost of living
- Schools and social services.[62]

79. However, they noted that tax changes "may have an impact at the margin, especially for high earners, influencing longer term decisions about whether or not to move in the context of 'a life event' when say, a taxpayer changes jobs or downsizes".[63]

80. This view was supported by WFA using the removal of the Severn bridge tolls as an example, which it noted has had a significant effect on house prices. It cited that there is "clearly evidence that these non-tax factors are playing a big role", adding:

> "I suppose when we're looking at this, when we're trying to find clues in this about what big tax-rate changes might signify for migration, I suppose the question is: given that house prices and living costs are so much lower in Wales already, why haven't people moved already? On that basis, we'd expect that quite large tax-rate changes would be needed to trigger some sort of large response. Small changes at the margin—given that we already have these big differentials, these small rate changes are unlikely on their own to trigger a large migration response."[64]

[62] Written evidence: NSIT 05 Chartered Institute of Taxation (CIOT) and the Low Incomes Tax Reform Group (LITRG)
[63] Written evidence: NSIT 05 Chartered Institute of Taxation (CIOT) and the Low Incomes Tax Reform Group (LITRG)
[64] Finance Committee, Record of Proceedings, 27 February 2020, paragraph 185

81. When asked whether the Welsh Government has examined the potential consequences of attracting more taxpayers to Wales, such as the impact on house prices and rental costs, the Minister said:

> "…there would have to be huge movement in order to have any real impact on house prices and rents in Wales. You can look at areas where Government policy has changed or had an impact on house prices. When you think about the removal of the Severn bridge tolls, people there, for example—. The cost to a commuter for using the Severn tolls was in excess of £1,000 a year but, in contrast, a 1p change to the basic rate in Wales for the median earner would result in a change of tax of just £100 a year. So, I think that the level of impact it would have on those individuals is very different."[65]

Extent of tax change

82. The Committee heard that short and long term tax rate changes would generate different behavioural responses: The CIOT and LITRG said:

> "…a short term divergence (provided the public knew it was short term) might not cause, for example, someone to incorporate a business or refuse a promotion. In our opinion, divergences would probably have to be significant and long-term to result in migration out of a state."[66]

83. When asked whether short-term and long-term tax rate variations would encourage different behavioural responses by taxpayers, Cardiff Business School agreed that in the short-term, tax variations may not make a great deal of difference but in the long-term a migratory response would be expected.[67]

84. David Phillips also highlighted the importance of considering the extent of the tax change, noting that the scale of response to a significant tax rate change could be proportionally greater than a response to a small change:

> "For example, one might expect a 5 percentage point change in tax rates to lead to a more-than 5 times as large a response as a 1 percentage point change in tax rate. This is because adjustment costs can attenuate the responses to small changes or differences in tax policy. This means that the scope for learning how taxpayers may

[65] Finance Committee, Record of Proceedings, 12 March 2020, paragraph 221
[66] Written evidence: NSIT 05 Chartered Institute of Taxation (CIOT) and the Low Incomes Tax Reform Group (LITRG)
[67] Finance Committee, Record of Proceedings, 12 March 2020, paragraphs 29-30

respond to a big tax change from how they responded to a small tax change may be limited."[68]

85. The CIOT and LITRG estimated the changes in rates required to influence Welsh taxpayers' behaviour:

> "Anecdotally, we think that a 5% to 10% long term variation in income tax rates may be needed to have any significant effect on people's choices of residence. But…we recommend further research in this area."[69]

86. Whilst Professor James Foreman-Peck expressed the view that a relatively small change would eventually have a significant impact:

> "The point would have to be that it would have to be credible and sustained, precisely because we don't know how long it's going to take. So, it would involve people believing that this income tax change was going to persist for maybe 10 years or more, because of the time it takes for people to adjust their behaviour and to believe it's going to be worthwhile and won't be changed back to where it was before. So, I think the credibility of the change, or the credibility of the persistence of the change is probably the most important aspect of deciding on whether the effect is going to be significant or not."[70]

87. Professor James Foreman-Peck concluded:

> "In the search for tax revenue, changing income tax rates seems perilous. Seeking a broader tax base or encouraging the growth of existing tax bases appear preferable."[71]

88. Elaborating on the levers available to expand the Welsh tax base, Professor James Foreman-Peck referred to the policy to attract Admiral to Wales:

> "…Admiral is such a big company now, and it didn't exist before it came to Wales. And it seems to me if you could just do two or three more like

[68] Written evidence: NSIT 06: Institute for Fiscal Studies
[69] Written evidence: NSIT 05 Chartered Institute of Taxation (CIOT) and the Low Incomes Tax Reform Group (LITRG)
[70] Finance Committee, Record of Proceedings, 4 March 2020, paragraph 53
[71] Written evidence : James Foreman-Peck and Peng Zhou, Cardiff University

> that, you would be making a great deal of difference to the Welsh economy."[72]

89. In response to the suggestion that seeking a broader tax base would be preferable to changing income tax rates, the Minister said:

> "I think that it's good that we have both tools. So, we have Welsh rates of income tax but we also have the opportunity to grow our tax base through the right investment and policies. Changing tax rates, of course, would give us more of an immediate impact, whereas growing the tax base is a much longer-term endeavour. The difference now I think is, really, that we've got more skin in the game in the sense that we're exposed now to the growth and to increasing the take of tax in Wales, so that's the difference, I think, now that we do have both of those levers."[73]

Welsh Government tax policy

90. David Phillips highlighted that, if the Welsh Government is considering a more progressive tax regime, both the income tax and property tax systems can be utilised.[74] This was echoed by the OECD:

> " I think looking at personal income tax in isolation may not be the optimal approach, and that really also thinking about the property tax design is really important."[75]

91. David Phillips pointed out that the way in which the WRIT has been set-up means that increases in income tax rates are relatively more attractive to the Welsh Government from a revenue perspective:

> "…unless migration responses are very large indeed, the set-up of income tax devolution in Wales means that it is very highly likely that increases in tax rates, even the additional rate, would increase Welsh Government revenues. Conversely, reductions in tax rates would reduce revenues, unless behavioural responses were very large. This is because whilst the Welsh Government gains or loses the full 'mechanical' effect

[72] Finance Committee, Record of Proceedings, 4 March 2020, paragraph 77
[73] Finance Committee, Record of Proceedings, 12 March 2020, paragraph 219
[74] Finance Committee, Record of Proceedings, 27 February 2020, paragraph 71
[75] Finance Committee, Record of Proceedings, 27 February 2020, paragraph 188

> of the tax rate change, it only bears a portion of the behavioural effect."[76]

92. This was illustrated in the WFA's evidence, which modelled the WRIT revenue effect with a change in tax rates for each income tax band. The estimate showed that:

> "…the Welsh Government would be relatively shielded from the behavioural response of Welsh taxpayers if it decided to change income tax rates…the 'mechanical' effect of a tax rate change (with no behavioural change) are relatively close to the revenue effects that assume a behavioural response. For instance, a 1p increase at the basic rate would raise around £190 million in revenue in the absence of a behavioural response; these receipts would reduce only marginally to £186 million even under an assumption of large income elasticities."[77]

93. The Welsh Government has committed to not increasing income tax rates during the 2016-21 term.[78] When questioned on the Welsh Government's priorities for developing future income tax policies, the Minister told the Committee:

> "So, I think we're all in a similar place at the moment in the sense that the Welsh Government has said that it won't raise income tax rates over the course of this Assembly. So, the kind of discussions and thought I'm giving to it now is where we take things for the next Assembly and what our manifesto commitments might look like. So, obviously, I wouldn't want to go into too much detail. But I know that all parties will be using the work that this committee does in terms of considering the way forward. But I think that if we start from a base of fairness and progressivity—I think that that would be where we are."[79]

Committee view

94. The Committee recognises the challenges faced by the Welsh Government in seeking to anticipate taxpayers' migratory, avoidance and economic responses to potential income tax rates change in Wales – though these are challenges faced by every jurisdiction. Ultimately the only way the Welsh Government will

[76] Written evidence: NSIT 06: Institute for Fiscal Studies
[77] Written evidence: NSIT 07: Wales Fiscal Analysis, Figure 2
[78] Welsh Government, Welsh Tax Policy Report 2019, paragraph 12
[79] Finance Committee, Record of Proceedings, 12 March 2020, paragraph 199

build its own evidence base is to undertake a longitudinal research study when embarking on new income tax policies.

95. The Committee is aware that growing the Welsh tax base is an important element in raising tax revenue for public spending in Wales and encourages the Welsh Government to focus on implementing innovative strategies to develop the tax base.

96. The Committee notes that literature suggests responsiveness to tax divergence increases with income and an individual's flexibility to relocate, and believes that the Welsh Government must examine how its tax policies can attract and retain these influential groups.

97. The Committee recognises the Welsh Government's efforts to maintain parity with England in areas such as NHS pensions and teachers' pay to mitigate migratory responses. Given the evidence pointing to the influence of non-tax factors on where an individual chooses to live, such as house prices, the cost of living, employment opportunities, the quality of public services and the quality of life in general, the Committee would welcome research into what role these factors play in a taxpayer's response to diverging tax rates across the Wales-England border.

98. The Committee is concerned that the evidence suggested that the way in which the WRIT operates promotes a bias towards increasing income tax rates and could therefore impose limitations on the Welsh Government's ability to cut rates.

99. Whilst acknowledging the Welsh Government's ambition to move towards a more progressive tax system in Wales, the Committee heard no evidence of any intention to develop WRIT policy options as a contingency for potential economic downturns and cuts to public spending. The severe health and economic repercussions of the ongoing COVID-19 pandemic demonstrates the need to consider how the WRIT can support Wales's economic recovery.

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

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

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

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

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

5. Approaches to mitigating personal income tax

100. A number of contributors referred to ways in which individuals could mitigate their tax payments if income tax diverges across the Wales-England border. Tax mitigation legally reduces tax liabilities through the use of tax laws, for example, by gifting to charity.

101. The Committee heard that those who are self-employed would have the option to respond to tax variations by registering their existing business as a limited company (incorporation). The joint response by the CIOT and LITRG stated:

> "With earned income being liable to sub-national variations but dividend income (and corporation tax) being liable to UK national income tax rates, a variation in income tax rates between Wales and England could lead to some self-employed individuals incorporating their business to change the basis of taxation on themselves and their earnings (i.e. so that they would pay corporation tax on the profits and dividend savings income tax on the withdrawal of profits from the business rather than Welsh income tax on the profits of a self-employed business)."[80]

102. Similarly, business owners could change the form of income in which they take their remuneration to minimise their personal income tax. WFA noted:

> "Converting income between dividend income (still taxed at the UK government rates) and earned income will also be an additional behavioural response available to some taxpayers. Taxpayers with total incomes over the additional rate threshold in Wales received around £220 million of dividend income in 2014-15. Tax-motivated incorporations have been increasing in recent years, and any income tax rate change in Wales may affect the relative trends in incorporations."[81]

103. The CIOT and LITRG also highlighted other behavioural effects, which are most likely to impact on middle and high earners:

[80] Written evidence: NSIT 05 Chartered Institute of Taxation (CIOT) and the Low Incomes Tax Reform Group (LITRG)
[81] Written evidence: NSIT 07: Wales Fiscal Analysis

- making more pension contributions / Gift Aid donations (both extend the basic rate band which gives relief from higher and additional tax rates)
- choosing not to take a pay rise / promotion / increase work hours.[82]

104. The CIOT and LITRG suggested that these behaviours are more likely to occur in Scotland as it would be an easier solution than moving house. Although they acknowledged that, there is no data at present to determine whether this is the case.[83]

Non-savings and non-dividend income

105. The WRIT only applies to non-savings and non-dividend (NSND) income. David Phillips suggested that this type of income is less responsive than capital income due to the fact that there are "more opportunities to avoid taxation of capital income – especially by retaining income within a business and taking advantage of lower tax rates later (particularly on capital gains)".[84]

106. This was reiterated by the OECD:

> "…one of the things that we observe in many jurisdictions in relation to the personal income tax is that where there are significant differences in tax rates of the personal income tax compared to the corporate rate of taxation, there are opportunities for restructuring of activities and many higher income earners are able to change the nature of their activities or the way they're structured in order to reduce the tax that they pay…one of the challenges that you face is that you do not have much control over the taxation of capital income, whether it be through the corporate vehicle or whether it be in the form of the taxation of dividends or other forms of capital return. So, we think that these are considerations to bear in mind."[85]

107. Referring to the modest revenues generated in WFA's modelling of additional tax rate changes, the OECD anticipated that many high income earners in Wales may have already been incorporating their activities:

[82] Written evidence: NSIT 05 Chartered Institute of Taxation (CIOT) and the Low Incomes Tax Reform Group (LITRG)
[83] Written evidence: NSIT 05 Chartered Institute of Taxation (CIOT) and the Low Incomes Tax Reform Group (LITRG)
[84] Written evidence: NSIT 06: Institute for Fiscal Studies
[85] Finance Committee, Record of Proceedings, 27 February 2020, paragraph 150

"So, what you do or do not do in terms of your partial devolution and the ability that gives you around personal income tax rates is likely to be operating in an environment where that's already built in."[86]

108. Given that there is less evidence in terms of incorporation and dividend income, David Phillips encouraged the Welsh Government to examine this response further:

"I think we don't have very good evidence about the extent to which the fact that you've got these two effects—. Employment income is less responsive, but this new margin for response by incorporating, we don't know how that plays out. So, I think, if a gap opens up between tax on non-savings non-dividends income in Wales and the dividends tax rates, doing an investigation of how that's affecting the incorporation rates, how that's affecting revenues, it won't necessarily be easy, but I think that's something to look at."[87]

109. David Phillips illustrated the differences between dividend and non-dividend income:

"…if you're on £40,000 a year, if you are an employee, the total tax on that with national insurance is about £11,500. Actually, I think it's £11,800. If it's £40,000 as a small business, through dividends and other things, and corporation tax, it's £7,500, so a £4,500 difference in tax. That's just nonsense and that's what's driving these behaviours is the differences in taxes."[88]

110. He went on to suggest that consideration could be given to devolving savings and dividends income to Wales:

"I think, initially, it [savings and dividend income] wasn't devolved because we had a lot of interest on bank accounts being taxed, and that was partly difficult for the banks to sort out. That's not the case, bank interest is more or less tax-free nowadays. Dividends income is all via self-assessment, we know where they live, it's the same with self-employment. I think that can be done now and I think that is probably worth doing."[89]

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[86] Finance Committee, Record of Proceedings, 27 February 2020, paragraphs 168 and 172
[87] Finance Committee, Record of Proceedings, 27 February 2020, paragraph 11
[88] Finance Committee, Record of Proceedings, 27 February 2020, paragraph 29
[89] Finance Committee, Record of Proceedings, 27 February 2020, paragraph 33

111. Whilst recognising that raising the tax rates for both employees and businesses may result in a reduction in economic activity in Wales, David Phillips suggested that devolving savings and dividend income would provide the Welsh Government with different options. He also acknowledged that pursuing powers over savings and dividend income would "expose the Welsh Government to the more volatile part of the revenues".[90]

112. Responding to the suggestion that many high income earners in Wales may have already incorporated their activities to mitigate personal income tax, the Minister's official said:

> "… if that has happened, in some ways—it's a bit callous to say this—we don't always care, because it's in our baseline, so, if that has already happened, then that's fine; it won't affect us going forward so much. Now, it might if tax rates vary, and, as we described, HMRC would be interested in this as well, but maybe it would be dampened because maybe most of that behaviour's already happened, because there already is the differential in the tax rates."[91]

113. The Minister agreed to provide the Committee with details of Welsh additional rate taxpayers employed in the public and private sectors, to ascertain the potential scope of income tax mitigation by means of restructuring activities:

- 27,300 (23 per cent) of the estimated 116,000 higher or additional rate income taxpayers who would have paid the WRIT in 2016-17 were employed in the public sector;
- 700 (19 per cent) of the 3,800 additional rate taxpayers subject to the WRIT in 2016-17 were employed in the public sector;
- £57 million (23 per cent) of the £244 million that the higher rate element of the WRIT would have raised in 2016-17 would have come from public sector workers;
- £3 million (7 per cent) of the £42 million that the additional rate element of the WRIT would have raised in 2016-17 would have come from public sector workers.[92]

[90] Finance Committee, Record of Proceedings, 27 February 2020, paragraphs 102 and 105
[91] Finance Committee, Record of Proceedings, 12 March 2020, paragraph 213
[92] Note from the Minister for Finance and Trefnydd: Higher and additional rate earners in Wales employed in the public sector

114. When asked whether the Welsh Government would seek to have savings and dividend income devolved to Wales, the Minister replied:

> "…in terms of Welsh rates of income tax, as you know, they are very new, so we haven't looked beyond the income tax that we have. So, we haven't looked, for example, towards dividends and savings and seeking to have extra powers to devolve, because I don't think that we're in that space at the moment. And if devolved rates were to increase in Wales for dividends and savings, then it could increase the difference between the dividend and non-dividend income and then creating a further incentive for self-incorporating. So, there are all kinds of things to think about. But this isn't an area that we've explored very deeply, because we don't have the levers at the moment, and they're not levers that we would be seeking, certainly in the near future, just because income tax devolution is just, at the moment, bedding in."[93]

Committee view

115. The Committee notes the significant differences between the taxation of dividend and non-dividend income, illustrated in the example provided by David Phillips, which demonstrates that an individual earning £40,000 can mitigate their tax liability by £4,500 if they incorporate their business. The Committee believes that the Welsh Government should explore taxpayers' response to mitigating personal income tax further, especially given that a significant proportion of higher and additional rate payers are employed in the private sector in Wales and therefore capable of incorporating their activities.

116. Whilst recognising that the Welsh Government's focus is on the newly devolved Welsh Rates of Income Tax powers, the issue of tax mitigation through incorporation and dividend income featured heavily during this inquiry. The Committee believes that the potential devolution of savings and dividend income deserves further exploration, to provide the Welsh Government with the levers required to close the gap between dividend and non-dividend income in Wales.

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

[93] Finance Committee, Record of Proceedings, 12 March 20202, paragraph 294

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

6. Spill-over effects

117. David Phillips discussed the importance of considering other effects of tax policy decisions, not just the revenue implications. His evidence also focused on the potential spill-over effects as a consequence of decisions made, for example:

> "An increase in the additional rate of tax might yield revenue due to the fact the Welsh Govt [Government] bears only a portion of the migration and avoidance effect on the size of the Welsh tax base. But the Welsh Govt may still decide it does not want to do this if it is concerned with the welfare of additional tax rate payers appropriately, or it thinks there could be spill-overs on the wider Welsh population (e.g. lower wages or fewer employment opportunities) if there is a reduction in the number of additional rate taxpayers in Wales."[94]

118. He suggested that the Welsh Government could undertake "research to actually estimate these impacts on wider things, recognising that you're not going to get an exact answer" to mitigate the risks of spill-over effects.[95]

119. The joint submission by the CIOT and LITRG also referred to potential spill-over effects from tax rate changes:

> "…when the Scottish starter rate of 19% was introduced in April 2018, this was stated to mean that all those Scottish taxpayers with incomes up to £24,000 would pay £20 less tax over the course of the tax year than taxpayers living in the rest of the UK on the same level of income. However, Scottish taxpayers who were also in receipt of a means-tested benefit such as Universal Credit that depends on net income after tax, found that their benefit was reduced, cancelling out all or part of the tax reduction."[96]

120. The fiscal framework agreed between the UK and Welsh Governments details mechanisms for the treatment of three categories of spill-over effects:

- Direct effects – These will all be accounted for, either mechanically through the block grant adjustment or separately once identified.

[94] Written evidence: NSIT 06: Institute for Fiscal Studies
[95] Finance Committee, Record of Proceedings, 27 February 2020, paragraph 125
[96] Written evidence: NSIT 05 Chartered Institute of Taxation (CIOT) and the Low Incomes Tax Reform Group (LITRG)

- Behavioural effects – These will only be accounted for in exceptional circumstances, where the effects are material and demonstrable, and both governments agree that it is appropriate to do so.
- Second round effects – These will not be accounted for.[97]

121. In terms of the direct spill-over effect that increasing the basic rate of income tax in Wales would have on the eligibility for Universal Credit, and consequently on UK Government's spending, WFA commented:

> "…a 1p rise in income tax rates on the basic rate, will probably have quite a small effect. I don't think the Treasury will regard that a material sum of money and worth the effort of starting a dispute resolution with the Welsh Government. So, it's probably too small an amount. They're probably too small amounts to actually trigger this mechanism in the fiscal framework agreement."[98]

122. Similarly, WFA could not envisage the UK Government pursuing compensation for behavioural spill-over effects of a rate change:

> "I can't imagine that ever being the case—the two Governments coming to an agreement with each other that a policy rate change by the Welsh Government has caused a demonstrable or material effect…the effect of a 5p cut in the additional rate taxpayers—say that encouraged people to move additional rate taxpayers to move to Wales. Because of the nature of the tax system that we have, they'd still be contributing to the UK Government. They'd still be contributing 35p in the £1 of their additional rate income to the UK Government. So, I think it's very unlikely that you'd see a demonstrable and material effect, and then it comes to the question of how you actually measure that accurately, given the absence of a counter-factual scenario."[99]

123. In the absence of "material and demonstrable" effects being defined in the fiscal framework, WFA pointed out that "this would all have to be negotiated between the two Governments, and, if there's no resolution, the dispute falls".[100]

[97] The agreement between the Welsh Government and the United Kingdom Government on the Welsh Government's fiscal framework, December 2016
[98] Finance Committee, Record of Proceedings, 27 February 2020, paragraph 220
[99] Finance Committee, Record of Proceedings, 27 February 2020, paragraph 216
[100] Finance Committee, Record of Proceedings, 27 February 2020, paragraph 217

124. David Phillips was of the view that the UK Government's appetite to pursue compensation would depend on those in power at the time:

> "…when George Osborne was asked about this a few years ago when it first was raised in Scotland, his view on this was 'Well, this is what it's about; it's about giving flexibility on taxes, and if Scotland wants to cut it and draw more business in, that's just what this is about; we wouldn't be pursuing this.' I don't know what…Rishi Sunak thinks. I think that will play a role as well—how they interpret these rules."[101]

125. On the issue of transfers between governments for spill-over effects, the Minister's official agreed that accounting for behavioural effects would be difficult to estimate and agree, but accepted that the direct effects on Universal Credit would be more identifiable.[102]

Committee view

126. Whilst accepting that accounting for behavioural spill-over effects and agreeing any transfers between the Welsh and UK Governments will be challenging, the Committee believes that the identification and estimation of potential spill-over effects, both positive and negative, is fundamental to designing effective tax policies.

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

[101] Finance Committee, Record of Proceedings, 27 February 2020, paragraph 94
[102] Finance Committee, Record of Proceedings, 12 March 2020, paragraph 300

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
27 February 2020	**David Phillips, Associate Director** Institute for Fiscal Studies
27 February 2020	**Ed Poole, Senior Lecturer in Politics and International Relations** Cardiff University **Guto Ifan, Research Associate, Wales Governance Centre** Cardiff University **David Bradbury, Head of the Tax Policy and Statistics Division** OECD **Bert Brys, Head of the Country Tax Policy and Personal and Property Taxes Units** OECD **Sean Dougherty, Senior Adviser** OECD
4 March 2020	**Professor James Foreman-Peck, Professor in Economics** Cardiff University
12 March 2020	**Professor Kent Matthews, Sir Julian Hodge Professor of Banking and Finance** Cardiff Business School **Dr Long Zhou, Research student** Cardiff Business School
12 March 2020	**Rebecca Evans AM, Minister for Finance and Trefnydd** **Anna Adams, Deputy Director, Head of Tax Strategy Policy and Engagement** Welsh Government **Tom Nicholls, Economic Adviser** Welsh Government

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
NSIT 01	Cardiff Business School
NSIT 02	Women's Equality Network (WEN) Wales
NSIT 03	Institute of Chartered Accountants of Scotland (ICAS)
NSIT 04	Welsh Government
NSIT 05	Chartered Institute of Taxation (CIOT) and the Low Incomes Tax Reform Group (LITRG)
NSIT 06	Institute for Fiscal Studies (IFS)
NSIT 07	Wales Fiscal Analysis

Additional Information

Title	Date
Written evidence: James Foreman-Peck and Peng Zhou, Cardiff University	February 2020
Note from the Minister for Finance and Trefnydd - Higher rate earners in Wales employed in the public sector	March 2020