Wales Bill: Financial Empowerment and Accountability

March 2014

HM Government

Wales Bill: Financial Empowerment and Accountability

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FOREWORD

Today the UK Government has introduced the Wales Bill in Parliament. Our legislation is a major milestone for Wales, demonstrating the Government's commitment to strengthening Welsh devolution and Wales's role within the United Kingdom.

In November 2013 the Government accepted almost all of the recommendations made by the Commission on Devolution in Wales (Silk Commission) in its first report. The Wales Bill provides the legislative framework to devolve a package of tax and borrowing powers to the National Assembly for Wales ("the Assembly") and the Welsh Government. These powers provide the Welsh Government with further tools to grow the Welsh economy, help Wales to compete in the global race, and build a stronger economy and a fairer society. Crucially, they will also increase the financial accountability of the devolved institutions by making them accountable for raising more of the money they spend.

The Bill makes changes to the Welsh devolution settlement in a number of areas, and this Command Paper provides further detail on the new arrangements. In particular, it explains how the Government intends to implement the financial measures set out in Part 2 of the Bill. It describes how the legislative changes will work in practice and the practical changes that need to happen as a result of this legislation.

We would like to thank the Silk Commission for its hard work and diligence in preparing such a detailed analysis of the financial aspects of Welsh devolution, and the Welsh Affairs Committee for its thorough pre-legislative scrutiny of the draft Wales Bill. We trust that the contents of this Command Paper meet the Committee's request for further information on the Government's proposals.

The Wales Bill, together with the broader plans outlined in this paper, will strengthen the democratic institutions in Wales, make the Assembly and the Welsh Government more accountable to the people in Wales and enable them to support stronger economic growth.

RT HON DAVID JONES MP
SECRETARY OF STATE FOR WALES

RT HON DANNY ALEXANDER MP
CHIEF SECRETARY TO THE TREASURY

The new funding framework for Wales

1. Since devolution in 1999, the National Assembly for Wales (the "Assembly") has been almost entirely funded by a block grant from the UK Government. Tax revenues from across the UK (including from Wales) are pooled centrally, with a share of these redistributed to the Assembly. While the Assembly has had substantial responsibility and flexibility to determine how this funding is used to deliver devolved public services in Wales, it has had very limited responsibility for funding its spending.

2. The Government established the Commission on Devolution in Wales (the "Silk" Commission) in 2011 to examine the financial and constitutional arrangements in Wales, and recommend ways in which they might be improved. The Commission concluded that the Assembly needs to have stronger financial accountability to the people of Wales, while retaining the security and stability of sharing resources as part of the United Kingdom.

3. The Government's response to the Silk Commission's Part I report accepted 30 of the 31 recommendations (that were for the UK Government) in full or in part, and set out its plans to increase the financial accountability of the Assembly. The Wales Bill now provides the legislative framework to deliver these changes, while this Command Paper provides further details on the implementation and operation of the Assembly's new tax and borrowing powers.

4. Under these new arrangements, the budget for public services in Wales will be generated by two separate funding streams.

5. A new funding stream will comprise revenues from business rates, devolved taxes (a Welsh land transaction tax and a Welsh landfill tax) and, subject to a referendum, a Welsh rate of income tax. With UK Government consent, the Assembly could also legislate to introduce new devolved taxes in Wales. The revenues generated from this funding stream will therefore be determined by decisions made by the Assembly.

6. The second funding stream will continue to be a block grant from the UK Government determined by the Barnett formula. While the UK Government recognises some of the concerns expressed about the Barnett formula, the system has many strengths. Resources and risks are shared across the UK, which ensures that the Assembly is provided with stable levels of funding to deliver devolved public services. The system is also simple, transparent and efficient; key requirements for any funding system. The UK Government's priority is to reduce the deficit and it does not have any plans to reform the Barnett formula before the stabilisation of the public finances.

7. However, the joint statement made by the Government and the Welsh Government in October 2012 established a process to review relative levels of funding for Wales and England in advance of each spending review and, if convergence is forecast to resume, to discuss options to address the issue in a fair and affordable manner. These robust arrangements therefore provide a firm basis for moving to the new Welsh funding framework, including the devolution of income tax (should this be the outcome of the referendum).

8. Alongside the devolution of these new tax powers, the block grant will need to be adjusted to reflect the reduced revenues flowing to the UK Exchequer. The Command Paper sets out the Government's detailed proposals for calculating the adjustments, consistent with the Commission's recommendations. While the income tax block grant adjustment mechanism will shield the Assembly from UK-wide macro-economic effects that the UK Government is better placed to manage, the Welsh Government will need to manage the fluctuations in the devolved tax revenues. The new funding arrangements therefore include tools for the Welsh Government to manage this volatility, including current borrowing powers and a cash reserve.

9. These new tax powers will also provide an independent revenue stream to support capital borrowing. This will provide the Welsh Government with further flexibility to decide when and how to invest in infrastructure to drive growth in the Welsh economy. In advance of these new capital borrowing powers being implemented, the UK Government has also agreed that the Welsh Government can use its existing, more limited, borrowing powers to start improvements to the M4.

10. The Government's plans for a new funding framework in Wales will therefore substantially empower and enhance the accountability of the Assembly and Welsh Government. To ensure that these fundamental changes are efficiently and effectively implemented, the Government will put in place new governance arrangements, including the creation of a bilateral inter-governmental Ministerial committee.

<u>Full devolution of non-domestic (business) rates</u>

11. The UK Government is aiming to fully devolve business rates to the Assembly in April 2015. The details of how this will operate in relation to the budgetary system will be discussed with the Welsh Government. The UK Government will consult with Welsh Ministers before determining a final date for full devolution of this tax.

12. The Assembly already has legislative competence in relation to business rates in Wales[1], and can pass laws to amend, or replace, the current system. No provision therefore needs to be made in the Wales Bill. However, under current arrangements the revenue generated does not directly affect the level of funding available to the Welsh Government. Instead the Welsh Government's budget is currently set with reference to spending funded by business rates in England, i.e. this funding is included in the block grant baseline and the Welsh Government receives Barnett consequentials when there are changes in the level of local authority spending funded by business rates in England. The revenues generated by business rates in Wales do not therefore currently affect the Welsh Government's budget. As a result the amount collected just affects the size of the cash transfer from the UK Government.

13. Fully devolving business rates, as recommended by the Silk Commission, means that the Welsh Government's budget will be directly affected by the amount of business rates revenues generated in Wales, i.e. the Welsh Government will be able to spend however much is raised by business rates in Wales rather than an amount determined by business rates in England. As a result, the Welsh Government will directly benefit from growth in business rates, which will provide a further incentive to grow the economy.

Block grant adjustment in relation to business rates

14. Following the precedent set when business rates were fully devolved to Scotland and Northern Ireland, the full devolution of business rates will involve a one-off adjustment to the Welsh Government's block grant comprising two elements:

    - a deduction will be made to the block grant baseline, the size of which the UK Government is discussing with the Welsh Government. The Welsh Government will then be able to spend

[1] Heading 12 in Part 1 of Schedule 7 to the Government of Wales Act 2006 includes "local government finance" in the list of subjects on which the Assembly can legislate. This includes non-domestic (business) rates and council tax.

however much is generated by business rates in Wales rather than an amount determined via the Barnett formula; and

- the business rates Barnett comparability factor for Wales will be changed from 100 per cent to 0 per cent, i.e. total Barnett consequentials will subsequently be smaller than under current arrangements as changes in the Welsh Government's budget (in relation to business rates) will be determined by changes in business rates revenues in Wales rather than in England (through Barnett consequentials).

<u>Stamp duty land tax and landfill tax</u>

15. The Wales Bill provides for the full devolution of stamp duty land tax (SDLT) and landfill tax (LfT). This means the Assembly will have complete control over whether and how to tax land transactions and waste disposed to landfill. SDLT and LfT will cease to apply in Wales and any replacement taxes will be introduced at that point. There will be a corresponding reduction in the block grant to reflect these new revenue-raising powers, details of which are set out from paragraph 26 below).

16. Based on initial discussions with the Welsh Government, the intention is to 'switch off' the UK-wide versions of the taxes insofar as they apply to Wales from April 2018. An adjustment will be made to the block grant from this point, to reflect the reduction in revenues that the UK Government receives from these devolved taxes. The Welsh Government will make decisions about possible Welsh replacement taxes, subject to Assembly approval. The UK Government will consult with Welsh Ministers before determining a final date for switching off the UK taxes in Wales.

Welsh replacement taxes

17. The design of the devolved taxes and their administration will be a matter for the Assembly and the Welsh Ministers.

18. It is for the Assembly and Welsh Ministers to determine how the devolved taxes should be collected and managed. The Wales Bill makes provision for HMRC to be able to operate the devolved taxes on behalf of the Welsh Government if this is an acceptable solution to both parties. The terms of any such arrangement would be agreed between HMRC and the Welsh Government.

Impact of devolution on stamp duty land tax taxpayers

19. The change to the compliance burden for taxpayers transferring land in Wales will depend upon the design of the devolved tax, which is for the Assembly to determine, working with Welsh Ministers. The existing SDLT return already identifies the local authority area in which a land transaction takes place and this will allow HMRC to identify transactions to which SDLT still applies. From the date of devolution, this return will no longer be applicable to transactions in Wales but will continue to be required, and will not need to be amended, for transactions in England and Northern Ireland.

20. A separate tax return may be required for Welsh land transactions, depending on the design of the tax and the organisation tasked with its collection. This will be for the Assembly to determine, working with Welsh Ministers. There is no reason in principle why the compliance burden for taxpayers purchasing a single property in any one part of the UK should increase. There will be a set of rules for Wales, one for Scotland and one for England and Northern Ireland. Those purchasing a property or land that straddles the border between England and Wales may see an increase in their compliance burden – this will be treated as two transactions, one of which is liable to SDLT and the other of which is liable to the Welsh tax on land transactions. The value would then be apportioned across the two transactions on the basis of their relative values. Additionally, those engaged in the purchase of multiple properties in Wales, Scotland and elsewhere in the UK in a single transaction may experience an increase in compliance burden as up to three tax returns may be needed.

21. As the devolved tax will be levied on transactions of land in Wales it will affect anyone choosing to purchase Welsh property, whether resident in Wales, Scotland or elsewhere. In practice, any increase or decrease in administrative burden will affect the conveyancing and legal professionals acting for the parties choosing to purchase Welsh property, which could be passed onto the purchaser.

22. The SDLT return collects data for the Valuation Office Agency (VOA) that is used in other parts of the tax system and for wider HMRC compliance work. The Bill requires the Welsh Government, if asked by HMRC, to provide this data in future in respect of Welsh land transactions, from information in their possession. The VOA will continue to perform its current functions in Wales after devolution of the tax on land transactions.

Impact of devolution on landfill tax taxpayers

23. The current UK-wide tax return for LfT does not identify the geographical location of the taxable activity. A separate tax return for waste disposed in Welsh landfill sites would be likely to be required, depending on the design of the tax specified by the Assembly and the organisation tasked with its collection. The compliance burden on landfill operators in Wales will be determined by the rules that are set by the Assembly and the Welsh Government, arising from the design and administration of the Welsh tax on disposals of waste to landfill. In principle, and subject to the detailed arrangements, there should be little or no increase in the compliance burden for taxpayers operating at a single site in any part of the UK: there will be a separate set of rules for Wales, Scotland and the rest of the UK. Landfill operators operating sites in both Wales and elsewhere in the UK may

experience an increase in compliance burden as up to three landfill tax returns may be needed in future where one is needed at present.

24. A number of minor amendments to the existing LfT regime will be necessary following devolution.

- The landfill communities fund (LCF) was introduced alongside LfT and aims to address some of the impacts of landfill activity by improving the environment in the vicinity of landfill sites. The LCF is financed by contributions from landfill site operators, who receive a LfT credit worth 90 per cent of any qualifying contribution they make to environmental bodies enrolled in the scheme. Once LfT is devolved to Wales, operators of landfill sites in Wales will no longer be eligible for a UK LfT credit, which will subsequently only be available for contributions benefiting the environment in England and Northern Ireland. At the point when the tax is devolved, environmental bodies will be holding unspent funds derived from contributions by landfill operators across England, Northern Ireland and Wales. For two years after the devolution of this tax, these unspent funds will be allowed to be spent on projects in England, Northern Ireland and Wales. This will provide for any contributions made in respect of landfill activities in Wales to be used for projects in that locality;
- LfT is a key lever for the UK Government to achieve its 2020 landfill reduction target under the Landfill Directive (relating to biodegradable municipal waste). Member states may be fined if they fail to achieve their target. In the unlikely event that the UK fails to meet its landfill reduction target solely because of changes to landfill tax policy in Wales, the Government will seek to recover this cost from the Welsh Government.

Cost to Welsh Government of devolution of stamp duty land tax and landfill tax

25. Both SDLT and LfT will be completely devolved, with the design of the taxes and arrangements for their collection being entirely the responsibility of the Assembly and the Welsh Government. The UK Government will discuss in more detail with the Welsh Government the potential administration cost to HMRC of implementing the changes to the existing SDLT and LfT regimes. Any additional costs associated with the devolution of SDLT and LfT (net of savings to the UK Government arising from the fact that those taxes will no longer be collected or administered in Wales) will be borne by the Welsh Government. The UK Government will work constructively with the Welsh Government to minimise any such costs.

Block grant adjustment in relation to stamp duty land tax and landfill tax

26. The Government has accepted the Silk Commission's recommendation that the block grant adjustment should not be indexed against the corresponding UK tax base.

27. This will therefore transfer to the Welsh Government the full responsibility for managing the volatility of devolved tax revenues (for which purpose new tax management tools are being provided). It is also far simpler operationally than ongoing indexation. However, it is not straightforward to identify the precise nature (or size) of such an adjustment that both governments agree is likely to be equitable in the longer term.

28. The purpose of the adjustment is to reduce the block grant by the amount that the UK Government's tax revenues will decrease as a result of devolution. The Welsh Government can then decide whether (and how) to replace this funding through levying devolved taxes. The aim is therefore to develop an adjustment mechanism that reflects not only the revenues being generated at the point of devolution but also the expected longer term prospects. This will help to ensure that the devolution of these taxes is equitable for both Wales and the rest of the UK, although the adjustment could also be subject to periodic review.

29. While there are no directly comparable precedents, a useful starting point is provided by the block grant adjustment applied alongside the devolution of business rates to Scotland and Northern Ireland (which will also be used when business rates are fully devolved in Wales). This cannot be directly applied more widely because there is a specific Barnett comparability factor for spending funded by business rates (where this revenue is used to fund local expenditure) and this is not the case for any other tax.

30. The block grant adjustment mechanism for business rates devolution is set out in paragraph 14. Briefly, this involves making a deduction to the block grant baseline and making subsequent Barnett consequentials smaller. This reflects that the block grant is funding a smaller part of the Welsh Government's spending, with the Welsh Government instead retaining business rates revenues (including all growth in these revenues). Similar to the incentives achieved by indexing the income tax adjustment, the Welsh Government's budget will benefit from this approach where business rates in Wales grow faster than Barnett consequentials from changes in business rates in England.

31. Taking the key principles from this approach, it would be possible to apply a block grant adjustment for stamp duty land tax and landfill tax that also

involved a baseline deduction and smaller Barnett consequentials. On the latter element, while business rates have Barnett comparability factors (which other taxes do not) a similar effect could be achieved through alternative means - for example by reducing all Barnett consequentials by a small percentage, reflecting the proportion of Welsh Government spending that is funded by the devolved taxes. Growth in the devolved taxes would therefore replace the amount deducted from Barnett consequentials.

32. The Government continues to discuss this proposal, and other options, with the Scottish Government and has now opened similar discussions with the Welsh Government.

Welsh rate of income tax

33. Subject to the outcome of a referendum in Wales on the introduction of a Welsh rate of income tax, the main UK rates of income tax will be reduced by 10p for those defined as Welsh taxpayers, and the Assembly will be able to set, annually, a new Welsh rate of income tax which will be added to the reduced UK rates. The rest of the income tax structure will remain a non-devolved matter, and continue to be determined by the UK Parliament.

34. While the Silk Commission recommended that the Welsh Government should be able to set separate Welsh rates of income tax for each of the three bands, the Government believes that a single Welsh rate for all three bands (as is being introduced in Scotland) is the most appropriate system for Wales.

35. The Government is firm in its view that the income tax structure is a key mechanism to redistribute wealth across the whole of the UK, which is why the "progressivity" of this system is properly determined at the UK level. The inclusion of the so-called lock-step is also consistent with the principle that fiscal devolution should not benefit one part of the UK to the detriment of another - this could occur if the Welsh Government is able to set a substantially lower rate for higher/additional taxpayers without needing to change the basic rate (attracting higher earners across the border, benefitting Wales to the detriment of the UK as a whole).

36. The Government therefore believes that the lock-step system achieves the key benefits identified by the Commission (providing the Welsh Government with flexibility over tax and spending, while increasing accountability for funding its spending) while maintaining a consistent UK-wide redistributive structure and minimising the associated risks of tax competition.

37. The Welsh Government's block grant will be reduced to reflect these new revenue-raising powers, using the indexed deduction mechanism recommended by the Silk Commission. Details are set out from paragraph 52 below. Following a referendum vote in favour of partially devolving income tax, the Treasury will consult with Welsh Ministers before determining a date to introduce the Welsh rate of income tax.

Operating the Welsh rate of income tax

38. The Bill determines that the new Welsh rate of income tax would be collected by HMRC, using the existing PAYE and Self Assessment income tax systems. If the Welsh rate is introduced, HMRC will work closely with all parties potentially affected by this change (in particular the Welsh Government, but also including other UK Government departments).

Deciding the Welsh rate of income tax

39. The new Welsh rate would need to be set every year by the Assembly, with a resolution passed in such time as to allow the taxes to be collected at the start of each tax year. In order to minimise the cost to HMRC and to employers of the necessary administrative and compliance measures, the rate for a particular tax year would need to be formally communicated to the UK Government by the end of November in the preceding calendar year. If there were a delay in announcing the rate, the Welsh Government would need to agree an assumption to enable HMRC to issue PAYE codes to employers and employees taking account of the Welsh rate. This timetable would also allow taxpayer compliance burdens to be minimised. The rate would then need to be passed by the appropriate procedure in the Assembly by 5 April at the latest, to provide the statutory basis for the collection of tax receipts from the start of the tax year. (It is possible for a resolution to be passed setting a different rate from that previously announced, although this would lead to increased costs.) Once this date has passed the resolution would not be able to be cancelled or amended.

40. The UK Government will work closely with the Assembly and the Welsh Government to ensure the parameters of the annual budgetary cycles of the Welsh and UK Governments support this process.

Cost of delivering the Welsh rate of income tax

41. As set out in HM Treasury's Statement of Funding Policy, the costs associated with income tax devolution will be borne by the Welsh Government. The Bill enables the Welsh Government to reimburse HMRC for the additional costs associated with implementing and maintaining the Welsh rate of income tax. The costs that would be charged to the Welsh Government would be the additional (sometimes referred to as the 'marginal') costs of implementing the Welsh rate. Costs that would have fallen to HMRC in any case, relating to income tax in Wales generally, would not be passed on.

Impact of Welsh rate of income tax on taxpayers and businesses

42. If the Welsh rate is introduced, HMRC will consult on a number of detailed implementation issues for the Welsh rate of income tax. This will draw on the conclusions of similar consultations on the introduction of the Scottish rate of income tax, which resulted in HMRC's Technical Note[2] published in May

[2] http://www.hmrc.gov.uk/news/technote-scot-taxrate.pdf

2012. In order to keep the administrative burdens on businesses and individuals across the UK to a minimum, HMRC would expect the rules for the application of Scottish and Welsh rates of income tax to be the same (unless there are good reasons for different treatment).

43. The Impact Assessment (IA) which accompanies the Wales Bill includes an assessment of the impact of the proposed new Welsh rate of income tax.

Definition of a Welsh taxpayer

44. The Welsh rate of income tax would apply to UK resident taxpayers who are defined as Welsh taxpayers; those whose closest connection is with Wales. A close connection with Wales is defined as having a sole place of residence in Wales or, for an individual with more than one place of residence, having their main place of residence in Wales for longer than in any one other part of the UK in a tax year. In addition Assembly Members, MPs representing a Welsh constituency in Parliament or a member representing Wales in the European Parliament will be Welsh taxpayers.

Interest and penalties

45. An existing feature of the UK tax system relates to the charging of interest on taxes paid late. HMRC is required to pay interest on tax overpayments and charge interest on late payments. As the Welsh Government would be able to draw down forecast receipts, the impact of late or overpaid tax would be managed by the UK Exchequer rather than the Welsh Government. This provides greater certainty for the Welsh Government in managing its finances. Interest payments received would not therefore be included as part of revenue allocated to the Welsh Government. This would also simplify administration. For example, where part payment has been made it would not be necessary to consider whether the Welsh, Scottish or UK part of an income tax debt has been paid. Similarly, any interest paid by HMRC to taxpayers due to overpayment of tax would not be charged to the Welsh Government.

46. HMRC also administers a number of penalties that act as deterrents and safeguards for the UK tax system. These include, for example, penalties for late payment (in addition to the interest charged on this), late filing and incorrect returns, and are intended to encourage taxpayers to meet their obligations as regards making tax returns or paying their tax liabilities. The revenues accrued from these penalties are therefore associated with the administration of the tax system by HMRC and would not be allocated to the Welsh Government.

Income tax on savings and distributions

47. The Welsh rate would not apply to income from savings and dividends. The Silk Commission recognised that the changes that would have been necessary in order to apply the Welsh rate to income tax on savings and distributions were prohibitive. The Welsh rate will therefore apply to taxable non-savings, non-dividends (NSND) income.

Relationship between the Welsh Government and HMRC

48. The Commission identified the need for a formal relationship between the Welsh Government and the Assembly and HMRC, as the collection of Welsh rate income tax would be a function of HMRC. The relationship between HMRC and the Welsh Government on income tax would be set out in a Memorandum of Understanding, which would be published in advance of implementation. Separate Memoranda would also be needed to define relationships between HMRC and the Welsh Government on the fully devolved taxes.

49. The Bill requires the Comptroller & Auditor General to produce an annual report to the Assembly on HMRC's administration of the Welsh rate. HMRC would also produce an extract from their accounts for the Assembly showing income and expenditure associated with the Welsh rate of income tax.

50. An HMRC Additional Accounting Officer would be made specifically accountable for the collection of the Welsh rate of income tax. The Additional Accounting Officer would be available to give evidence to the Assembly on HMRC's operation of the Welsh rate.

Impact on other UK Government departments

51. If the Assembly chooses to vary the Welsh rate of income tax so that the combined rates in Wales differ from the UK rates, this could have an impact on wider UK Government policies where the needs of individuals are calculated net of income tax, such as income-related benefits, including the new Universal Credit. A fuller picture of these possible impacts would be developed with UK Government departments concerned, in the lead up to a referendum and as policy is developed. Where different tax rates could lead to an increase or decrease in liabilities for the UK Government, the principle which is set out in the Statement of Funding policy that 'the body whose decision leads to the additional cost will meet that cost' will be adhered to. HMRC and other relevant departments would consult the Welsh Government over the size and implications of any such costs.

Block grant adjustment in relation to income tax

52. If the Welsh rate of income tax is implemented following a referendum, the Government has accepted the Silk Commission's recommendation that the block grant adjustment should be determined using the indexed deduction mechanism originally proposed by the Holtham Commission. As set out below, this mechanism helps to increase the accountability of the Welsh Government while shielding Wales against UK-wide effects that the UK Government is better placed to manage, thereby ensuring secure and stable funding will continue to be available to deliver public services in Wales. The detailed operation of the system will be discussed with the Welsh Government.

53. The mechanism involves two elements - a first year adjustment and then indexing this amount against growth in the corresponding UK tax base (i.e. taxable non-savings and non-dividends income) to determine the adjustment in subsequent years. By indexing against the tax base rather than tax revenues or total income, the Silk Commission recognised that this "automatically incorporates the principle of 'no detriment'" as is also the case in Scotland[3]. This is because the UK tax base will reflect decisions made by the UK Government in relation to thresholds, allowances and reliefs.

54. In advance of implementing this mechanism, the Government has also accepted the Silk Commission's recommendation for a transitional period "to help manage the transfer of risk". The Government expects this transitional period to last for two or three years. The block grant arrangements for these transitional years would be the same as for the first post-transition year, except without a year-end reconciliation process.

Transitional years

55. During the transitional years, the block grant adjustment would be determined by the amount of tax revenue generated by the Welsh rate of income tax set at 10p. This is the amount of income tax forfeited by the UK Government as a result of reducing the main rates of income tax by 10p in Wales. The key consequences of this are:

    - If the Welsh Government sets a rate of 10p during these transitional years then there will be no impact on its budget compared to current arrangements.

[3] The 'no detriment' clause in the Scotland Bill Command Paper was based on the use of a different block grant adjustment mechanism, which wouldn't have automatically incorporated the 'no detriment' principle. The UK and Scottish governments subsequently agreed to use the indexation method, as would be the case in Wales.

- By setting a rate of, for example, 11p or 9p the Welsh Government could increase or decrease its budget (respectively) compared to current arrangements, as the block grant adjustment will still be based on the 10p forfeited by the UK Government, i.e. the rate set by the Welsh Government changes its tax revenues but has no impact on the size of the block grant adjustment.
- There would be no risk transferred to the Welsh Government during this transitional period, either in relation to growing the tax base in Wales or managing forecast error. Both of these risks would be partly transferred to the Welsh Government post-transition.

56. The tax revenue generated by the Welsh rate of income tax will be forecast by the Office for Budget Responsibility (OBR) and paid to the Welsh Government. There are two scenarios for the block grant adjustment:
    - If the Welsh Government sets a rate of 10p during year 1, the OBR forecast will determine both the amount of tax revenues paid to the Welsh Government as well as the deduction from the block grant. There will therefore be no impact on the Welsh Government's budget compared to current arrangements.
    - If the Welsh Government sets a rate other than 10p during year 1, the OBR forecast of Welsh rate revenues (using the rate set by the Welsh Government) will still be paid to the Welsh Government but the block grant adjustment will be determined by a separate forecast of the amount of revenue that would have been generated by a rate of 10p. By setting a rate other than 10p, the Welsh Government can therefore change its budget (upwards or downwards) compared to current arrangements.
57. Using the revenues generated by the Welsh rate to determine the block grant adjustment means that the risks around growing the income tax base aren't transferred to the Welsh Government during the transitional years. Similarly, as there is no year-end reconciliation during the transitional years, the UK Government will also retain the forecasting risk.

58. Both of these risks will be partly transferred to the Welsh Government post-transition, the forecasting risk in the first post-transition year and the growth risk in the second post-transition year.

First year of operation (post-transition)

59. In the first post-transition year of operation, the block grant arrangements will be the same as in the transitional years except there will be a year-end process to recalculate the Welsh rate revenues and block grant adjustment using actuals (rather than forecasts).

60. This year-end process will partly transfer responsibility for managing forecast error to the Welsh Government. It will take place around 12 months after the end of the financial year once HMRC has collected sufficient information, particularly from self-assessment taxpayers. This process will involve recalculating both the revenues generated by the Welsh rate and the block grant adjustment using actuals.

61. The purpose of this year-end reconciliation is twofold:

- to ensure the correct starting point for indexation in subsequent years;
- to transfer the relative forecast error risk to the Welsh Government, i.e. responsibility for forecast error in the NSND tax base in Wales over and above the forecast error in the UK as a whole.

62. Any over- or under-payments identified during this process (which can only occur in year 1 if a Welsh rate other than 10p is set) will be reflected in the Welsh Government's budget in the subsequent financial year. This timetable gives the Welsh Government time to plan following this year-end process rather than needing to manage the risks in-year (which remain a responsibility of the UK Government).

63. For example, if the first post-transition year was 2013-14, the year-end process would be performed in early 2015-16 and any over- or under-payments applied to the block grant in 2016-17.

Subsequent years

64. In subsequent years (i.e. the second post-transition year onwards) the deduction made in the previous year is indexed against movements in the UK NSND income tax base. This means that if the UK NSND income tax base contracts by 2%, the block grant adjustment will decrease by 2%; if the tax base grows by 2%, the adjustment will increase by 2%.

65. The key features of this indexation mechanism are:

- It provides incentives and enhances the accountability of the Welsh Government as its budget will be directly affected by the performance of the Welsh economy, i.e. it transfers the risk that the NSND tax base in Wales grows at a different rate from the UK average. Specifically:
    - If the Welsh Government sets a rate of 10p, then its budget will be higher (than under current arrangements) if the NSND tax base in Wales grows faster than the UK average, but lower if growth in Wales is slower.

    - The Welsh Government can further vary the size of its budget by setting a Welsh rate that is higher or lower than 10p (i.e. the rate set by the Welsh Government again affects its tax revenues but has no impact on the size of the block grant adjustment).

- It protects the Welsh Government's budget from volatility caused by UK-wide macro-economic shocks, which the UK Government is better placed to manage. For example, using purely illustrative figures:
    - assume the Welsh Government's Barnett-based block grant and block grant adjustment are £1000 and £100 respectively in a given year, giving an adjusted block grant of £900 (£1000 less £100);
    - in the following year, if the UK NSND tax base contracts by 10 per cent then the block grant adjustment will also fall by 10 per cent from £100 to £90;
    - the adjusted block grant will therefore increase to £910 (£1000 less £90) assuming no Barnett consequentials are due. This would therefore offset a 10 per cent fall in Welsh rate revenues, stabilising the overall Welsh budget against UK-wide impacts.

66. Like the revenues generated by the Welsh rate, the size of the UK NSND income tax base is initially a forecast. Therefore, as in year one, there will need to be a year-end process whereby both the Welsh rate revenues and the block grant adjustment are recalculated based on actuals.

67. For year two onwards, the sole purpose of this recalculation is to identify any over- or under-payments from the UK Government to the Welsh Government. This transfers the relative forecast error risk, as well as the relative growth risk, to the Welsh Government from year two onwards.

68. In the case of under-payments, additional funding will be paid alongside the subsequent year's block grant. The first call on this additional funding will be to repay outstanding current borrowing. After this, the Welsh Government can save this funding into a cash reserve or use it to support additional spending on any devolved matter. Any over-payments will be deducted from the block grant, which the Welsh Government can make up by accessing funds previously paid into the cash reserve or through current borrowing.

69. These arrangements therefore allow saving in good years to be retained and used by the Welsh Government in future years to make up any shortfalls (as set out in more detail in the section on the cash reserve from paragraph 79).

Creating new devolved taxes

70. The Wales Bill defines stamp duty land tax and landfill tax in Wales as 'devolved taxes'[4]. However, the Bill also enables further taxes to be similarly designated through secondary legislation. This power could be used for two purposes:

    - Enabling the Welsh Government to introduce specific new taxes in Wales, with the agreement of each House of Parliament and the Assembly; or
    - Allowing the UK Government to devolve further existing or new UK taxes, again with the agreement of each House of Parliament and the Assembly.

71. The ability to introduce new taxes in Wales provides the Welsh Government with a new policy lever with which to raise additional revenue and/or affect behaviours.

72. Proposals for new taxes will be assessed against a range of criteria, including the extent to which the new tax:

    - affects UK macro-economic or fiscal policy and/or the single market;
    - may be non-compliant with EU legislation;
    - increases tax avoidance risks; or
    - creates additional compliance burdens for businesses and/or individuals;
    - is aligned with devolved responsibilities.

73. Consistent with the process set out alongside the Scotland Bill, any proposal from the Welsh Government for a new tax would need to include full details on the following:

    - the tax base (i.e. taxable activity);
    - estimated revenue and economic impact;
    - estimated impact on UK revenue or interaction with UK-wide taxes;
    - expected impacts on business and individuals (including a distributional impact);
    - assessment against all relevant legislation and directives, including the Human Rights Act, EU State Aid rules, Equality Act etc; and

[4] Rather than being defined as a 'devolved tax', both council tax and business rates fall within 'local taxation' and (subject to a referendum) the Welsh rate of income tax would be created within the UK's income tax system and administered by HMRC.

- collection and compliance plans.

74. The criteria for assessing new tax proposals set out above provide a framework within which constructive discussions can take place. The UK Government will work with the Welsh Government to assess any such proposals in a timely manner. If at the end of that process the UK Government decides not to grant powers to the Assembly to create a new devolved tax, it will explain its reasoning.

75. As set out in the Government's response to the Silk Commission, the impact on the Welsh Government's block grant would be expected to be limited to the application of a 'no detriment' principle. Under this principle, the Government would apply a block grant adjustment only if a new tax in Wales was expected to reduce revenues to the Exchequer.

76. If the UK Government intends to introduce a new tax that has a degree of alignment with areas of devolved responsibility, it will consult with the Welsh Government about the scope for that tax to be devolved.

Managing Tax Powers

77. The Welsh Government is being provided with new tools to manage the volatility of devolved tax revenues[5] and deal with forecast errors (i.e. where actual receipts are different from forecasts). This includes creating a Welsh cash reserve and extending powers to borrow to fund current spending. The detailed arrangements for managing tax powers will be discussed with the Welsh Government and will in due course be set out in a revised Statement of Funding Policy.

78. If there is a temporary mismatch between tax and spending during the year (e.g. due to the volatility of devolved tax revenues) or if devolved tax revenues are lower than forecast, the Welsh Government can either:

    - access funds previously built up in the cash reserve; or
    - use the short-term current borrowing powers (if funds in the reserve are insufficient to cover the shortfall).

Cash reserve

79. The UK Government will provide the Welsh Government with the ability to pay surplus tax revenues into a cash reserve, which can be drawn upon when future revenues are lower than forecast. This will provide a mechanism for the Welsh Government to manage the volatility in its budget resulting from its new tax powers.

80. The Welsh Government may generate a surplus in two ways: when devolved tax revenues are higher than forecast; or when the year-end reconciliation for the Welsh rate of income tax and corresponding block grant adjustment determines that additional funding needs to be paid by the UK Government to the Welsh Government.

81. The first call on surplus tax revenues will be to repay any outstanding current borrowing. Any surplus remaining after repayments can either be paid into a cash reserve, which can be drawn upon when future revenues are lower than forecast, or it can be used to finance additional public spending on devolved matters.

82. The cash reserve must be held within the UK Government and will operate separately from the system of budget exchange.

[5] The Welsh Government will not need to deal with in-year volatility in relation to the Welsh rate of income tax as the UK Government will pay over a forecast of these revenues as required during the course of the year.

Current borrowing powers

83. The Wales Bill provides Welsh Ministers with up to £500 million of current borrowing powers, which the UK Government intends to be available alongside the implementation of the devolved taxes from April 2018. This limit remains as previously set in GOWA 2006 and is separate from the new £500 million capital borrowing limit (with no switching between the two permitted).

84. Within the overall limit, HM Treasury has agreed that the Welsh Government can borrow up to £200 million each year (from 2018-19 onwards).

85. The Welsh Government's powers are being extended to comprise both in-year and 'across years' current borrowing. While the Government will continue discussions with the Welsh Government over the precise arrangements for cash management, the Wales Bill provides for the following:

    - *in-year current borrowing* – the Wales Bill retains the Welsh Government's existing in-year borrowing powers, whereby Welsh Ministers can borrow from the National Loans Fund (NLF) via the Secretary of State for Wales in order to provide a working balance to the Welsh Consolidated Fund (WCF) or to manage in-year volatility of receipts (where actual income differs from the forecast receipts for that month); and
    - *across years current borrowing* - to deal with differences between the full year forecast and outturn receipts for devolved taxes, the Wales Bill additionally provides the Welsh Government with the ability to borrow from the NLF via the Secretary of State for Wales across years. This across years borrowing must be repaid within 4 years.

86. The Wales Bill also includes a power that enables the UK Government to vary the overall limit both upwards and downwards (but not below the initial £500 million) through secondary legislation.

Capital Borrowing

87. The Wales Bill is devolving two taxes – SDLT and LfT. This will allow the Assembly to legislate to introduce replacements for those taxes in Wales, providing the Welsh Government with an independent revenue stream (worth around £200 million per year) to support borrowing. The Welsh Government's new capital borrowing powers will therefore be implemented alongside the devolved taxes in April 2018. Borrowing against these revenues will provide additional flexibility and bring a further element of financial accountability to the Welsh Government.

88. The statutory capital borrowing limit is set by the Wales Bill at £500 million. Based on the c£200 million of revenue initially being devolved, this limit is higher than if it had been set solely with reference to the tax/borrowing ratio applied in Scotland.

89. Specifically, the Scottish Government's capital borrowing limit is £2.2bn while it is taking on responsibility for tax revenues that are currently worth around £5bn. Hence the ratio between the two is slightly less than 1:2. Applying the same tax/borrowing ratio in Wales would have given the Welsh Government a limit of around £100m.

90. This has been increased to £500 million in order to allow the Welsh Government to proceed with improvements to the M4 (should it choose to do so) in advance of an element of income tax being devolved. The Government has judged that this level of borrowing is affordable both for the Welsh Government and in relation to UK net borrowing and net debt.

91. The Wales Bill contains a power that enables the UK Government to vary the overall limit both upwards and downwards (but not below the initial £500 million) without further primary legislation. The UK and Welsh governments have previously agreed a joint process to review levels of convergence in Welsh funding at each Spending Review, and the UK Government proposes to extend this process to ensure that the capital borrowing limit remains appropriate. The limit will be set at a level that the UK Government considers to be appropriate based on its assessment of the economic and fiscal circumstances at the time of each Spending Review, the impact of inflation on the real value of the limit, and on the size of the independent revenue stream available to the Welsh Government.

92. Within the overall limit, HM Treasury has agreed that the Welsh Government can borrow up to £125 million each year (from 2018-19 onwards). Alongside the overall cap, this annual limit ensures that the Government maintains control over total UK public sector borrowing. If an element of income tax is

devolved in Wales, the Government would review the annual limit (as well as the overall limit) with the expectation that this would move onto the same basis (10 per cent of capital DEL each year) that is used in Scotland.

93. Within the overall and annual limits, the Welsh Government will be able to borrow for any capital[6] purposes without HM Treasury consent. Welsh Ministers will therefore have the autonomy and flexibility to determine when and how to make additional investment in infrastructure in Wales to help grow the Welsh economy.

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94. Welsh Ministers can borrow from the NLF or from commercial banks to fund capital spending. The Wales Bill also enables the UK Government to change the sources of borrowing available to the Welsh Government without primary legislation, for example if it was decided that the Welsh Government should be able to issue bonds. The Government has recently judged that bond issuance is consistent with the Scottish Government's financial powers and responsibilities set out in the Scotland Act 2012. It is willing to consider further whether this might be appropriate alongside the package of financial powers initially being devolved by the Wales Bill.

95. In advance of implementing the Welsh Government's new borrowing powers in April 2018, the Government has agreed that the Welsh Government can use its existing, more limited, borrowing powers[7] to proceed with improvements to the M4 (should it choose to do so). The amounts that the Welsh Government can borrow during this period are subject to HM Treasury agreement. This arrangement therefore provides the Welsh Government with the option to begin investing in the M4 in anticipation of devolved tax revenues. As this effectively gives the Welsh Government early access to their new borrowing powers, any amounts borrowed under these existing powers following Royal Assent will count towards the £500 million cap[8].

[6] Spending that would be classified as capital in https://www.gov.uk/government/publications/consolidated-budgeting-guidance

[7] These powers were gained when the Welsh Government subsumed the Welsh Development Agency.

[8] Any historic borrowing for which the Welsh Government is liable at the time of Royal Assent will not count towards the £500 million cap.

Intergovernmental arrangements

96. The Government's response to the Commission's Part I report recognised the need to ensure that institutional and governance arrangements continue to be appropriate as changes are made to the financial powers of the Assembly and Welsh Government. In particular:

    - the OBR has agreed to the Government's formal request that it starts to forecast Welsh taxes in Autumn Statement 2014 and biannually thereafter (alongside the forecast of Scottish taxes). This will initially include forecasts for stamp duty land tax, landfill tax, aggregates levy (which the Government is intending to devolve subject to the resolution of current legal challenges) and the Welsh rate of income tax. The OBR will forecast revenues from the replacement taxes for SDLT and LfT once the arrangements for these taxes are sufficiently clear;

    - details of the OBR's relationship with the Assembly and Welsh Government will be subject to further discussions. However, it is expected to give evidence on its Welsh tax forecasts to the Assembly. Subject to the successful passage of the Wales Bill, the Government will work with the Welsh Government to develop suitable memoranda of understanding to support the implementation and operation of the new powers. This will initially involve an arrangement between HMRC and the Welsh Government to support efficient and effective devolution of responsibility for stamp duty land tax and landfill tax in Wales; and

    - consistent with its transparency programme, the Government is fully committed to improving the information that is made available to assist public understanding and increase accountability. For example, HMRC has for the first time (in October 2013) published a country breakdown of the UK-wide taxes it collects.

97. The Government has also agreed with the Welsh Government to set up a bilateral Ministerial committee to oversee the transfer of these financial powers. This will be based on the Joint Exchequer Committee (Scotland) and will involve representatives from both governments. An early priority for this Committee will be to consider further details on the operation of the new budgetary arrangements, including the block grant adjustments that accompany tax devolution and the cash management arrangements.

Housing Revenue Account Subsidy (HRAS)

98. The Localism Act 2011 changed the way social housing is funded in England, in order to pass more power to a local level. Instead of sending rental income to central government and waiting to see what share is allocated back each year, councils are able to keep the rent and use it locally to maintain their social homes. This gives them a more predictable and stable basis to plan for the long term.

99. Wales is the only nation in the United Kingdom where the Housing Revenue Account system remains in place. Provisions in the Welsh Government's Housing (Wales) Bill seek to abolish this, and enable local housing authorities to become self-financing, which will permit them the flexibility to do more to improve the quality of their existing housing.

100. The effect of the related provisions in the Wales Bill would be to facilitate the Welsh Government's proposed reforms, by establishing the manner in which limits on Welsh Local Housing Authority debt is determined. The Treasury will be introducing a new power to set a cap on the maximum level of housing debt that may be held, in aggregate, by Welsh local housing authorities (LHAs). The Treasury will consult with Welsh Ministers prior to the setting and revision of the borrowing cap. The Welsh Ministers are required to determine how much housing debt may be held by each LHA within that cap.

101. This will enable the Welsh Government to implement its reforms, whilst ensuring that the overall level of housing debt held by Welsh LHAs reflects the UK's overall fiscal position and deficit reduction plans.

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