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Fiscal powers: A review of the fiscal powers of the Northern Ireland Assembly

A Report prepared by PwC on behalf of the Northern Ireland Council for Voluntary Action's Centre for Economic Empowerment

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Foreword

This research report has been produced as part of NICVA's Centre for Economic Empowerment (CEE), a skills development project and observatory that seeks to build the capacity of the voluntary and community sector to engage in economic debate.

Our aim in commissioning this report is to initiate and inform discussion on the economic merits of devolving additional fiscal powers to Northern Ireland. The regionalisation of economic policy is a common trend across the world but there is no one size fits all approach. Some countries opt for a high level of fiscal centralisation while others operate a relatively decentralised system of economic governance. We should be mindful of approaches elsewhere – and this report usefully reviews developments in Scotland and Wales – but it is important to consider what powers are appropriate to the particular circumstances of Northern Ireland.

A notable feature of those circumstances is the potential for debates to quickly become embroiled in constitutional-related positions. From our perspective it is unhelpful and unproductive to adopt a stance on fiscal devolution on the basis of particular notions of national identity. What is needed rather is dialogue based on careful consideration of the potential costs and benefits of particular powers, and their capacity to improve democratic accountability, good governance and social and economic well-being. In producing this report, PWC has provided a solid basis for such discussion to proceed, and upon which more detailed work can be conducted. The report also sets a thoughtful tone which, it is hoped, will be sustained in subsequent public and political debate.

Finally I would like to record my thanks to Eoin Rooney, Peter Hutchinson, and Lisa McElherron of the CEE who devised and managed this research, and to our two peer reviewers who provided feedback on a draft version of the report.

Seamus McAleavey,

NICVA Chief Executive

Executive summary

The success of previous attempts to agree and implement a vision for the Northern Ireland economy has been limited.

A number of studies, including the *Strategy 2010* in 1999, the most recent *Programme for Government* and the *Northern Ireland Economic Strategy* have all identified and articulated a vision of a more prosperous Northern Ireland. This is summarised in *Strategy 2010* as, *"A fast growing, competitive, innovative, knowledge-based economy where there are potential opportunities and a population equipped to grasp them."* Of course, without a single, cohesive and generally agreed economic objective, policy making and objective setting will remain challenging. Hitherto, successful implementation has remained elusive.

There has been little progress towards closing the prosperity gap between Northern Ireland and the rest of the UK.

At least, 15 major reports on the state of the Northern Ireland economy, since the 1957 Isles and Cuthbert's report have reached broadly similar conclusions about the region's shortcomings. Successive strategies and reviews have collectively failed to close the productivity, innovation and earnings gaps between Northern Ireland and the UK average.

Maintaining the status quo in economic strategy is unlikely to significantly improve Northern Ireland's economic performance, relative to the rest of the UK.

So, it is reasonable to suppose that a continuation of previous performance is unlikely to substantially narrow or close the existing gaps between Northern Ireland and the UK average in terms of performance.

The current macroeconomic climate and the absence of public spending growth is likely to further disadvantage the region for the foreseeable future.

Given that an improvement in economic performance towards a defined vision is desirable and can be assumed to be feasible it is worth considering how policy might be adjusted to promote such an outcome. This is particularly appropriate in the current climate of austerity where pressures on public expenditure are likely to be continued well into the next Spending Review period beginning in 2015.

Northern Ireland is the only devolved region that has not been subject to a comprehensive review of fiscal policy and legislation/proposals to devolve a variety of fiscal powers.

Recent developments in terms of comprehensive reviews of the fiscal powers available to the devolved administrations in both Scotland (the Scotland Act 2012), potentially in Wales (the Silk Commission) and in the English regions (the Heseltine Growth Review), suggest there is a real opportunity to begin a similar debate in Northern Ireland as to the further devolution of fiscal powers that could assist in rebalancing the economy.

Northern Ireland's current position in terms of funding the devolved administration could be characterised as one of:

- Very limited fiscal variation, where only a few taxes, the Regional Rate and Air Passenger Duty (APD) direct long haul, are under devolved control and where there are limited powers to borrow and gain extra resources from, for example, the EU;
- Overwhelming dependency on the block grant from HM Treasury;
- Being the recipient of a longstanding and sizeable net transfer from the UK Exchequer.

In considering which taxes might be devolved it is important to quantify the revenue generating potential of those taxes.

Drawing upon the deliberations of the Calman, Holtham and Silk Commissions in determining which taxes might be devolved, it is helpful to define taxes as "major" and "minor" in terms of the size of the revenues raised. Devolving a major tax will potentially make a greater contribution to increasing the revenue stream, autonomy and accountability of a devolved assembly. Having said that, it might still be decided to devolve certain minor taxes because of their potential contribution to particular economic, social or environmental policy agendas.

In terms of the scale of revenues collected three taxes stand out as major: Income Tax, National Insurance Contributions and VAT. In practice, only Income Tax is a strong candidate for devolution, as has been identified in both Scotland and Wales. Devolving and thus potentially varying the rate of National Insurance Contributions from that of the rest of the UK would in practical terms be hard to reconcile with welfare and benefits policy commitments. EU law appears to prohibit regional variations in VAT rates.

Corporation Tax is not a major tax, although the revenue raised is greater than some of the minor taxes. There has been a prolonged debate about, and campaign for, devolving Corporation Tax varying powers to Northern Ireland. The Prime Minister has indicated that any decision about this will not happen until after the Scottish independence referendum in September 2014. In addition, devolving Corporation Tax is subject to the strict Azores Judgement and would have a direct and substantially detrimental impact on the block grant for many years.

In identifying potential taxes for fiscal devolution in Northern Ireland, we should make allowance for:

- Developments in Scotland (additional Income Tax variation powers, Stamp Duty and Land Tax, and Landfill Tax) and proposals in Wales (Silk proposed Income Tax variation, Stamp Duty and Land Tax, Landfill Tax, Aggregates Levy and APD);

- Developments in England under the Heseltine Growth Review proposals where, while the majority of the proposals to decentralise powers to the English regions/cities seem to have been accepted, the magnitude of financial transfers have yet to be determined;

- In addition, a number of criteria will influence the suitability of a tax for devolution:

    1. Would devolution improve accountability?
    2. Is devolution possible without creating significant economic distortions?
    3. Is devolution possible without imposing significant costs (either administrative or compliance)?
    4. Could devolution promote various policy objectives; economic, social, health or environmental?
    5. Would devolution be compatible with EU law?
    6. Is devolution possible without a major negative effect on the tax base in the rest of the UK?

- Further reform of the tax base across the UK, whereby fiscal incentives will add to the attractiveness of Northern Ireland for foreign direct investment (FDI) and indigenous investment, even without specific regional devolution. The recent progressive reduction of Corporation Tax rates, introduction of the Patent Box regime and increased tax incentives for R&D are examples where UK wide policy has had a potential benefit to Northern Ireland. Regardless of what happens in terms of enhanced powers it is important to make the most of the incentives Northern Ireland already has.[1]

Given these considerations and the experience of Scotland and Wales, the following taxes would theoretically become candidates for full or partial devolution in NI:

- Income Tax;
- Stamp Duties;
- APD;
- Landfill Tax.

Of the so-called "major taxes", only Income Tax is a major tax in terms of revenues raised.

The size of the revenues raised and the fact that devolution has already occurred in Scotland and is proposed for Wales is an argument in favour of considering Income Tax devolution for Northern Ireland. At the same time, there are some other significant considerations relevant to whether Income Tax should in fact be devolved. There is considerable uncertainty about the extent of responsiveness on the part of employees to tax rates and the elasticity of labour supply. This is both in general terms and amongst Basic and Higher Rate[2] taxpayers but there are indications from the external evidence that if the Assembly wished to maximise revenue it would increase the Basic Rate by a small amount and hold the Higher Rate at current levels.[3]

Care must be taken in choosing the method to index deductions from the Northern Ireland spending block if any of the taxes were to be devolved.

This would especially be the case in terms of Income Tax as a large source of revenue (such deductions are a requirement under EU law). Indexing to the growth of UK revenues for that tax (the method favoured by Holtham for Wales) has the advantage of insulating the block deduction from the general UK economic cycle and UK policy risk (things that would have a general impact on the amount of Income Tax revenue collected but are not under the control of the devolved administration). However, it is much less clear, based on the past performance of the Northern Ireland economy, that Northern Ireland would be able to grow its regional Income Tax base above the UK average.

So, it is uncertain whether the gains to revenues could outgrow the deduction from the spending block. This creates the risk that Income Tax devolution would lead to the Assembly having less resources in the future. Such a risk has to be weighed against any benefits (e.g. economic or political accountability) from such devolution.

1 Of course, none of these characteristics of the UK business tax system mark Northern Ireland out relative to other UK regions. Our point, however, is that we suspect more could be done to sell these attractions to potential international investors given that it is undoubtedly the case that the UK overall has a relatively attractive offering compared to many other Western economies.

2 Strictly speaking, "Rates" as both the 40p and 45p rates are relevant.

3 It remains unclear how far an elasticity taken from US or UK experience would accurately predict how the Northern Ireland labour market would respond to, say, a 2p increase in the Basic Rate or a 3p decrease in the Higher Rate. The revenue maximising argument for actually cutting the Higher Rate becomes stronger if we assume a very strong behavioural response (i.e. considerable increase in labour supply) and/or strong in-migration by high earners from, say, GB and the Republic of Ireland.

If Income Tax was devolved policy makers must balance the respective priorities of revenue maximisation, the promotion of entrepreneurship amongst high earners and distributional objectives.

Trade offs are likely and it is very unlikely the Assembly could use Income Tax variation to pursue all three of these goals at once. This reinforces the point that the question of whether the power to vary a tax should be devolved (the subject of this report) is in principle *separate from* the question of how such a power might be used. Greater tax powers might require the Assembly to clarify or define its policy position, e.g. on the relative priority to be given to economic efficiency or distributional considerations.

Defence of the Northern Ireland funding block is understandable but not the only consideration.

Especially during a period of austerity, it would be entirely understandable if the Executive gave strong emphasis to defending the extent of the block grant to Northern Ireland (hence producing a concern about possible off-setting reductions in the block grant which arise from fiscal devolution given the need to ensure compatibility with the Azores Judgement). This reinforces the point that devolution of a tax may require confidence that it could produce sufficient compensating growth in the private sector to set against any reduction in the block grant. This confidence will be reinforced if the induced gains in other tax receipts relate to tax streams which are also under devolved control. Even if the other tax streams are not devolved such a policy might be justified if the aim were to contribute to rebalancing the Northern Ireland economy, i.e. the % share of the private sector and social enterprise sector compared to the public sector.

Fiscal variation should be seen as a supplement to other policy emphases and not as a solution in its own right.

Northern Ireland has hitherto not engaged in the level of debate about wider fiscal powers which has been going on in Scotland and Wales. While it may be useful to initiate that debate, it does not mean that enhanced fiscal powers would, in themselves, become a game changer to transform the economy.

Other, previously identified objectives should still be pursued; these would include improving the quality of management across the private, public and third sectors whilst having a single minded emphasis on raising productivity and exporting performance through gains to R&D and management capabilities. Indeed, regardless of what happens in terms of enhanced fiscal powers, the scope to use the UK's existing business tax package (e.g. Corporation Tax falling to 20% in 2015, and Patent Box now in place) should be maximised as a selling point for Northern Ireland as a destination for international investment.

1. Introduction

Context

The Centre for Economic Empowerment (CEE) at the Northern Ireland Council for Voluntary Action (NICVA) commissioned PwC on 1st February 2013 to undertake a review of the fiscal powers of the Northern Ireland Assembly. CEE was mindful of recent reviews of the financial arrangements of the National Assembly for Wales and the Scottish Parliament; the latter relating to the passing of the Scotland Act in 2012, while the former, subject to the final outcome of the Silk Commission, may ultimately enjoy similar devolution of fiscal powers.

Since devolution was first established in 1999, the Northern Ireland Assembly has acquired a borrowing capacity and control of Air Passenger Duty (APD) for direct long-haul flights and while a decision on the devolution of Corporation Tax has been deferred until after the Scottish independence referendum in September 2014, no review of the Northern Ireland Assembly's economic powers, comparable to those undertaken in Scotland and Wales, has been conducted.[4] Consequently, CEE commissioned PwC to produce a report that would answer the following questions:

- What is the current scope of the Northern Ireland Assembly to tax, borrow and spend?
- What have been the developments in Scotland and Wales towards greater financial autonomy?
- What is the feasibility and desirability of enhancing the Northern Ireland Assembly's fiscal powers, especially on a tax by tax basis?[5]
- How might any additional powers be administered?

It is envisaged that this report will help stimulate and inform a public debate on the Assembly's fiscal powers. It is important to stress that this report is intended to start such a debate rather than conclude it. Given that the emphasis here is on the changes which might be most practical in the short to medium run our consideration is largely in terms of taxes which already exist within the UK's current tax system. Of course, a more root and branch approach might consider entirely new taxes especially given that the UK system could itself benefit from fundamental reform.[6] Comparisons with Scotland and Wales are of particular interest since these are also devolved administrations operating within the UK. Also, in the longer term and especially in the context of any fundamental review, comparisons with tax systems further afield might be useful.[7]

Content of the report

There are six parts in the remainder of this report:

- An underperforming economy is the context for enhanced powers;
- Northern Ireland Assembly's scope to tax, spend and borrow;
- Fiscal developments in Scotland and Wales;
- Should the Northern Ireland Assembly's fiscal powers be enhanced;
- Administrative aspects of additional fiscal powers;
- Overall conclusions.

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4 Although the Economic and Integration Pact announced by the Prime Minister and the First and Deputy First Ministers on 14th June 2013 could kick start examination of the potential for additional fiscal powers.

5 A consideration of the pros and cons of the various options as to how any such powers might be used was not in the scope of this report.

6 Compared to other western economies, the UK tax system is characterised by a relatively small share of revenues from National Insurance Contributions equivalents, a large share from annual charges on properties (Rates), the wide range of zero rated goods and services for VAT, the absence of any tax relief on mortgage interest payments and the "exceptionally centralized" nature of the system (i.e. local and regional taxes are small compared to national ones). These were the views of J. Mirrlees et al. 2010, *Dimensions of Tax Design The Mirrlees Review*, Institute for Fiscal Studies and Oxford University Press, Oxford. A recent report on funding government in London proposed three entirely new taxes; a tourism tax, a tax on enveloped dwellings and a capital gains tax on property sales; see London Finance Commission/T. Travers (Chair) May 2013, *Raising the Capital*, London Finance Commission, London.

7 This could, theoretically, include the Crown Dependencies such as the Isle of Man and the Channel Islands although this does beg the question whether the UK Government would allow Northern Ireland to pursue such an agenda. See, the outcome of the recent Downing Street Meeting (15th June 2013) where those Dependencies undertook to participate in the OECD's Multilateral Convention on Mutual Assistance in Tax Matters. See also *Financial Times* 28th May 2013, "Cameron pressed on G8 tax battle", p.3.

2. An underperforming economy is the context for enhanced powers

Introduction

The question of whether to enhance the fiscal powers of the Northern Ireland Assembly should be put into context of what have been some of the key performance characteristics of the Northern Ireland economy and what have been the previous policy responses to these.

In order, therefore, to set the context for our consideration of the fiscal powers of the Assembly, the rest of this Part considers the following policy questions:

- Has a vision for the economy been agreed and implemented?
- Can the argument for enhanced fiscal powers move beyond Corporation Tax?
- What is the accountability argument for devolution?
- What are the consequences of developments in Scotland and Wales?

Has a vision for the economy been agreed and implemented?

Reviewing the performance of the economy

The Northern Ireland economy has never been short of analysis. There have been 15 major reports on the state of the economy starting in 1957 with the Isles and Cuthbert's report, *An Economic Survey of Northern Ireland*[8], through to the *Independent Review of Economic Policy* (IREP) in 2009 (which in turn formed the basis for the Executive's *Economic Strategy* published in March 2012).

The fact that there have been so many reviews in just over half a century suggests that not much has actually been achieved. Having a number of policy reviews *could* be an indication of good practice in policy making. However, the frequency of reviews in Northern Ireland, together with the fact that much of the message of those reviews was very similar, may indicate that there were unresolved difficulties in terms of implementing the policy recommendations contained in those reviews and strategies.

Many of the concerns raised by Isles and Cuthbert in the mid 1950s – such as low productivity and lack of competitiveness – were repeated in the reports in the following five decades, implying that certain fundamental problems remained unresolved.

True, during the mid 1990s to late 2000s Northern Ireland succeeded in boosting employment, but some of that gain proved transitory. In the decade to 2008 the region created a record 124,000 new jobs[9], yet comparative productivity actually fell to below where it had been in the mid-1980s.[10] And with a third of those new jobs lost since 2008, the local economy remains dependent on a level of public expenditure that is regarded by the UK government as no longer affordable.[11]

This context framed a commitment in 2010 from the Coalition Government to offer the Northern Ireland Executive powers to, "rebalance the economy." These rebalancing powers were subsequently confirmed as including (some form of) Enterprise Zone status and *a "…paper examining potential mechanisms for changing Corporation Tax in Northern Ireland."*[12]

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8 Published as the book K.S. Isles and N. Cuthbert 1957, *An Economic Survey of Northern Ireland*, HMSO, Belfast.

9 As recorded in the *Quarterly Employment Survey*. See also PwC 2010, *Business as Usual? The Need for Radical Change to the Delivery of Economic Policy*, Government Futures Publications, PricewaterhouseCoopers LLP, Belfast.

10 See Independent Review of Economic Policy 2009, *IREP Report*, IREP, Belfast, and NIE March 2012, *Economic Strategy*, Northern Ireland Executive, Belfast.

11 Implicit in the Coalition Government's commitment to "rebalance" the Northern Ireland economy; Coalition Government May 2010, *Programme for Government*, Coalition Government, London.

12 Coalition Government May 2010, *ibid*. It is worth noting that in the subsequent 3 years of debate as to how to rebalance the Northern Ireland economy the possibility of Northern Ireland (like England, Scotland and Wales) introducing an Enterprise Zone (or Zones) received relatively little attention at least until recently.

The sort of vision which Northern Ireland policy makers are likely to be working towards may be implied from three sets of documents: the recent *Programmes for Government* (for 2008-11 and 2011-15); *Strategy 2010* (1999) and *The Northern Ireland Economic Strategy* (2012). All three sets of documents were aspirational, in that they either set out or implied a vision for Northern Ireland's future.

The *Programme for Government 2008-11* claimed to form the basis for the 2007-11 Executive's *Budget* and *Investment Strategy*. It drew upon a very wide consultation (more than 9,500 people and organisations responded to an earlier draft). Interestingly, it contained both an economic efficiency and equality goal:

"Growing the economy is the top priority... We need to meet the challenge of global competition;"

"Inequalities exist, and we must strive to eliminate all forms of inequality."

Underpinning these goals were five specific subject area priorities:

- Growing a dynamic, innovative economy;
- Promote tolerance, inclusion and health and wellbeing;
- Protect and enhance our environment and natural resources;
- Invest to build our infrastructure;
- Deliver modern high quality public services.

Those five priorities have been carried forward into the current (2011-15) *Programme for Government*. That said, some of the detailed economic targets contained in the earlier *Programme* (e.g. to halve the private sector productivity gap relative to the UK average excluding Greater South East England and to increase Northern Ireland's employment rate from 70% to 75%) have not been maintained.

In fact, evaluation of the extent to which the detailed targets underpinning the first *Programme* had actually been achieved by 2011 suggests the overall record was patchy.[13] Whilst the introduction to the first *Programme* contained a commitment to review it every year to reflect changing circumstances in a rapidly changing world, it is not clear that *Programme* proved flexible enough in the face of the serious downturn which began in Northern Ireland in the middle of 2007.

Eight years before, the first *Programme for Government, Strategy 2010* (1999)[14] provided a contrasting approach to constructing a serious vision of Northern Ireland's future. *Strategy 2010* was more focused on the economy in the sense of being a less inter-Departmental approach than the *Programme;* it was driven by the then economy Department (DED). That said, it did involve a systematic attempt to include the views of the private and third sectors, e.g. through the use of 18 sectoral and subject working groups. *Strategy 2010*'s goal was:

"A fast growing, competitive, innovative, knowledge-based economy where there are potential opportunities and a population equipped to grasp them."

13 PwC March 2011, *Whatever Became of the Programme for Government*, PricewaterhouseCoopers LLP, Government Futures, Belfast.
14 Report by the Economic Development Strategy Review Steering Group March 1999, *Strategy 2010*, Department of Economic Development, Belfast.

In the face of increased competition (i.e. impact of globalisation), Northern Ireland needed to play to its strengths (small size in the sense that this might make internal networking easier, and a good representation of certain skills and technologies) and tackle its weaknesses (a relatively small private sector) to prosper. Action was needed in terms of improving partnership, the knowledge base and enterprise culture, being more outward looking and developing self help. The *Strategy* helpfully highlighted ten targets (a mixture of outcome and input related) and these are illustrated in Table 1.

Table 1: The recent performance of the Northern Ireland economy

	Baseline c. 1998	Target for 2010	Outcome achieved in recent years, i.e. 2010-12
GDP per capita as % of UK average	80	90	**79.2** (2011, gross value added (GVA) per capita)
Average weekly wages as % of UK average	86	91	**90** (2011)
Employment growth rate	0.5	1.5	**-0.6%** pa (employee jobs, comparing September-November 2012 with the same period in 2011)
Long term unemployment as % of labour force	4	2	**4.4** (September- November 2012)
Registration of new businesses per head of population (per 10,000 population aged 16 or more)	31	40	**28** (2009)
Exports as % of GDP	21	30	**22** (2010, estimated % of GVA)*
Share of high technology industries in total employment	2.9	6.0	**3.5** (September 2012)#
% of workforce with at least NVQ level 4 qualification	23	35	**41** (2011)
Business R&D as % of GDP	0.6	1.5	**1.2** (2010, % of GVA)
Investment in roads as % of GDP	1.0	1.5	**1.2** (2011, % of GVA)**

*Note: Based on combining the figure for manufactured exports for 2010-11 (from the *Northern Ireland Manufacturing Export Survey*) plus an estimate of total NI exports from all other sectors (e.g. agriculture, tourism, financial and business services), as estimated in PwC March 2012, *Northern Ireland Economic Outlook*, PricewaterhouseCoopers LLP, Belfast.

#Estimated from Classes 21, 26, 30, 28, 27 and 61 of *Quarterly Employment Survey* (this is likely to exaggerate the true extent of high technology activities).

**Using the *planned* level of total spending on roads by DRD (both current and capital programme) for 2011-12 (as contained in DRD 2012, *Spending Plan* 2011-15), Department for Regional Development.

Source: Various, e.g. ONS, Labour Force Survey, Annual Survey of Hourly Earnings, Inter-Departmental Business Register *and* Quarterly Employment Survey.

The third major policy document which provides a vision for Northern Ireland's future is the Executive's *Economic Strategy* (March 2012). This *Strategy* is intended to complement the current *Programme for Government* and, indeed, the current *Investment Strategy*.

However, and significantly, whereas the *Programme* has a three to four year time horizon (through to 2015) much of the *Economic Strategy* and especially its emphasis on rebalancing the Northern Ireland economy focuses on a longer term, through to 2030.

In its emphasis on increasing the competitiveness of the Northern Ireland economy, especially to achieve export-led growth, there was a lot of similarity to the approach in *Strategy 2010.* At the same time, the *Economic Strategy* has a shorter term priority to re-build the Northern Ireland economy, i.e. achieve a full recovery after the 2007-8 downturn and in so doing begin to reduce unemployment. The *Economic Strategy* summarised its vision (really, a cross-cutting commitment) as:

"*We are determined that the wealth and prosperity we are seeking will be used to help reduce poverty, promote equality, tackle existing patterns of disadvantage and division. We are also committed to building an economy that provides opportunities for the present, without compromising the ability of future generations to meet their own needs.*"

So, a vision for Northern Ireland's future, a competitive world class economy but also one that is socially inclusive, has been identified, consulted upon and has been re-iterated (with many common features) over the course of the past 14 years in these three sets of documents. Whilst, each of the documents was the product of a particular set of circumstances (e.g. the immediate post-Belfast Agreement period in 1999, the restoration of devolution in 2007, or the aftermath of the global downturn in 2008-9) there is enough of enduring significance to imply a vision which is still relevant but, crucially, how far has this vision been universally accepted and achieved?

Where are we now?

Table 1, above, shows the large number of shortfalls in performance which are indicated when one compares the out-turn in terms of where Northern Ireland had reached by about 2010 relative to the target set in 1999.

In relative terms, Northern Ireland's GDP per capita and wage levels remain very similar to where they were at the end of the 1990s (or, indeed, the start of the 1980s). One bright spot is the recent very rapid growth in R&D spending in Northern Ireland manufacturing, though even here performance remained below the target level set back in 1999.

It is also true that some of Northern Ireland's largest businesses have had very notable export successes. The challenge, however remains what it has been throughout the twentieth century, the highly competitive segment of the Northern Ireland private sector (and economy) is relatively small.

What happens if it is "business as usual"?

The *Economic Strategy* contains some forecasts of what might happen to the Northern Ireland economy if there is little change with respect to either policy or performance ("business as usual").[15] These suggest most of the gaps, in terms of performance relative to the UK average, e.g. in terms of GDP per capita and GDP per worker and employment rates, will persist at current levels throughout the next 18 years.

The outstanding challenges

As has already been discussed, what the Northern Ireland economy does not lack is a ready supply of detailed analysis. There has been a fairly consistent message emerging from the economic reviews and strategies as to what needs to be done. However, the underlying problem seems to have been one of execution and implementation.

The Northern Ireland economy needs to become more successful in external markets. Such trading and exporting success will follow on from the application of a much more innovative approach in the business and production process (e.g. more R&D, some of which is associated with more inward investment) which leads to high and rising levels of productivity.

Perhaps some consolation may be gained from remembering that Northern Ireland's challenges are not unique. For example, as the World Bank pointed out recently[16], much of Europe (both in terms of national and regional economies) has been struggling for some time now to achieve sufficient success with respect to economic growth to underpin wide-ranging and expensive social policy commitments.

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15 The Executive Economic Strategy implied that a business as usual scenario would be one where Corporation Tax was not devolved. We think the concept is broader than that.

16 World Bank January 2012, *Golden Growth*, World Bank, Washington DC. Specifically, the World Bank fears the "European economic convergence machine" has either slowed down or gone into reverse gear in the sense that whereas before the mid 1990s levels of GDP per head and per worker were converging between the EU as a whole and the USA and also between the "northern" EU economies and the "southern" EU ones, this is no longer true.

Can the argument for enhanced fiscal powers move beyond Corporation Tax?

As has already been argued, half a century of economic analysis and the accompanying strategies and plans, have not materially altered the economic performance of Northern Ireland relative to the UK average, nor its continued – and indeed increasing – dependence on a Westminster subvention, i.e. the net transfer of funds from the Treasury (see Part 3, below).

The argument that radical action is needed to rebalance the economy was supported by a recent PwC *Government Futures*[17] report demonstrating that these government sponsored economic development reviews and strategies had failed to close the productivity gap with GB.

PwC concluded that half a century of reviews and strategies had made no substantive improvement to the region's productivity and competitiveness, and that new measures to make the Northern Ireland economy more competitive must, inter alia, attract significantly higher levels of FDI, while stimulating increased productivity, exports and international competitiveness amongst both FDI and indigenous undertakings.

IREP in 2009 supported this contention, arguing that any new strategy should seek to identify and attract organisations, whether in the manufacturing or service sectors which:

- Pay salaries above the Northern Ireland private sector average;
- Can generate labour productivity levels (gross value added (GVA) per hour) above the NI average.

Hence:

- Generate GVA per capita above the Northern Ireland private sector average;
- Deliver GVA per job filled above the Northern Ireland private sector average.

Only by targeting and delivering FDI that significantly outperforms the average can we begin to rebalance the economy; and if the price of attracting such investment is a penalty on foregone tax, that element too, should be factored into the mix.

Pre-dating this, but taking a similar line was the 2006 report by the Economic Research Institute of Northern Ireland (ERINI)[18], with assistance from Oxford Economics, which concluded that Corporation Tax harmonisation with the Republic of Ireland would allow Northern Ireland to capture part of the Republic of Ireland FDI inflow and could:

- Create 180,000 new jobs by 2030;
- Double the growth rate of the Northern Ireland economy and eliminate the productivity gap with the UK in a decade;
- Recover the initial (estimated) loss of £300 million in reduced Corporation Tax within six years with substantial benefits to the exchequer thereafter;
- Increase private sector exports and employment;
- Result in a substantial reduction in the level of the fiscal transfer from the Treasury.

In 2010, a second report - this time from the Northern Ireland Economic Reform Group[19] – concluded that Corporation Tax harmonisation between Northern Ireland and the Republic of Ireland would:

- Create 90,000 new jobs by 2030;
- Cut unemployment "…*much further than would otherwise be the case*…";
- Reduce the level of Westminster subvention by £1bn by 2030.

17 PwC 2010, *op.cit*.
18 ERINI 2006, *Assessing the Case for a Differential Rate of Corporation Tax in NI*, Economic Research Institute Northern Ireland, Belfast.
19 Northern Ireland Economic Reform Group 2010, *The Case for a Reduced Rate of Corporation Tax in Northern Ireland*, ergNI, Belfast.

In December 2010, the Northern Ireland Business Alliance[20] wrote to MLAs and to the then Secretary of State, Owen Paterson, calling for Corporation Tax to be devolved to the Northern Ireland Assembly. The letter said, in part:*"We believe that a reduction in Corporation Tax is the fastest way to rebalance and grow the Northern Ireland economy and create jobs. Without reform, the NI economy will continue to be untenable and over-dependent on GB taxpayers. We implore you to now take the necessary steps to introduce these powers for Northern Ireland so that we can begin to pay our way."*

A third set of forecasts[21] argued that the employment gain consequent on the reduction in Corporation Tax could be 58,000 extra jobs by 2030 compared to 2012.

Given nearly a century of failure to close Northern Ireland's productivity and prosperity gap with the rest of the UK, it should not be surprising that commentators, employers' organisations and politicians such as the then Secretary of State, were anxious to find a game changer[22] for economic performance, particularly in the context of the reduction in public spending which was heralded by the onset of the Coalition's austerity policies.

But while half a century of economic assessment had finally concluded that fiscal powers were one of the keys to regeneration, the question remains if Corporation Tax reduction by itself is really the game changer or if Corporation Tax, as part of a wider portfolio of fiscal incentives, or indeed a wholly separate package of fiscal inducement, could have the potential to be the game changer that rebalances the economy.

What is the accountability argument for devolution?

Our focus throughout this report is on the *economic* case for and against devolution. There is, of course, a more politically based debate, i.e. is devolution per se a good thing? At the same time, some economists have developed theories of fiscal federalism which attempt to identify how far devolution of particular taxes could be compatible with principles of equity and efficiency. Such theories are, admittedly, somewhat high level.[23]

However, alongside these theories, there is a strong emphasis on accountability, i.e. a layer of government (be it, central, regional or local) becomes more democratically accountable to the extent that decision makers make decisions not only about spending but also about tax revenues to pay for that spending.

"No taxation without representation" is a phrase which has resonated around world politics since the English, American and French Revolutions of the seventeenth and eighteenth centuries but it may also imply its converse, "No representation without taxation". It is also possible that greater accountability could improve governance and hence, in turn, the quality of policy making.

20 Business Alliance letter signed by: CBI Northern Ireland; Institute of Directors; NI Chamber of Commerce; Centre for Competitiveness; NI Independent Retail Trade Association; NI Food and Drink Association.
21 Oxford Economics June 2012, *Preparing for a lower Corporation Tax Environment,* A Report prepared by Oxford Economics for the Department for Employment and Learning, Belfast.
22 See, PwC January 2011, *Corporation Tax- Game changer or game over?*, Government Futures Publications, PricewaterhouseCoopers LLP, Belfast.
23 R. Musgrave 1971, "Economics of fiscal federalism", *Nebraska Journal of Economics and Business,* vol. 10., no. 4, and T. Persson and G. Tabellini 1996, "Federal Fiscal Constitutions: Risk Sharing and Moral Hazard", *Econometrica*, May.

What are the consequences of developments in Scotland and Wales?

Alongside a priority to rebalance the Northern Ireland economy, the Coalition Government in May 2010 also set itself commitments to consider further devolved powers for the administrations in Wales and Scotland (building on the *Holtham Report* in 2010 and the *Calman Report* in 2009, respectively).[24] This led to the first report of the Silk Commission (in 2012)[25] and also the Scotland Act in 2012.

Influence can work in both directions across the Irish Sea. For example, it is very likely that one of the factors which led the Scottish government to push (unsuccessfully, as it turned out) for Corporation Tax powers to be included in the Scotland Bill in 2011-12 was the strength of the lobby for Corporation Tax varying powers in Northern Ireland. The recent report of the London Finance Commission wondered why government in London could not be given some of those tax raising powers already granted to (or about to be given to) the devolved administrations.[26]

Similarly, whilst the Silk Commission was sceptical about the merits of devolving Corporation Tax varying powers to Cardiff they did qualify this by saying that if either Northern Ireland or Scotland obtained such powers then Wales should seek to match them. Influence and or unintended consequence could work in the opposite direction. For example, if the perception grows that Corporation Tax powers are not coming to Stormont or, at least not coming for some considerable time, then it is possible that the Executive will pay even closer attention to developments in the other two devolved administrations over the last five years.

At the same time, given austerity and dependence on a large fiscal transfer from London it would be understandable if the Executive maintained a strong emphasis on defending the size of the block grant from London to Belfast. However, that concern need not exclude fiscal options which could lead to a more than compensating growth in the private sector.[27]

Conclusions

The question of whether to enhance the fiscal powers of the Northern Ireland Assembly should be put into the context of a vision for Northern Ireland's economic future, the debate around Corporation Tax powers and a wider consideration of fiscal devolution (including developments in Scotland and Wales and, indeed, the recommendations of the Heseltine Growth Review as to decentralisation to the English regions/cities[28]).

That context allows for the CEE's premise that a deeper exploration of the potential of the Northern Ireland Executive to tax, borrow and spend, will help address a number of arguments that can be summarised thus:

- It is widely recognised that the Northern Ireland economy has long underperformed compared to its potential. This has serious consequences for the general wellbeing of Northern Ireland society;
- That recognition of economic underperformance helped to spark the debate around the possibility of devolving the power to reduce Corporation Tax;
- At the same, with the exception of APD (particularly on trans-Atlantic flights) there has been little or no debate around any wider variation of fiscal powers;
- In this, Northern Ireland contrasts with both Scotland and Wales where there has been a consideration of the advantages and disadvantages of fiscal devolution across the entire range of taxes;
- This report seeks to contribute to the beginning of such a consideration in Northern Ireland.

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24 Independent Commission on Funding and Finance in Wales July 2010, *Final Report*, Holtham Commission, Cardiff, and Commission on Scottish Devolution, June 2009, *Serving Scotland Better: Scotland and the UK in the Twenty First Century*, Calman Commission, Edinburgh.

25 Silk Commission November 2012, *Empowerment and Responsibility: Financial Powers to Strengthen Wales*, Commission on Devolution in Wales, Cardiff.

26 London Finance Commission/T.Travers (Chair) May 2013, *op.cit.*

27 Even allowing for the likelihood that some of the fiscal gains (in terms of enhanced tax revenue streams) from such greater economic activity are likely to work to the benefit of HM Treasury rather than the Northern Ireland Assembly to the extent that most taxes are not devolved.

28 Lord Heseltine 31 October 2012, "No stone unturned in pursuit of growth", *The Heseltine Growth Review*, Department for Business, Innovation and Skills, London.

3. Northern Ireland Assembly’s scope to tax, spend and borrow

Introduction

Here we examine the current scope of the Northern Ireland Assembly to tax, spend and borrow both in terms of the current sources of funding for public spending in Northern Ireland and in terms of the public spending control system which applies. In particular, we consider:

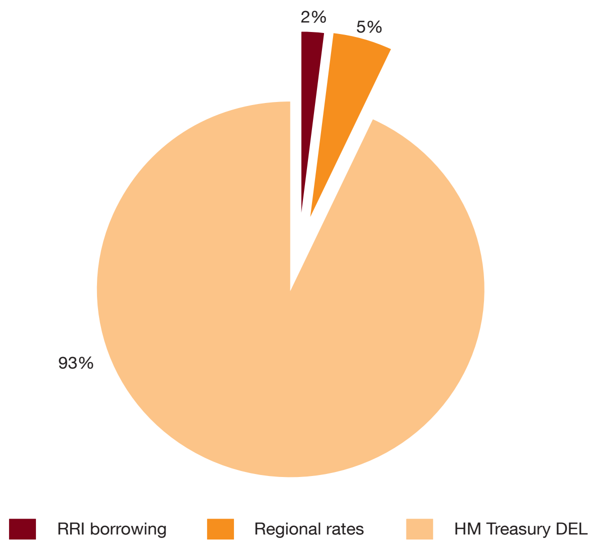
- Sources of funding, namely:
  - The block grant;
  - Regional Rate;
  - Borrowing through the RRI;
  - EU funding;
  - Charges;
  - Sale of public sector assets;
  - Private finance/alternative finance.
- Additionally, we outline the public spending control system.

Sources of funding

The block grant

In one sense, the main source of block grant funding is taxation. However, that comprises UK tax revenues rather than the tax receipts from Northern Ireland alone and separately. The Northern Ireland Assembly has, as of yet, only limited control of regional tax revenue streams. By implication, the main source of funding (see Figure 1) is the block grant from the Treasury; in 2010-11 the block grant provided 93% of Departmental funding according to the Departmental Expenditure Limit (DEL) definition (i.e. 93% of £11.1bn, for definition of DEL see section below on the Northern Ireland public expenditure control system).

Figure 1: Comparison of the scale of the main sources of funding available to NI Executive, 2010-11 (all %s of total DEL spending)



Source: NIE March 2011, *Budget 2011-15*, Northern Ireland Executive, Belfast.

Changes in public spending in England which are deemed “comparable” to programmes in Northern Ireland produce a pro rata allocation to Northern Ireland. This is the Barnett Formula, whereby for comparable spending programmes, an increase of £100m in England yields an increase in Northern Ireland (a “Barnett consequential”) of £100m times Northern Ireland’s population, calculated as a proportion of that of England. Barnett consequentials can be either positive (during a period of growth of public spending) or, indeed, negative (which has sometimes been the case in recent years given the application of austerity policies by the Coalition Government).

The working of the Barnett Formula, some of its limitations and the scope for reform are considered in the next Part of this Report where we outline the development of greater fiscal autonomy in Scotland and Wales (see Part 4).

As part of the UK’s fiscal union, the level of public spending in Northern Ireland is somewhat determined by “need”, especially to the extent that a large part of spending is classified as Annually Managed Expenditure (AME) and is demand led (42% of the total of DEL plus AME in 2010-11 was AME, see section below on the Northern Ireland public expenditure control system).

The total level of spending has in fact, throughout the period since the early 1970s, been considerably higher than level of tax receipts generated in the region. As part of the UK’s fiscal union, Northern Ireland receives a sizeable net transfer from the Treasury.[29] By implication, one of the challenges facing policy makers will be trying to retain whatever advantages follow from being able to access such a large transfer whilst also gaining whatever advantages may follow from greater fiscal devolution.

Major allocations, or reductions, from this source are made to the Northern Ireland Executive as part of the UK Comprehensive Spending Review (CSR). The most recent CSR was in 2010 covering the period until 2014-15 whilst negotiations to underpin the next CSR are close to completion at the time of writing (June 2013).

Allocations received through the Barnett Formula are not hypothecated. The Executive and Assembly can determine allocations for specific priorities and programmes regardless of the nature of the comparable spending in England that produced the Barnett allocation. This, of course, is very much in keeping with the spirit of the 1998 devolution settlement.

There are some further ways in which the gross spending power available to the Executive can be increased over and above the allocations determined by HM Treasury. These include the Regional Rate and the borrowing power within the Reinvestment and Reform Initiative (RRI).

Regional rate

There are two elements to the Rates bills paid by both households and the non-domestic sector in Northern Ireland. First, the District Rate set by each of the 26 District Councils, which is used to finance the services provided by those Councils. Second, the Regional Rate, which is determined by the Executive, which provides additional resources to support those central public services which are the responsibility of the Executive.

Regional Rate revenues are also “unhypothecated” so the revenue collected is not targeted on any specific public spending programme. Instead the revenue received is added to the total sums available for allocation by the Executive.

In the budget for 2008-11, the Executive agreed that the Business Regional Rate increases would be limited to 2.7% per year meaning no increase in real terms over that period. A similar approach has been agreed in the budget for the 2011-15 period with increases in the Business Rate to be held in line with forecast inflation.

In addition, the revenue forecasts associated with the Regional Rate for the 2011-15 period assumes that manufacturing rates will continue to apply at only 30% liability until 31 March 2015; Northern Ireland manufacturing firms pay 70% less Business Rates than would otherwise have been the case. The Executive has decided that the revenue foregone is more than compensated for by the benefits which follow from this form of support for the manufacturing sector in Northern Ireland.

It is also worth noting the Large Retail Levy, which was introduced in 2012. The 76 retail units with highest rateable values pay a 15% supplement to their Business Rates. The sum raised (about £6m in 2012-13) is entirely hypothecated; it is redistributed to reduce the rating liability of the smallest premises.

29 DFP November 2012, *Northern Ireland Net Fiscal Balance Report 2009-10 and 2010-11*, Department of Finance and Personnel, Bangor.

Borrowing through the RRI

The Reinvestment and Reform Initiative (RRI), announced in May 2002, included a new borrowing power, at relatively low rates, intended to support a very substantial infrastructure investment programme in Northern Ireland. This borrowing is subject to annual limits determined by HM Treasury and at present this limit is £200m per annum and can be used for capital spending only.

To date, £1.8bn has been borrowed under the RRI and the annual service payments on that debt amount to £65m. Part 5 of this report will consider the possibility of bond based borrowing by the Executive (although, there would obviously be no incentive to use bond finance if the Treasury simply reduced Northern Ireland's block grant by an amount equivalent to any bond based borrowing). Additionally, in principle, the Assembly could reintroduce the Ulster Savings Certificates scheme which expired in 2004.

EU funding

The EU funding that the Assembly receives provides additional spending power although the necessary national matched funding has to come from within Northern Ireland's allocated Departmental Expenditure Limit (DEL) budget. The Departmental allocations in the budget for 2011-15 include this impact of matched funding in respect of EU Programmes.

The EU Programmes have two elements – the EU funding provided through the European Commission (which adds to Northern Ireland's spending block) and the national matched funding that Member States are required to provide (which becomes a claim on the Northern Ireland block). In recent years EU funds have represented an annual addition to the Northern Ireland spending block of about £450m (the largest part of this being the Single Farm Payment subsidy for farm operation under the Common Agricultural Policy).[30]

Several points are worth emphasising regarding the control system around EU funds. First, the monies allocated have to be spent within a certain time frame. If the Northern Ireland government is unable to spend allocated money on a designated project and then fails to find an alternative project within the time frame the money is likely to be "lost", i.e. it "goes back to Brussels" (admittedly, the Northern Ireland block is also relieved of the requirement to find the matched funds). Second, the UK central government exercises a strong influence over determining the total size of Northern Ireland's allocation of EU funding. For example, during his meeting with the First and Deputy First Ministers on 26th March 2013, the Prime Minister disclosed that whilst given the planned reduction in the overall EU budget Northern Ireland's Structural Funds (e.g. European Regional Development Fund and European Social Fund) would have declined by 43% for the 2014-20 period, redistribution of funds from within the UK will imply that the actual reduction will be "only" about 5%.

In the context of EU funds it is also worth noting that local government in Northern Ireland could, for example, borrow from the European Investment Bank (EIB) to fund infrastructural projects. This would be an indirect benefit to the Executive relieving it of the need to commit funds to certain projects.

30 Estimated as the combination of the EU funds, i.e. ERDF, PEACE III, Cross-Border co-operation, ESF, Fisheries Fund and EAGF plus the Single Farm Payment (which was about £290m in 2009 and £245m in 2012, for example). Sources: European Commission, NIE 2011, *op.cit.* and Statement from the DARD Minister 27 December 2012.

Charging

Currently, there is some relatively limited use of charges for public services. If such amounts were increased this would represent a source of increased funding for public spending in Northern Ireland. An exercise undertaken by the Economic Research Institute Northern Ireland (ERINI)[31] in 2009 identified the potential to maximise income in terms of charging for services currently provided at low or zero price by the public sector. This exercise, while responding to a specific request to identify potential revenue streams, proved extremely contentious. Wider comparisons with governments elsewhere are also of interest.[32]

Table 2 provides a summary of the possible scope for charging, based on, for example, proposals contained in the budget for 2011-15. This represents an attempt to set out what *might* happen if the Executive and Assembly set themselves the goal of maximising revenues, with the sums in Table 2 mostly indicative. It should be noted, that Table 2 does not represent a proposal or recommendation, but merely reflects the potential for charging. Each of the proposed changes in charging, taxes or level of reserves involves a range of complex issues and would require a detailed assessment of the impact of the policy and would almost certainly require extensive public consultation.

Together with "charging" we have included the potential to draw down the reserves held by various public bodies.

Although our main focus in this report has been in terms of *existing* taxes at the UK level (especially those which have been or may be devolved to Scotland and Wales), it is worth remembering the very wide range of possibilities provided by the Assembly's power to introduce entirely new taxes.

Nevertheless, it should be noted the 1998 Northern Ireland Act qualifies that power, "taxes or duties under any law applying to the United Kingdom as a whole", are excepted matters, i.e they cannot be devolved without an Act of Parliament and may not therefore be duplicated . Interestingly, a proposal was made recently to introduce three new taxes to help fund government in London; a tax on tourists, a tax on enveloped dwellings and a capital gains tax relating to sales of properties.[33]

31 ERINI 2009, "Mitigating the recession: Options for the Northern Ireland Executive", *Economic Research Institute Northern Ireland Report,* ERINI, Belfast.

32 PwC 2011, *Charging Ahead: Should Government Charge More?* Public Sector Research Centre, PricewaterhouseCoopers LLP, London.

33 London Finance Commission/T. Travers (Chair) May 2013, *op.cit.* Although an Annual Tax on Enveloped Dwellings (ATED) at the UK level was actually introduced (from 1 April 2013) in the March 2013 Budget.

Table 2: Possible charges

Revenues , possible (additional) annual amount by 2015, £m	
MOTs/Tolling	15 (MOT)* < 50 (tolling)
Car parking	12**
Public Transport	3-24***
Tuition fees	40#
Water charges	200
Port of Belfast (reserves)	20
Housing Association (reserves)	?
Further Education Colleges	?
Plastic Bag Levy	4
Large Retail Levy	6##
Text Tax/ Mobile Phone Masts	2-20###
Medical Charges	20@
Other~	?
Total	**c.400**

*Note: If the MOT charge increased to £100, roughly tripling the current charge per car. Source, Committee for Finance and Personnel 16 February 2011, *Report on the Executive Draft Budget 2011-15*, vol. 1, DFP Committee, Northern Ireland Assembly, Belfast.

** Based on proposals in DRD 2011, *Draft Budget 2011-15 Spending and Saving Plans*, Department for Regional Development, Belfast. A similar scale of revenue collected was implied by separate proposals to introduce charges for car park spaces for public sector employees; Committee for Finance and Personnel 16 February 2011, op.cit.

*** The lower figure derives from various proposals in DRD 2011, *ibid.*, regarding reducing various subsidies to public transport. The higher figure is the current Public Service Obligation (PSO) subsidy to Translink to run the services of Northern Ireland Railways, in other words, the reduction in required public funding if fares were entirely without subsidy (see, J. Simpson 5 March 2013, "Transport wish list is stuff of fairy tales", *Business Telegraph*, p.4). This figure would be roughly doubled if the PSO for the bus service operation of Translink was also included.

Based on proposal in the 2011 *Stuart Report* on tuition fees which suggested that these might be increased from a maximum level (then) of £3,290 to about £5,500 (J. Stuart 2011, *Independent Review of Variable Fees and Student Financing*, Report for the Department for Employment and Learning).

Assuming Rates supplement on largest retailers (currently 15%) is doubled and, also the revenue raised, i.e. assuming all other things remain the same (e.g. that such an increase in Rates would not provoke any disinvestment by the large retailers).

Lower figure, a tax of 1% on customer bills (assuming about 500,000 mobile phones in Northern Ireland and annual average bill of £400), and higher figure, a tax of 10%. £24m was suggested as the yield of a proposed tax of 1p per text message, see Committee for Finance and Personnel 16 February 2011, *op.cit*.

@ i.e. a reversal of previous decision to make prescriptions "free".

~ For example; end senior citizens' free travel, introduce wider/higher charges for museums and libraries, charge for freedom of information requests and for accessing planning applications, also, increase Northern Ireland Housing Executive rents and apply Community Interest Levies.

Sources: Various, see notes above.

In respect of **MOT charges and tolling**, there are existing charges for use of MOT centres, which could be increased; one proposal was to increase the charge to £100 per car; roughly three times the current rate. Alternatively, the service could be sold to the private sector to gain a one off addition to revenues.

In contrast to either England or the Republic of Ireland, there are no examples of road tolls in Northern Ireland, although charges for road usage could be introduced. Whilst these would almost certainly be unpopular, they do have *some* theoretical attractions (a closer alignment to any environmental impact from road usage than the existing reliance on tax on vehicle ownership). Any revenues raised could be hypothecated (which could increase public and political support for such a charge, especially if it becomes clear that the current budget settlement is leading to a progressive deterioration in the quality of roads in Northern Ireland). However, the cost of administering road usage charges could be relatively high[34].

Turning to **car parking charges**, three elements are relevant:

- Existing provision of car parking spaces "free" to Northern Ireland Civil Service and some other public sector employees (mainly in central Belfast)[35];
- The level of charges for on street parking in Belfast and some other towns and cities across Northern Ireland;
- The level of charging for off street car parking.

Table 3: Car parking charges in Belfast compared to cities in England and Wales

City	On street parking charge (per 1 hour)	Off street parking charge (per 1 hour and up to 2 hours stay)
Belfast	£1.20	£2.33*
Nottingham	£2.00	£3.50
Liverpool	£2.00	£2.60
Cardiff/Bristol	£1.50	£2.30

*Note: average of three city centre car parks; it is unclear how representative these car parks are.
Source: For England and Wales, internet (guidance on charges on City Council websites).

Comparison of the level of charges compared to towns and cities elsewhere indicates some scope to increase the level of charges (although there are indications that such a change would provoke a strong negative public response). We do know that levels of congestion on road travel in Belfast are increasing. The demand for car parking is likely to be fairly inelastic from the point of view of parking by commuters so there is scope to increase revenue. However, previous experience suggests that shoppers have a more elastic demand- to what extent would they stop coming into the centre of Belfast and other large towns and instead shop at out of town centres (where car parking remains free)?

In respect of **public transport**, the policy option would be to make more funds available to the rest of Northern Ireland spending block by reducing the subsidisation of public transport and/or raising fares; or an outright disposal/privatisation. Such an approach could conflict with other policy priorities of the Executive, e.g. avoiding policies which impact negatively on low income groups or promoting policies to encourage a shift away from the private car. It may also be important to note that higher fares will only lead to higher revenues raised if the demand for public transport is fairly unresponsive to the price being charged.

34 McKinsey November 2010, *From Austerity to Prosperity: Seven Priorities for the Long Term*, McKinsey Global Institute, London, reckoned road tolling a relatively inefficient way to raise revenue (given indicated installation and administration costs of 10-50% of revenue) but they still judged it notable that UK was much less reliant on this policy than much of Continental Europe.

35 A levy on car park spaces in the public sector was suggested by V.Hewitt of ERINI in his evidence to a joint session of the DFP and DRD Committees 18th February 2009.

Like the other devolved administrations, the Northern Ireland Assembly has refused to follow England's lead in introducing a higher level of **university tuition fees** of up to £9,000. The fees charged to "local/regional" students at the Northern Ireland universities remain at about £3,500 (increasing annually by the inflation rate). One estimate is that the revenues foregone by not increasing fees to about £5,500 (as recommended in the Stuart Report to the Department for Employment and Learning Minister in 2011) are about £40m annually. Of course, the Executive may have higher policy priorities which would imply that tuition fees should not be used simply as a device to maximise revenues. For example, it may be judged that lower fees are necessary to encourage a high level of participation in higher education especially amongst persons from a low income background.

In respect of **water charges**[36], the water industry was privatised in England in the late 1980s, which meant that government in England avoided paying for further infrastructure spending on water and sewerage from public funds. In Northern Ireland, in contrast, funding for Northern Ireland Water's (NIW) capital spending continues to rest largely with allocation out of the general Northern Ireland Budget allocation to DRD and hence to NIW ("largely" because NIW does charge business and farming customers).

This implies an opportunity cost; that part of Northern Ireland's budget which is allocated to water cannot be used to fund, say, schools, hospitals or retraining of the unemployed. Now that the English water system has been privatised, Northern Ireland receives no Barnett consequentials relating to investment in water. If anything, HM Treasury could, given principles of resource accounting, penalise the Executive for its "failure" to introduce domestic water charging, i.e. the Treasury could "charge" for the retention of about £6bn of infrastructure in the state sector given the "failure" to turn NIW into a self-financing public corporation.

The restoration of devolution in 2007 was followed by the establishment of the Independent Water Review Panel (IWRP) led by Professor P. Hillyard. During 2007 and 2008 IWRP recommended that NIW be mutualised (i.e. a status similar to the counterpart company in Wales, *Glas Cymru*) and that households should be charged explicitly for water (i.e. over and above that element of the previously established level of Regional Rates which could be assumed to represent a payment for water services). The IWRP proposed that such charges be linked to the net capital value of each domestic property with low income households being protected in the following ways; there would be an affordability tariff, the charge to net capital value relationship would be highly progressive (i.e. families in properties with low net capital values would pay relatively small amounts of charge) and there would be no standing charge.

At that time and since, neither DRD nor the Executive/Assembly more widely, showed much desire to apply the IWRP recommendations. Nor was much support offered for any alternative method of calculating charges for water (notably metering). As of present, the Executive has a commitment not to introduce any charges for domestic water in the period up until 2016. It remains to be seen what commitments the political Parties might make in the 2016 Assembly Election.

In the draft budget for 2011-15, the DFP Minister outlined proposals to reduce the reserves which he believed were held by **the Port of Belfast**. A commitment to "raise" £20m annually by 2014-15 survived into the agreed budget for 2011-15. However, it remains unclear if such proposals are achievable (also, what consequences might there be for levels of investment in the Port and hence efficiency and levels of charges to customers, and would Westminster provide the necessary UK legislation which might prove problematic given possible implications for Trust Ports in GB?).

Similarly, there has sometimes been a view that a range of **other public bodies** (e.g. Housing Associations, perhaps Further Education Colleges and the Universities) have a sufficient level of reserves that some of these could be drawn down. It is not so much that DFP/the Executive would "raid" these resources, what they might do is to reduce annual grant payments (indeed, a grant reduction to these public organisations has already occurred during the 2011-15 budget period). Unsurprisingly, the true extent of "excess" reserves remains a contentious issue.

The Plastic Bag Levy was introduced on 8th April 2013. There is a charge of at least 5p for new single carrier bags in Northern Ireland. Retailers may charge more than 5p if they wish, however, only 5p from the sale of each bag is payable to the Department of the Environment. Revenues raised (projected to be £4m annually) are to be dedicated/hypothecated to supporting a small scale version of the Green New Deal.[37]

36 For a consideration of the issues, see ERINI, *op.cit.*

37 The original Green New Deal as first conceived by a business and third sector lobbyists was an ambitious investment programme to leverage in significant amounts of private sector funding to deliver energy efficiency measures, and create thousands of jobs especially in construction. The scheme as actually agreed aims to reduce waste, cut bills for participating households, sustain employment through the recession and modernise our housing stock, albeit limited to the funding provided by the Plastic Bags Levy which is expected yield of £4m annually, but with no revenue anticipated in the first year of the Budget period (for that year the Green New Deal measures were to be funded out of the NI spending block).

The Large Retail Levy was introduced in 2012. The 76 retail units with highest rateable values annually now pay a 15% supplement to their business Rates. Here we assume, perhaps implausibly, that the Rates supplement could be doubled leading to a doubling of revenues. This Levy has already been criticised on at least two fronts. First, by the large retailers which suggest that it could lead to disinvestment. Second, by those who do support some measures to support small shops but regard this redistribution arrangement as a very blunt instrument (because it is not just small shops which get some relief but all premises below a certain size).

The Assembly does have a power to introduced entirely new taxes; this has already been demonstrated by the Plastic Bag Levy. Some commentators suggested a tax related to **mobile telephony** (e.g. on usage, such as per message or on phone masts). Obviously, *part* of any such tax would have its incidence on the mobile phone customer (and part would fall on the profits of the operators). In any case, it appears there is some uncertainty as to the legal/constitutional standing of such a tax. Would it be a genuinely new tax (as opposed to a variation on the existing VAT on mobile usage) and hence would it really fall within the competency of the Assembly?

Medical charging is an example where charging previously existed until the Executive (in the 2007-11 Assembly) decided to forego such charges. Prescription charges could be re-introduced. When the policy of free medical prescriptions was introduced, the cost in terms of revenue figure was estimated at £12-£13m per year but the actual cost probably now exceeds £20m given that free prescriptions have themselves induced extra demand. In continental Europe it is common to charge small amounts for Accident and Emergency (A&E) or General Practitioner (GP) consultation/visits.[38]

In the Republic of Ireland a Medical Card is in place - which entitles holders to free hospital care, GP visits, dental services, optical services, aural services, prescription drugs and medical appliances – and is available to those receiving welfare payments, low earners, those with certain long-term or severe illnesses and in certain other cases. People who are not entitled to a Medical Card (i.e. 68% of the population) must pay fees for certain health care services. There is a €100 charge for those who attend an accident department without a referral letter from a family doctor (a visit to that doctor usually costs €50-75). Hospital charges (for inpatients) are a flat fee of €100 per day up to a maximum of €1000 in any twelve-month period, irrespective of the actual care received. Specialist assessments and diagnostic assessments (such as X-rays, laboratory tests, physiotherapy, etc.) are provided for free.

Medical charges (including those for prescriptions) would have the disadvantage that there would be a cost of administration (which could be large relative to the revenues would might be collected). Furthermore, there could be potential inequities (e.g. would the system rely solely on means testing according to income, if so there would be no special allowance for individuals who suffered from chronic medical conditions implying frequent use of medical care/prescription drugs?). Also, could people be discouraged from accessing medical attention which they need?

There are many **other potential charges**, such as for museums and libraries and a Community Interest Levy (i.e. a charge on building firms and property firms which attempts to “extract” some of their profit gain from large scale developments) which could be introduced and/or increased. A number of considerations apply:

- It would seem beneficial to have a more consistent approach regarding charges for museums (some are free but others not);
- Revenue raising must be balanced against any goal to achieve a wider social access to cultural venues;
- Whatever may have been the case before 2007, Northern Ireland’s construction sector is probably not robust enough now to absorb any Community Interest Levies.

Sale of public sector assets

The draft budget for 2011-15 contained an aspiration to raise some funds through sale of assets. However, in the agreed budget for 2011-15 and, indeed, the *Investment Strategy* there is little detail about which assets could be sold or estimates of amounts that might be raised. The Asset Management Unit is to seek sales of up to £100m. Short of outright sale, there may be scope to “commercialise”, i.e. gain revenues by selling certain services whilst retaining the asset. This is being explored in terms of the Forest Service. The Agri-Food and Bioscience Institute could be commercialised further.

38 In Sweden, for example, a charge of £10-15 per visit to the GP subject to a cap on maximum annual charges of about £85.

Private Finance/alternative finance

During the 1990s and 2000s there was extensive use of public private partnerships (PPPs)/private finance initiatives (PFIs) in Northern Ireland and elsewhere. There has now been some reaction amongst policy makers against PPP/PFI (reflecting a perception that sometimes value for money was not being achieved). Attempts to evaluate the relative value for money of PPP/PFI relative to "traditional procurement" have generated a huge literature.[39]

Furthermore, the impact of austerity and the very low rates of interest on UK government bonds have worked to decrease the cost of traditional procurement relative to PPP/PFI. It has also become less clear if "borrowing" through PPP/PFI will actually be defined as off the government's balance sheet. If borrowing through PPP/PFIs remains on the balance sheet the attraction to government in terms of meeting deficit/debt reduction targets is removed. In principle, the Executive could still "borrow" from the private sector through some sort of child of PPP/PFI, or through some form of "alternative finance" as the *Investment Strategy 2011-2021* terms it.[40] The *Investment Strategy 2011-2021* indicates a possible level of total Departmental capital spend of £8.2bn over 2015/16-2020/21 of which £1.1bn would derive from alternative finance (of this £500m would relate to health and £390m would be in roads).

Northern Ireland exemptions/reliefs

Our focus, so far, has been on ways in which the Northern Ireland Assembly does raise revenue or could raise revenue. It is also worth noting that there are some examples of how exemptions and reliefs apply to various taxes and charges. These obviously *reduce* revenues but may be judged justifiable by appeal to some other policy objective.

Air Passenger Duty (APD)

APD was first introduced in 1994 as a flat charge of £5 per passenger within the UK/EU and £10 elsewhere. Since then, the structure of the tax has been changed, rates have been graded by distance travelled as well as seat type, and the rates increased. APD is currently between £13 and £188. In November 2011, the NI Executive gained an exemption from the higher APD tax rate which had applied to the long haul, trans-Atlantic route. Power to set the tax for that route has since been formally devolved and the rate reduced so that the same rate now applies to the route to the US as to routes to GB and the rest of Europe (the extent of lost revenues consequent on this policy and hence the scale of reduction from the block grant has yet to be agreed, see Part 6, below).

Aggregates Levy – Credit Relief Scheme

This was introduced at a UK wide level as an application of the polluter pays principle, i.e. a response to the environmental damage from quarrying. A partial relief was applied to Northern Ireland to reflect the special circumstances implied by the border with the Republic of Ireland, i.e. the possibility that a levy in the UK could incentivise increased use of materials extracted south of the border and then transported north; this would be a perverse unintended consequence since environmental harm could thereby be *increased*. The relief was subject to legal challenge and has been suspended since 1st December 2010.

Environmental taxes, climate change levy and carbon pricing

In his 5th December 2012 Autumn Statement the Chancellor recognised the particular challenge facing Northern Ireland within the Single Electricity Market within the Republic of Ireland. The relatively high rate of carbon pricing in the UK compared to the rest of the EU could imply that Northern Ireland based generators would face a major competitive disadvantage relative to their Republic of Ireland counterparts in the single electricity "pool". Northern Ireland has therefore been exempted from the proposed UK increases in the level of carbon pricing.

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39 Studies which focused on the UK and came to a favourable conclusion include J.Hall 1998, "Private opportunity, public benefit?", *Fiscal Studies,* 19(2), pp. 121-40, Arthur Anderson and Enterprise LSE 2000, Value for Money Drivers in the Private Finance Initiative, UK Treasury Taskforce, London, and M. Pollitt 2005, "Learning from the UK private finance initiative experience", in G. Hodge and C. Greve 2005, *The Challenge of Public Private Partnerships*, Edward Elgar, Cheltenham, pp. 207-30. Less favourable conclusions were drawn by, for example, A. Pollock, J. Shaoul and N.Vickers 2002, "Private Finance and Value for Money in NHS hospitals", *British Medial Journal*, 324, pp. 1205-8, and, internationally, in P. Bloomfield, D. Westerling and R. Carey 1998, "Innovation and risks in a public-private partnership: Financing and constructing a capital project in Massachusetts", *Public Productivity and Review,* 21 (4), pp. 460-1, and in B. Walker and B.C. Walker 2000, *Privatisation: Sell off or Sell out?* The Australian Experience, ABC Books, Sydney.

40 In 2012 the Chancellor proposed Private Finance 2 (PF2) whereby private could be combined with public finance but with a higher public sector stake (49%) than would have been the case with PPP/PFI. Any PF2 projects, including those in Northern Ireland, are to have a scale of at least £50m. Obviously, given the smaller absolute scale of most investment projects in Northern Ireland that threshold requirement could represent a constraint.

Spending: The Northern Ireland public expenditure control system

The main public expenditure categories

Public expenditure in Northern Ireland is subject to two separate controls – the Departmental Expenditure Limit (DEL) and Annually Managed Expenditure (AME). DEL and AME together make up Total Managed Expenditure (TME). In 2010-11 total DEL in Northern Ireland was £11.1bn and total AME £8bn.[41]

DEL totals have been fixed for a four year period in the UK wide Comprehensive Spending Review (CSR) (the most recent CSR was carried out by HM Treasury and published on 20th October 2010 and the next CSR negotiation process is ongoing at the time of writing in June 2013), whereas AME is controlled on an annual basis, based on updated forecasts. This is because AME is largely comprised of demand led programmes (e.g. social security benefits), which cannot be readily subject to multi-year limits. However, it is worth noting that in his recent Budget (20th March 2013), the Chancellor George Osborne signalled a desire to move to a position where there would be some sort of cap on the growth of total AME at the UK-wide level. This could be a particularly significant development for Northern Ireland where welfare benefits per head (and hence total AME spend) are relatively high.

Reflecting the differing nature of these controls, the main focus of the Northern Ireland budget process is on the DEL, in that it is subject to allocation at the discretion of the Executive, in accordance with local needs and priorities.

The budgetary structure also provides a clear separation of current spending and capital spending:

- Current expenditure – the resource DEL including administration costs and ring-fenced items such as depreciation and impairment costs;
- Capital investment – the capital DEL including expenditure which enhances or creates an asset of government and capital grants which support investment by other bodies, including some public bodies as well as the private and voluntary sectors.

Invest to save allocations

In its revised spending plans for 2010-11, the Executive established a £26m Invest to Save Fund which allocated funding to Departments for a range of discrete projects that were focussed on delivering long term savings. Given the success of these initiatives, the Executive agreed to pursue a similar initiative in each of the years of the budget for 2011-15. The draft budget for 2011-15 proposed allocations to Departments of £75m per annum to fund such projects and these allocations have been retained in the final budget plans. These funds have been allocated to Departments on a ring-fenced basis i.e. they cannot be used for any other purpose by Departments. If these resources are not deployed as intended then they will be returned to DFP for reallocation elsewhere.

Current/capital switch

The CSR outcome in 2010 resulted in a 40% real terms decrease in the capital funding provided by the UK Government. In view of the importance of continued infrastructure investment and the impact public sector capital investment has on the construction industry the Executive proposed to transfer resources from current expenditure into capital investment in the draft budget. The overall amount of resources transferring from current expenditure to capital investment has been maintained in the final budget. However the yearly profile has changed to reflect the pressures identified by individual Departments. This reclassification of resources will help counteract the impact of the reduction in the capital DEL. The sums envisaged in the final budget for 2011-15 are £10.8m (2011-12), £78.8m (2012-13), £86.2m (2013-14) and £80.9m (2014-15). It is worth pointing out that these sums are not large when compared to the total capital (about £1bn) and current budgets (about £11bn). Indeed, these sums are maximum amounts and in practice Departments may decide that the actual scale of transfer is lower.

Whilst the Executive can choose to relocate current spending to capital, it requires Treasury permission to move in the opposite direction.

41 According to NIE March 2011, *op.cit.*

End Year Flexibility

End Year Flexibility (EYF) had previously allowed Northern Ireland Departments some flexibility to carry over unspent money into the next financial year. Since the 2010 CSR, HM Treasury has limited the extent of end year flexibility. EYF has been replaced at the UK wide level, including Northern Ireland, by the Budget Exchange Scheme (BES). Whereas with the old EYF the sums concerned could be quite large (several £100m annually and could sometimes even be "banked" and carried over more than one year), the BES offers a much smaller amount of flexibility (in 2011-12, the total BES limit for Northern Ireland was £59m for current spending and £14m for capital)[42] and money cannot be carried across more than one year. When EYF was ended in 2010 Northern Ireland's existing stocks of accumulated EYF with the Treasury were written off, the same applied to the other devolved administrations.

Conclusions

There are the following conclusions regarding the current scope to tax, borrow and spend:

- In principle, the Northern Ireland Assembly can seek funding from a wide variety of sources (e.g. RRI borrowing, the EU, charging, PPP/PFI/alternative finance).
- In practice, however, the Assembly is still predominantly dependent on the block grant from HM Treasury.
- Northern Ireland is part of the fiscal union which the UK constitutes. One implication of this is that levels of spending can be sustained at a level far in excess of the amount of regional tax receipts. Although it is not straightforward to measure the size of this deficit or the transfer to Northern Ireland, the estimates produced by the Department of Finance and Personnel indicate that total public spending in 2010-11 was £23.2bn compared to tax revenues of £12.7bn.[43] In other words, this is a net fiscal deficit of about £10bn (in 2011 Northern Ireland's total output, or gross value added, was about £30bn). Policy makers therefore face the challenge of trying to hold on to the advantages of being part of the UK's fiscal union, whilst also extracting advantage from enhanced fiscal powers.[44]
- Currently, the Assembly has very limited control over the tax base (it can vary the Regional Rate and, now, the long-haul rate of APD and it could, theoretically, introduce some new taxes).
- The existing scale of borrowing (up to £200m annually) might appear small compared to total levels of annual spending of about £20bn. However, Northern Ireland's borrowing powers under the RRI are not dissimilar to those proposed for Scotland and Wales (see Part 4).
- A relatively small net addition to funding is received through EU funds (adding about 4% to the annual DEL spending total).
- When comparison is drawn with elsewhere in the UK or EU, some scope to increase charges is implied and such policies could be unpopular. In some cases the policy change could be a reversal of a previous decision to remove charges.
- In this Part of the report we have considered the scope of the Northern Ireland Assembly to tax, spend and borrow. We have not considered the related issues of achieving greater value for money and efficiency from existing resources. One important aspect of this could be greater control of the level of public sector pay in Northern Ireland. Advantages of such a policy could include an ability to match pay levels more closely to levels of costs and price and private sector wages in the region and the possibility that employment reductions arising from austerity policies could be minimised. However, certain disadvantages are also likely. Would the Treasury allow devolved administrations to keep 100% of any money "saved" through using regional pay and to what extent would this imply a major and negative change in living standards and the level of spending power in the region.[45]

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42 HM Treasury 18 July 2011, "Alexander announces new budget flexibility for Devolved Administrations", *Press Release*, Gov.uk. https://www.gov.uk/government/news/alexander-announces-new-budget-flexibility-for-devolved-administrations.

43 DFP November 2012, op.cit. Note, total public spending is defined here to include not only the expenditure "identifiable" within Northern Ireland but also, additionally, "Northern Ireland's share" of non-identifiable spending (i.e. certain types of spending on behalf of the UK as a whole) plus an accounting adjustment.

44 E.g. being able to support a higher level of spending than that which regional tax receipts could warrant and the insurance against region specific shocks which is provided by being part of a national level system of fiscal union with substantial transfers. Such advantages have to be weighed against the possibility that the scale of the fiscal transfer has itself begun to influence economic behaviour within Northern Ireland in a way which is damaging; the possible impact of a "soft budget constraint". The concept of a soft budget constraint as a cause of harmful effects on economic efficiency was first developed with particular reference to pre-1989 Eastern European economies by the Hungarian economist Janos Kordai and then applied to the Northern Ireland economy particularly in the 1980s; P. Teague (eds.) 1987, *Beyond the Rhetoric: Politics, the Economy and Social Policy in Northern Ireland*, Lawrence and Wishart, London.

45 The possibility of regional pay has been considered by UK Chancellors, both Labour and Conservative, since 2002 but so far actual movement in that direction have been limited.

4. Fiscal developments in Scotland and Wales

Introduction

This Part traces the development of fiscal powers in Scotland and Wales during the last five years. Specifically, it reviews a:

- Summary of developments;
- Specific tax devolution proposals in Scotland;
- Specific tax devolution proposals in Wales.

Summary of developments[46]

The following Table benchmarks the extent of fiscal devolution which currently exists in each of the devolved administrations:

Table 4: The current fiscal powers of each of the devolved administrations

Northern Ireland Assembly	National Assembly for Wales*	Scottish Parliament*
Regional Rates		Vary from UK Basic Income Tax Tate by up to 3p
Air Passenger Duty on direct long haul flights	Very limited powers to borrow**	Business Rates
Limited powers to borrow		Limited powers to borrow

*: Note: Both the Welsh Assembly Government and Scottish Government have indirect control of Council Tax as well (in a way that the Northern Ireland Assembly does not have relative to the District element of Rates). They can allow or require local authorities to set higher Rates and encourage local authorities to set higher Council Tax rates by reducing the amount of grant support provided. In practice, the Scottish Government has done the opposite by freezing Council Tax which has had the effect of increasing local authorities' reliance on funding support from the Scottish Government.

** Relates only to cash management and is a legacy power from the former Welsh Development Agency (so, restricted to spending on economic and social development).

The Table above shows the current position of each of the devolved administrations but the aim of this Part is to outline how thinking and policy towards fiscal devolution has developed over time in Scotland and Wales. We first of all summarise those developments.

In 2008 the Welsh Assembly Government set up the *Independent Commission on Funding and Finance for Wales* (the Holtham Commission)[47] to review the existing largely block granted basis of funding to the Welsh Assembly Government and to identify possible alternative funding mechanisms (including tax varying powers as well as greater borrowing powers).

The Scottish Parliament and the UK Government established the *Commission on Scottish Devolution* (the Calman Commission) which began work in April 2008 (reporting in June 2009).[48] Calman was tasked with reviewing the provisions of the Scotland Act 1998; recommending any changes to the present constitutional arrangements that would improve the financial accountability of the Scottish Parliament, which would continue to secure the position of Scotland within the UK. The outcomes of these reviews informed the potential for further devolution.

46 House of Commons Library 4 June 2010, "The Commission on Scottish Devolution- The Calman Commission", and 9 March 2012, "Devolution in Wales: The Silk Commission", UK Parliament, London.
47 Independent Commission on Funding and Finance in Wales July 2010, *op.cit.*
48 Commission on Scottish Devolution June 2009, *op.cit.*

Holtham concluded that the current arrangements for the financing of Wales lacked sufficient, "fairness and accountability", and that the Barnett formula through which the block grant to the devolved legislatures is determined should be replaced by a formula based on need. It also recommended devolution of limited powers over certain taxes and borrowing (see Table 6). Calman, in turn, recommended, that, "…part of the Budget of the Scottish Parliament should now be found from devolved taxation under its control rather than from grant from the UK Parliament" (see Table 5); there would be reduction in the block grant to correspond to the revenues raised through devolved taxes.

Effectively, the outcomes of these initiatives concluded that the devolution of additional tax varying and other powers to the devolved administrations was appropriate and these proposals were reflected in May 2010 in the Coalition Government's *Programme for Government* where the UK Government committed to (the following three quotations are from that document): [49]

Northern Ireland
"…produce a paper examining the potential mechanism for changing the Corporation Tax rate in Northern Ireland";

Scotland
"Implement the proposals of the Calman Commission";

Wales
"Introduce a referendum on further Welsh devolution, the outcome of which (assuming a favourable vote)", would result in the establishment of, "…a process similar to the Calman Commission for the Welsh Assembly."

In the latter case, the referendum was favourable leading to the creation of the Silk Commission in October 2011, with the deliberations of Silk now an integral part of a wider debate relating to the future structures and shape of the UK and the devolved nations.[50] Furthermore, Silk has, in its first report (in November 2012), recommended the devolution of fiscal powers to the National Assembly for Wales (see Table 6, below) that will grant the Welsh Assembly Government responsibility for setting and raising taxes in Wales rather than being wholly reliant on a block grant.

In addition, the provisions of the Scotland Act of May 2012 (see Table 5) will come fully into effect in 2016 and, as a result, the Scottish Parliament will move from raising about 14% of its own budget (mainly through Council Tax and non-domestic rates) to around 35%, replacing part of the UK Income Tax with a Scottish Rate of Income Tax from April 2016; devolution of land tax and landfill tax from April 2015; extensive new borrowing powers from April 2015; and the creation of a Scottish cash reserve to manage volatility in the devolved taxes.

The following sub-sections outline the specific proposals and changes in Scotland and Wales regarding tax powers. At this stage it is worth making the point that both in terms of what has been agreed and in terms of what may happen, a gap has opened up between Northern Ireland and the other two devolved administrations. A later Part of this report will consider on a case by case basis the arguments for and against devolving particular taxes to Northern Ireland. The experience of Scotland and Wales is obviously very relevant to such arguments.

49 Coalition Government May 2010, *op.cit.*
50 See, Silk Commission November 2012, *op.cit.*

Specific tax devolution proposals in Scotland

Table 5: Development of fiscal powers in Scotland

	Devolution recommended in:			Devolution achieved in:
	Calman	**Scotland Bill**	**The Scottish Government Amendments (14 March 2011)**	**Final Scotland Act (2012)**
Income Tax on employment* (10p in the £ should be taken off the UK rates of Basic and Higher Rate tax and replaced by the Scottish Rate of Income Tax)	Yes	Yes	Yes	Yes
Income Tax with ability to vary progressivity	No	No	Yes, wished for consideration for this option	No
Stamp Duty (land and property)	Yes	Yes	Yes	Yes
Aggregates Levy	Yes	No	Yes	No
Landfill	Yes	Yes	Yes	Yes
APD	Yes	No	Yes	No
Corporation Tax	No	No	No (but later Yes)**	No

*Note: Income tax paid on employment income only.

**"Yes" in the Fourth Parliament's Scotland Bill Committee in 2012 (i.e. after the SNP became a majority).

The 2012 Act granted a power to create entirely new taxes, albeit subject to agreement by the UK Government.

Borrowing powers in Scotland

Prior to 2009, the Scottish Government did have a limited ability to borrow to assist cash flow. Calman recommended that power be increased and also recommended a right to borrow to fund investment subject to prudential limits. The Scotland Act 2012 adds a "prudential power" to invest in infrastructure and capital projects and to allow for variability in Scottish Rate element of Income Tax revenues. The Act permits Scottish borrowings of up to £2.7bn cumulatively (£2.2bn of these to fund capital spending) and no more than £240m annually. This limit represents the additional burden of risk that Treasury judged was appropriate given that borrowing by the Scottish Government contributes to increased UK public sector net borrowing (PSNB) and public sector net debt (PSND).[51]

That borrowing would be from the National Loans Fund but on the foot of the Scotland Act, the Treasury issued a consultation on bond issuing powers in Scotland.[52] The Treasury has yet to respond to that consultation but the document outlined the following issues:

- Borrowing by the Scottish Government could have some effect on the UK's overall budgetary, public sector debt and macroeconomic position. Hence the desirability, in the Treasury's view, of imposing a ceiling on sub-sovereign borrowing;
- Going to the bond market and relying on that source of funding would, over time, exercise a degree of discipline over the approach of the Scottish government to borrowing and long term investment and would tend to eliminate or reduce the threat of moral hazard[53], while imposing market discipline.

51 The Scottish Government in 2011 proposed an amendment to the Bill to allow a much higher level of borrowing for capital projects (£5bn rather than £2.2bn).

52 HM Treasury 22 June 2012, *The Scotland Act: A Consultation on Bond Issuance by the Scottish Government*, HM Treasury, London.

53 The concept of moral hazard describes behaviour when agents do not bear the full cost of their actions and are thus more likely to take such actions; or which there is a tendency to take undue risks because the costs are not borne by the party taking the risk. In fiscal terms therefore, moral hazard occurs where sub-sovereign authorities may wilfully spend excessively in the knowledge and confidence that the financial consequences of such overspending will ultimately be shared across the entire country and not reside solely with the sub-sovereign authority.

Such discipline would, however, be weakened to the extent that any pledges by the UK Government not to bail out the sub-sovereign in extremis were not regarded as credible.

Each case is unique but the experience of existing sub-sovereign borrowers (e.g. commercial public agencies in the UK such as Network Rail and Transport for London as well as regional/state or city governments in federal systems, such as in Spain, Germany and the USA) is indicative that such borrowing occurs at a premium *above* national treasury rates, probably because sub-sovereign debt markets are smaller and hence less liquid.

Specific tax devolution proposals in Wales

Table 6: Development of fiscal powers in Wales

Item	Devolution of power recommended in Holtham	Devolution of power recommended in Silk
Income Tax on employment*	Yes	Yes
Income Tax ability to vary progressivity	Maybe	Yes
Stamp Duty (land and property)	Yes	Yes
Business Rates#	Not considered	Yes
Landfill Tax	Consider	Yes
Aggregates Levy	Consider	Yes
APD	Consider	Yes
Corporation Tax	Discuss with London government	No**

* Note: Devolution of the tax on interest payments and dividends was considered too complex.

#For Non-domestic Rates in Wales, a sum is added to, or subtracted from, the block grant to Wales according to what has happened to the total receipts collected in England and Wales by the Department for Communities and Local Government. De facto, currently Wales is insulated from any impact arising from a change in its “regional” tax base. In principle, Wales could set a different rate from England and HM Treasury adjust its take accordingly to make the devolution real.

**But if Corporation Tax varying powers are devolved to Scotland and NI, then Wales should get a similar power.

Both the Holtham and Silk Commissions recommended that the Welsh Assembly Government should be granted a power to introduce entirely new taxes (although any such taxes would also have to be agreed by the London Government).

Borrowing powers in Wales

Both Commissions in Wales agreed that an enhanced power to borrow to cover any temporary shortfall in revenues would be useful. Additionally, Holtham and Silk accepted the principle that the Welsh Assembly Government should be allowed to borrow to finance investment. Silk recommended that such borrowing for investment could be up to £130m annually subject to a cap of £1.3bn on the stock of debt. Silk was also open to the possibility that Wales could issue bonds.

Conclusions

There are the following conclusions regarding how the experience of Scotland and Wales might apply:

- With regard to the extent of devolution of Income Tax powers and the example being provided for Northern Ireland, an interesting contrast exists between the terms of the Scotland Act and what is proposed for Wales. The Scotland Act accepted a "lock step" (Silk's term for this), i.e. the Scottish Rate of Income Tax can now be applied (above 10p in the £, at 10p in the £ or less than 10p in the £) but crucially, the *same* rate must be applied to *both* Basic and Higher Rates. In other words, the Scottish Government will be able to choose to increase income tax or decrease it or keep it at the existing levels but they cannot alter the extent of progressivity or regressivity. Significantly, Silk recommended that in principle the Welsh Assembly Government should also have the power to alter the relationship between Basic and Higher Rates of Income Tax.
- So, the Northern Ireland Assembly has to consider how far to devolve Income Tax (either with or without the lock step). Interestingly, none of the major Commissions has recommended devolution of the power to set Income Tax allowances and bands[54].
- Related to issue of the extent of progressivity or regressivity, is that of behavioural change, i.e. how might application of the tax change behaviour in Wales or Scotland? Would it, for example, cause reduced economic activity (generally a bad thing although some taxes such as the Aggregates Levy were designed to discourage what was perceived to be harmful activity) and/or movement of activity to a lower tax area (e.g. displacement to England – the potential for people now living in the Welsh borders to move to England or to commute to work there was noted).
- To the extent that Holtham, Silk, Calman and the Scotland Act wished to maximise revenues for the devolved administrations they favoured devolution of tax powers relating to "immobile" items (e.g. land and property).
- At the same time, there was some recognition that certain taxes could be changed (probably reduced) precisely because there would be some elasticity in the economic response, e.g. APD. All these considerations also apply to Northern Ireland (noting also that Northern Ireland's land border is not with England but with a different state and tax jurisdiction, i.e. the Republic of Ireland).
- The general view emerging from Scotland and Wales is that additional borrowing powers would be a good thing subject to some of the cautionary arguments outlined by the Treasury in their consultation on bond issuance.
- The Commissions in Wales and Scotland agreed that the Barnett Formula was very hard to justify in principle. Calman was willing to continue to use it in the medium term. Holtham recognised that it could take some time to set in place a needs based approach and so recommended a "floor" to prevent continued operation of convergence or the Barnett squeeze, i.e. decline in the per capita level of funding in the devolved administrations relative to England.[55]

54 This is significant because it means the Chancellor of the Exchequer retains the ability to influence distributional impacts across the UK in terms of the level of the Income Tax allowances and bands. It also means that the Chancellor retains the power to decide how far to prevent fiscal drag or bracket creep by upgrading allowances and thresholds in line with inflation. Fiscal drag or bracket creep occurs whenever there is inflation of wages and salaries, in the absence of inflationary upgrades in the allowances and band, other things being equal, this would lead to more earners paying taxes and some earners paying more taxes. Some commentators (e.g. J. Cuthbert and M.Cuthbert September 2011, "An appearance before the Scotland Bill Committee", *Report by the Cuthberts of their appearance before the Scotland Bill Committee of the Scottish Parliament on 13 September 2011*, accessed from:
http://www.cuthbert1.pwp.blueyonder.co.uk/papers%201/SI%20Scotland%20Bill%20appearance%20220911.doc, accessed February 2013) have argued the retention of such powers at the London level represents a significant bias in the existing fiscal devolution settlement.

55 Northern Ireland, Scotland and Wales all spend more per capita than England (see http://www.hm.treasury.gov.uk/d/pesa_complete_2012.pdf), in 2011/12 relative levels of spending of 97 in England, 113 in Wales, 114 in Scotland and 120 in Northern Ireland (UK=100). This implies that an equivalent increase in spending programmes in England and in devolved programmes will be smaller in % terms in the devolved areas.

5. Should the Northern Ireland Assembly's fiscal powers be enhanced?

Introduction

There are eight sections in this Part of the report:

- Four options facing the Northern Ireland Assembly;
- How to determine suitability for fiscal devolution;
- Major and minor taxes;
- Tax by tax consideration of the case for devolution;
- Feasibility of adding flexibility to some of the Assembly's spending powers;
- Consideration of borrowing powers;
- Consideration of the costs of administering enhanced powers;
- Azores Judgement related issues, the block grant and issues related to the Barnett formula.

Four options facing the Northern Ireland Assembly

As the Holtham Commission argued in the case of Wales, four high level options are open to the Northern Ireland Assembly in terms of how far to devolve fiscal powers:

1. The status quo – rely mainly on the block grant

As we outlined in Part 3, the Northern Ireland Assembly is currently dependent on the block grant for well over 90% of its resources, with only fairly small sums raised by taxes which are under regional control (e.g. Regional Rates) or by borrowing (the RRI) or by charging or by EU funds. The Assembly *could* opt to retain this status quo. There are certain advantages which characterise the current position.

As Part 3 indicated, Northern Ireland has been for some time a beneficiary of a considerable net transfer of resources within the UK's fiscal union. Northern Ireland has even been somewhat insulated from the austerity measures which have impacted on levels of public spending elsewhere in the UK since 2010 (this has happened because education and health spending represent about 60% of total spending in Northern Ireland and these are Departmental areas which have, so far, been relatively protected in real terms in spending rounds in the GB and so the Barnett Formula has worked to similarly protect the total size of the Northern Ireland block).[56]

In fact, Holtham pointed out that even in the case of Wales where the Barnett Formula seems to be much less advantageous than has been the case for Northern Ireland, membership of the fiscal union plus reliance on the block grant brings the advantage of pooling risk within the UK, e.g. if there is some downturn in the sectors which are particularly strongly represented in the Wales/Northern Ireland economies the likelihood is that transfers from London will increase to partly compensate for this (in other words, there are certain built in stabilisers inherent in the status quo).

However, there are also very strong reasons why the status quo represents certain disadvantages, especially from a long term point of view. For example, over the long run, if levels of public spending are growing in GB, the Barnett Formula works to erode Northern Ireland's advantage in terms of having a higher level of per capita spend than England.

56 Although this point is subject to the important caveat that as austerity continues longer than originally envisaged there will be growing pressure on the Coalition Government to reduce the real terms protection in health and schools.

This Barnett squeeze is a long term consideration but more immediately the assurance of a large and "automatic" block grant from London could induce a measure of complacency on the part of policy makers in Northern Ireland[57], a failure to innovate in policy making and certainly a lack of accountability (because decisions about how much to spend at the devolved level are not being linked to decisions about how much to tax). The Calman, Holtham and Silk Commissions all concluded the status quo was an unsatisfactory place to be largely because of the opportunities foregone to use fiscal levers and improve accountability. It is unlikely the conclusion would be different in the case of Northern Ireland.

Some might argue the case for and against the status quo is very much bound up with the working of the parity principle.

The old Stormont Parliament/Government (i.e. pre-1972) sought to attain parity such that standards of public services and welfare benefits would be similar to or equal to those in GB. In practice, such parity was probably only achieved after 1972, i.e. during the Direct Rule period.

In more recent decades, in the Northern Ireland context the parity principle has been stated as the implied quid pro quo whereby if Northern Ireland is to have the same standard of public services as the rest of the UK it must accept the same conditions (e.g. criteria for benefit eligibility) and similar tax rates. In fact, the reality is more complex. Average government spending per head is substantially above the UK average (comparison to relative levels of "need" is less clear). Admittedly, the Barnett Squeeze (see Part 6) is working to reduce that gap over time.

So, the relationship between devolution and parity is not straightforward.[58] In fact, an Assembly with strong devolved powers could reduce taxes and hence revenues and still choose to protect parity in terms of particular areas of spending, e.g. welfare benefits (though this would imply compensating spending reductions in other areas). Alternatively, a very benign scenario is that if a reduction in tax rates incentivised strong economic growth and hence caused other tax revenue streams to increase, the Assembly might be able to fund parity.

2. Block grant plus some assignment of tax revenues

In this scenario, the Northern Ireland Assembly could remain somewhat reliant on the block grant but this would be supplemented by the assignment of certain tax stream revenues. For example, the Northern Ireland Assembly could be allocated a certain % of the revenues raised by, say, Income Tax, Corporation Tax etc. (the block grant would be reduced by an amount equivalent to that raised initially be the assigned tax streams).

Some federal political systems (e.g. Germany)[59] use such a system of revenue assignment to fund regional governments. At one level it might be seen as giving the regional government a certain level of independence from the national government; more of its revenues are being raised locally. At the same time, this option might appear to be something of a half way house and perhaps not a wholly satisfactory one. For example, the revenues raised through the assigned tax streams will bear little or no relationship to policy decisions made by the regional or devolved government (this might imply that accountability is not really being increased).

3. Block grant plus some fiscal devolution

In this option, a considerable % of total funding for the Northern Ireland Assembly could continue to derive from the block grant but these would be supplemented by a considerable devolution of tax varying power (with the block grant scaled back by an equivalent amount). In principle, if the right balance can be struck, Northern Ireland could continue to enjoy some of the benefits of membership of the fiscal union (e.g. the net transfer from London, pooling risk, built in stabilisers and some degree of application of the parity principle) whilst increasing the accountability of decision making in the Assembly.

57 Perhaps, partly, through the impact of soft budget constraints (as considered in Part 3); if decision makers treat funding as a given this could induce a certain measure of slack and inefficiency.

58 An interesting attempt to "square the circle", if that is what it is, between enhancing fiscal variation but maintaining any benefits of what it regards as the UK's "social union" is provided by the Scottish Labour Devolution Commission April 2013, "Powers for a purpose-Strengthening devolution", *Interim Report*, Scottish Labour, Glasgow. Similarly, Calman (Commission on Scottish Devolution June 2009, *op.cit.)* argued, "Even in federal states, however, it is common (though not universal) for social protection of this kind to be a federal, rather than state or provincial, responsibility".

59 See, *Bundesministerium der Finanzen*, "The Federal Financial Equalisation System in Germany", accessed from: http://www.bundesfinanzministerium.de/Content/DE/Standardartikel/Themen/Oeffentliche_Finanzen/Foederale_Finanzbeziehungen/Laenderfinanzausgleich/The-Federal-Financial-Equalisation-System-in-Germany-.pdf?__blob=publicationFile&, accessed 8 May 2013.

4. Total fiscal devolution or autonomy

In this option, a very wide range of taxes would be devolved, there would be no block grant and the Northern Ireland Assembly would exercise total fiscal autonomy, i.e. every pound spent would have to be raised through regional taxation (or borrowed). On the one hand, this would seem to improve accountability but on the other hand it would certainly imply an end to what has hitherto been a considerable fiscal transfer from London to Northern Ireland. It is not inconsistent to argue that whilst the scale of that transfer may have implied certain harmful long term effects (e.g. soft budget constraints, dependency, inefficiency) the *sudden* removal of, say, £10bn from levels of public spending would have a dramatic and perhaps calamitous impact on the economy. Significantly, none of the Commissions in Scotland and Wales argued for total fiscal devolution or autonomy.[60]

How to determine suitability for fiscal devolution

We set out here in Table 7 principles which the Holtham Commission[61] used to answer this question in the case of Wales. These principles can be applied to Northern Ireland (it may be worth stressing that we are taking a broader approach than simply considering just one evaluative principle, e.g. impact on economic incentives). A tax will be a strong candidate for devolution if it scores well across the following six principles:

Table 7: Principles to assess the suitability of a tax for devolution

1. Promotes accountability because the tax is:
   a. Paid by a high % of NI residents;
   b. Raises a substantial revenue;
   c. Visible to most citizens;
   d. Well understood by the general population.
2. Does not harm economic efficiency because:
   a. Avoids distorting NI's economic relationship with the rest of the UK[62];
   b. Avoids altering economic behaviour (to avoid paying the tax) in ways which damage efficiency.
3. Does not harm administrative efficiency because:
   a. Avoids a substantial compliance burden on citizens and businesses;
   b. Avoids a relatively high cost of administering collection (especially, as % of revenues raised).
4. Is relevant to policy in terms of providing a useful policy lever and helping to achieve policy goals of the Executive and Assembly (could be economic but also social, health or environmental policy objectives).
5. Is compatible with legal constraints (notably, EU law).
6. Has minimal impact on the tax base of the rest of the UK.

60 Although the platform of the SNP Scottish Government is one of independence through the 2014 Referendum which would, obviously, imply total fiscal autonomy.
61 Independent Commission on Funding and Finance for Wales 2010, *op.cit.*p. 42.
62 As will be seen below, see Table 9, on some occasions possible distortion of the economic relationship with the Republic of Ireland/RoI (e.g. in terms of tax competition and diversion of activity) becomes an important consideration.

Major and minor taxes

In terms of the scale of revenues raised by each of the taxes, a useful distinction can be drawn between major taxes which yield considerable receipts and minor ones which raise less revenue. This distinction was used by, for example, the Silk Commission. One implication is that major taxes, if devolved, are more likely to contribute to the achievement of greater accountability (there may still be other reasons for devolving some of the minor taxes).

Table 8: A tax by tax consideration for NI (2010-11) in terms of revenue raised and change in revenue (2006-7 to 2010-11) (taxes ranked by amount of revenue raised)

	Revenue 2010-11, £m	% share of total NI revenues*	% change in NI revenue raised 2006-7 to 2010-11 (% change in the UK in brackets)
VAT	2,898	22.8	14.3 (10.9)
Income Tax	2,575	20.3	-6.1 (4.0)**
National Insurance Contributions	1,946	15.3	0.1 (7.5)
Fuel Duties	928	7.3	19.0(15.6)
Corporation Tax*	775	6.1	-11.5 (-7.3)
Business Rates (non-domestic Rates)	524	4.1	11.7(13.9)
Domestic Rates	504	4.0	16.7(14.7)
Tobacco Duty	485	3.8	37.8(12.3)
Alcohol Duty	274	2.2	29.0(18.9)
Vehicle Excise Duty	167	1.3	16.8(12.6)
Stamp Duties (i.e. Stamp Duty& Land Tax)	135	1.1	-62.6(-33.3)
Customs Duties & Levies	87	0.7	29.6(28.9)
Capital Gains Tax	79	0.6	-9.6 (-5.8)
Insurance Premium Tax	73	0.6	9.6(9.0)
Air Passenger Duty	63	0.5	97.4(96.3)
Landfill Tax	46	0.4	51.5(32.6)
Inheritance Tax	39	0.3	34.5 (-24.8)
Betting & Gaming Duties	29	0.2	9.1(11.2)
Climate Change Levy	13	0.1	-4.5(-5.2)
Aggregates Levy	6	0.0	-13.5(-9.9)
Total all current receipts (excluding North Sea revenues)*	12,703	100	2.8(5.7)

* Note: For both total of all receipts and for Corporation Tax in particular excluding “NI’s share” of North Sea revenues. Total all current receipts also includes interest and dividends of £86m in 2010-11, gross operating surplus and rent of £785m and £187m of other taxes and royalties (e.g. money paid into the National Lottery Distribution Fund and NI’s apportioned share of TV Licence revenue).

**Income Tax revenues net of tax credits.

The methods used to produce estimates of tax revenues in NI and more specifically to apportion a certain share of total UK revenues to NI where no direct figures exist are those of DFP and these generally follow the methods similarly applied in Scotland in *Government Expenditure & Revenue Scotland 2010-11 (GERS)*, accessed from http://www.scotland.gov.uk/Topics/Statistics/Browse/Economy/GERS accessed 24th June 2013.

Source: DFP November 2012, Northern Ireland Net Fiscal Balance Report 2009-10 and 2010-11, *Department for Finance and Personnel, Belfast.*

The data presented in Table 8 for 2010-11 indicates that three taxes are clearly major; VAT (£2.9bn), Income Tax (£2.6bn) and National Insurance Contributions (£1.9bn). As percentages of total tax receipts in Northern Ireland in that year, those three taxes contributed to almost three-fifths in total or 23%, 20% and 15% respectively. A further two taxes are indicated as tending towards major, i.e. Corporation Tax (£0.8bn) and Fuel Duties (£0.9bn). Tobacco Duty, Business Rates and Domestic Rates were each indicated to generate about £0.5bn of annual receipts (though these Rates figures combine the District and Regional elements, only the latter is controlled by the Executive). The remaining taxes were indicated to be relatively minor in terms of revenues raised.

Associated with the question of how much revenues are collected by each tax is the question of is there any trend in those revenues?[63] In other words, whilst there *may* be case to devolve a tax which currently raises a considerable volume of revenues, that case (at least from an accountability point of view) would weaken if revenues were tending to decline over time. As might be expected, the data in Table 8 indicate some correlation between tax revenues raised in Northern Ireland and those in the UK as a whole. However, this association is not complete.

For example, and notably, during 2006-7 to 2010-11 revenues raised by Income Tax in Northern Ireland declined by 6% but grew by 4% in the UK (it is likely that the Northern Ireland economy, e.g. in terms of gross value added/GDP, underperformed the UK average during this period but the extent of the divergence may still be surprising). Corporation Tax receipts declined in both Northern Ireland and UK but by much more in Northern Ireland (this is consistent with some underperformance in the Northern Ireland corporate sector relative to its counterpart).

Northern Ireland Inheritance Tax revenues grew by one-third but, in contrast, UK receipts dropped by one-quarter (the scale and direction of this difference are hard to explain; was this a case of some very large bequests in Northern Ireland in the years immediately following the peak in the Northern Ireland housing market in 2007?). Stamp Duties revenues slumped in both but by much more (62%) in Northern Ireland compared to the UK (about one-third) (we know the Northern Ireland housing market experienced a greater slump than its counterpart). In some cases, e.g. VAT, Tobacco, Alcohol and Fuel Duty, revenues in Northern Ireland were more buoyant than their UK counterparts (given the relative states of the Northern Ireland and UK economies these differences are hard to explain). It is important to stress that most of the Northern Ireland figures in Table 8 are estimates and so may not always be reliable.

Tax by tax consideration of the case for devolution

In this section we consider the suitability of each tax for devolution. Given that the Regional Rate is already devolved we do not consider this tax again in this section other than to say that the Northern Ireland Assembly has a policy choice (or dilemma); do they increase the rate of this tax in order to raise more resources or, as they have in fact done in recent years, do they choose to restrict increases in Business Rates (or, indeed, give substantial reliefs to manufacturing) as part of their industrial or retail promotion policies?

Having outlined the principles to determine the feasibility and desirability of devolving each tax, the next Table considers how they might apply to each of the taxes in Northern Ireland. We also applied a simple scoring system[64] with each principle, taken from Section 2 above, being assigned a score of one if it is "yes" for devolution and zero if "no" (and a score of one half if, "maybe or uncertain"). (Appendix 1 illustrates some of the more detailed reasoning underpinning this Table). A total across the six principles of 6= strongest suitability for devolution, and 0= weakest suitability for devolution:

63 Strictly, there may be a third (though linked) question; how volatile are each of the tax revenue streams? For example, even if the average annual level of revenue from a tax were large, the argument in favour of devolution might be weakened if that revenue displayed considerable variation over time both up and down. The data in Table 8 covers too short a time period to allow any firm conclusions about volatility. In any case, apparent volatility may be sometimes be a product of unreliability in the data.

64 i.e. equal weights for each principle (and equal weights for the identified components within each principle, see Table 7). Obviously, it is a matter of judgment whether the weighting should actually be different.

Table 9: A tax by tax consideration for NI as to how the Holtham principles regarding suitability for devolution apply (ranked from the highest indicated score)*

Tax[65] (suitability for devolution score)	**Accountability** (see Table 7)	**Economic efficiency** (see Table 7)	**Adminstrative efficiency****	**Relevant to policy**	**Compliant with legal constraints** (e.g. EU)	**Limited impact on rest of UK tax base**
Stamp Duties[66] (4.3)	Amber	Green	Red	Green	Green	Green
Air Passenger Duty (4.1)	Amber	Green	Red	Green	Green	Green
National Insurance Contributions (3.8)	Amber	Amber	Red	Green	Green	Green
Income Tax (3.5)	Green	Red	Amber	Amber	Green	Amber
Tobacco Duty (3.3)	Amber	Amber	Red	Green	Amber	Green
Fuel Duties (3.3)	Amber	Red	Red	Green	Amber	Green
Alcohol Duty (3.3)	Amber	Amber	Red	Green	Amber	Green
Landfill Tax (3.0)	Red	Red	Red	Green	Green	Green
Betting & Gaming Duties (3.0)	Red	Amber	Red	Amber	Green	Green
Insurance Premium Tax (3.0)	Red	Green	Red	Red	Green	Green
Climate Change Levy (3.0)	Red	Red	Red	Green	Green	Green
VAT (3.0)	Amber	Amber	Red	Amber	Red	Green
Vehicle Excise Duty (3.0)	Amber	Amber	Red	Amber	Green	Green
Aggregates Levy (2.5)	Red	Amber	Red	Green	Red	Green
Corporation Tax (2.3)	Amber	Red	Red	Green	Green	Red
Capital Gains Tax (2.0)	Red	Red	Red	Amber	Green	Amber
Inheritance Tax (2.0)	Red	Red	Red	Amber	Green	Amber
Customs Duties & Levies (1.0)	Red	Red	Red	Red	Amber	Amber

*Note: Green – suitable, Red – not suitable, Amber – maybe.

**: In most cases in NI administrative costs are likely to be a significant % of revenues collected.

65 Score out of 6 indicates strength of case for devolution; 6= highest, 0= lowest.
66 Stamp Duty and Land Tax.

Figure 2: Feasibility and desirability of devolution of each tax

	Low desirability (low impact)#	High desirability (high impact)#
High feasibility*	**Landfill tax** **Stamp duties**	**APD** **Income tax**
Low feasibility*	Betting and gaming duties Insurance premium Climate change levy Vehicle excise duty Aggregates levy Capital gains tax Inheritance tax	Corporation tax Tobacco duty Fuel duties Alcohol duties VAT National insurance contributions Customs duties

*Note: e.g. "Low feasibility" could mean tax devolution is prohibited by EU Law or that the administrative costs are likely to be a significant % of revenues.

#: e.g. "High desirability (high impact)" means that either this is a major tax or a tax where devolution could strongly assist some particular policy agenda (e.g. economic, social, health or environmental).

Figure 2 illustrates a more simplified approach than that shown in Table 9. Here we reduce the evaluation to two dimensions. First, if a tax were to be devolved would this have a high or low impact? Major taxes (i.e. those with large revenues) would represent high impact as well as those which would help to further a particular policy objective in a strong way. (Admittedly, there is an element of judgement in combining together these two aspects, i.e. taxes as a source of revenue and taxes as a lever of policy.) Second, how feasible is devolution? Low feasibility is indicated by the likelihood that administrative costs of the tax could be a significant % of revenues collected or by incompatibility with EU law. Conversely high feasibility is indicated if the tax is being devolved elsewhere.

According to this approach, the taxes most suitable for devolution are those in the top right hand box, i.e. high impact and high feasibility. Our assessment is that only income tax and APD fall into this category. Landfill Tax and Stamp Duties probably combine high feasibility with low impact.[67] A caveat is that these assessments of impact are done ahead of a full economic impact assessment or macroeconomic forecasting exercise as to the impact of such tax changes. VAT and National Insurance Contributions represent examples of taxes which would have high impact *if* they could be devolved but are also characterised by very low feasibility (because of the constraints imposed by EU law and the UK welfare system respectively). Corporation Tax is probably another example of a tax within the high impact, low feasibility category. A large number of taxes fall into the bottom left hand box, i.e. low impact and low feasibility; in these cases the suitability for devolution is indicated to be low.

Additional comments on suitability for devolution

We now consider in more detail each of the taxes which in Table 9 above were indicated as likely candidates for devolution, i.e. on the zero to six score they got a total of more than three (it should be noted at the outset there is one possibly anomalous result arising from this scoring system; National Insurance Contributions had the third highest indicated score but, given the nature of the UK benefits system, which is partly though not wholly linked to contributions, it would almost certainly be impractical to introduce a lower rate of Contributions in Northern Ireland)[68]:

Stamp Duties (i.e. Stamp Duty and Land Tax)

Devolution of this tax would appear to have certain advantages (and it is being devolved in the case of Scotland under the Scotland Act 2012 where it will be known as Stamp Duty and Land Tax); it is a fairly "high visibility" tax which is probably understood by the public, it applies to an "immobile" asset (purchase of homes and land) so minimising the chances of distorting economic behaviour as between Northern Ireland and GB and it could be used as a lever for both economic (e.g. promote construction industry) and social (e.g. promote affordable homes) policies (though the most affordable houses would already fall below the threshold price for this tax). At the same time, there is the limitation from the accountability point of view that this is a minor tax in terms of the scale of revenue raised.

Air Passenger Duty

Holtham and Silk recommended devolution in the case of Wales (similarly, the Scottish Government tried but failed to amend the Scotland Bill to include APD). One complication in the case of GB would be tax competition relative to England, e.g. if a sufficiently low rate was charged on flights from Cardiff Airport this might provoke a displacement of traffic away from, say, Bristol Airport.

A similar effect could develop between, say, Edinburgh and Newcastle Airports (although, less likely because of the greater distance). The Northern Ireland Assembly has already had the power devolved to remove the higher rate of duty on direct long-haul flights (because this was where tax competition with Dublin Airport was most pressing) and this has been done. A case could still be made for devolving the rest of APD and, indeed, reducing it.

That case would be less compelling than that relating to the direct long haul flights. This is because the duty on flights to GB and continental Europe is at a lower level and therefore the extent of displacement to Dublin etc. would be much more limited. Nevertheless, it has been argued at a UK wide level that abolition of APD would entail substantial economic benefits (e.g. encouragement to tourism and inward investment through enhanced connectivity).[69] The same sort of argument could be made for Northern Ireland in particular and perhaps more strongly given the particular circumstances of Northern Ireland.[70]

A partial rejoinder could be that air travel contributes to increased carbon emissions and pollution in general. However, it is worth pointing out that APD was a poorly designed tax if the intention was to encourage lower carbon emissions (it taxed individuals rather than planes and so provided little incentive to the airlines either to fill their aircraft or introduce more fuel efficient models).

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67 At least from the point of view of the overall economy although there could be significant impact at a sectoral level.

68 National Insurance Contributions are inter-related to the level and structure of welfare benefits. It would be difficult to devolve National Insurance Contributions to Northern Ireland but at same time maintain the existing policy of "parity", i.e. common benefit rates across the UK. Significantly, none of the Commissions in Scotland and Wales recommended devolution of National Insurance Contributions. Ironically, Northern Ireland is the only one of the devolved administrations where powers over social security are devolved but hitherto the Assembly has been reluctant to depart from parity (except where welfare reform in GB could imply reductions in benefit payments).

69 PwC February 2013, *Air Passenger Duty*, Report by PricewaterhouseCoopers LLP, London.

70 Such as the relative potential for tourism, lack of alternative means of transport and peripherality. At the same time, if the key issue is a lack of international connectivity this might beg the question whether there could be more targeted policy interventions than a general reduction in APD such as a route development fund?

Income Tax

This is certainly a major tax and therefore has the advantage of helping to increase accountability. The Commissions in Wales and Scotland did recommend Income Tax devolution. At the same time, devolving Income Tax powers to the Northern Ireland Assembly would entail certain dilemmas. For example, how much power would be devolved?

Would Northern Ireland follow Scotland in having a lockstep, i.e. if rates are varied all the rates have to be varied by the same amount, or the recommendation made in Wales (that power to alter progressivity or regressivity would also be devolved)[71]?

This is turn begs some interesting questions, what might be the economic/behavioural response to any variations in rates[72], how might such tax varying powers be used and how might any dilemmas between policy goals be resolved? Some such policy dilemmas include the following; a devolved administration might wish to forward certain social policy goals by increasing the progressivity of the regional system of Income Tax, i.e. by increasing the rate of tax on Higher Rate tax payers relative to the lower paid, but it is by no means clear this would maximise total revenue raised or increase effort and entrepreneurship by high earners. To the extent that the elasticity of response of Basic Rate taxpayers is relatively low then to maximise revenues the Assembly could increase the Basic Rate by several p in the £. This would contrast to the Assembly's previous policy commitments, e.g. in terms of the Regional Rate and water charges, to constrain any increases in household taxation.

It is worth stressing that the available evidence does not allow us to determine how much income tax powers should be devolved nor, if powers are devolved, what they should be used for (and that latter question fell outside the remit of this study).

Tobacco Duty

None of the Commissions in Scotland and Wales recommended devolution of excise duty on tobacco even though an increase in Tobacco Duty could represent an interesting supplement to existing policies to discourage smoking (assuming the Duty was raised). If the objective was to try to use the tax to discourage use of tobacco and consequent negative health and social consequences then the Duty would be raised but in Northern Ireland there is the dimension of possible tax competition with the Republic of Ireland, i.e. if the duty was raised it could provoke an increase in cross-border shopping (i.e. shoppers travelling across the border to buy tobacco in the lower tax regime) or even smuggling.

Fuel Duties

Interestingly, none of the Commissions in Scotland and Wales recommended devolution of Fuel Duties. They considered there was too much scope for harmful distortion of the economic relationship between Scotland/Wales and England. In Northern Ireland there is unlikely to be such diversion of sales to/from GB but there is existing tax competition with the Republic of Ireland. This might imply a case for fiscal devolution but only if the power was then used to reduce the margin of tax between Northern Ireland and south of the Border.[73]

Alcohol Duty

None of the Commissions in Scotland and Wales recommended devolution of excise duty on alcohol even though an increase in Alcohol Duty represents an interesting alternative to suggested policies of a minimum price for alcohol.[74] If the objective was to try to use the tax to discourage abuse of alcohol and consequent negative health and social consequences then the Duty would be raised but in Northern Ireland there is the dimension of possible tax competition with the Republic of Ireland, i.e. if the duty was raised it would provoke an increase in cross-border shopping (i.e. shoppers travelling across the border to buy alcohol in the lower tax regime).

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71 That is the Northern Ireland Assembly could increase or decrease the Basic Rate whilst leaving the Higher Rate as it is or vice versa.

72 If Income Tax rates are increased workers could respond by either working fewer hours (because the benefit of an hour's work as opposed to an hour's leisure has decreased in terms of take home pay) or by working more as they attempt to make good the reduction in their net income. Attempts have been made to measure the scale and relative size of these two effects ("substitution" and "income") although few if any of these studies relate to the UK regional level and none to Northern Ireland in particular. The available estimates of US or UK elasticities suggest that average and lower paid workers (Basic Rate taxpayers) would be relatively unresponsive to moderate changes (up or down) in their tax rates but that Higher Rate taxpayers (40 p and 45 p) would be more responsive, i.e. tax rate increases for the Higher Rate payers might lead to a decrease in labour supply and even of the revenue raised (for some of the international evidence on elasticities see E. Saez, J.B Slemrod and S.H. Giertz 2009, "The elasticity of taxable income with respect to marginal rates: A critical review", NBER Working Papers 15012, National Bureau of Economic Research, Cambridge MA. Independent Commission on Funding and Finance in Wales July 2010, op.cit, pp. 61-67, considered these issues in terms of the policy options facing the National Assembly for Wales.

73 A further reason to reduce Fuel Duties relative might be to reduce the incentive for fuel laundering and smuggling.

74 A minimum price could produce a windfall gain for retailers. See, IFS November 2012, "What is the impact of a 45 pence minimum unit price for alcohol", Institute for Fiscal Studies website, accessed from: www.ifs.org.uk/bns/bn109.pdf, accessed 8 May 2013.

Two other taxes which should be considered

Corporation Tax

Significantly, in terms of our scoring system (see Table 9) Corporation Tax was not indicated as a highly scoring candidate for devolution (the low score was partly a factor of the likely negative impact on the tax base in GB and also of the fact that in terms of revenue raised Corporation Tax is not a major tax, and allied to this point is the likely significant impact on the block grant as a result of the application of the Azores Judgement). Arguments in favour of devolution have majored on the incentive impact on levels of business investment and FDI in particular (the OECD[75] and others have attempted to measure such effects and they are implied as the justification of the Coalition Government's policy of reducing UK wide rates from 28% in 2010 to a planned 20% in 2015).

In particular, Northern Ireland is in tax competition with a neighbouring low tax regime, i.e. the Republic of Ireland. At the same time, some commentators[76] have recognised that a lower Corporation Tax by itself would not be a game changer to transform Northern Ireland's economic competitiveness and hence performance. The Republic of Ireland story is more complex than is sometimes recognised; low rates of taxes on corporate profits were in place as early as the mid 1950s. The great leap in terms of levels of FDI did not happen until about three decades later.[77] It might be naive to expect that Northern Ireland, even with a 12.5% rate of tax, could leap up to Republic of Ireland levels of performance in the space of a few years.

There could be considerable disadvantages associated with devolution. The "cost" in terms of the adjustment to the Northern Ireland block required in terms of EU law (an implication of the Azores Judgement, see below) would be considerable and up-front or fairly immediate, as compared to the induced economic benefits which would probably take a number of years to realise (see Part 6). The "benefits" would be delayed and take time to develop (and some, indeed, would be felt in terms of other tax streams which might not be devolved).

There would be administrative and compliance costs as there would be complexities in applying inter-regional variations in this tax. In any case, as was confirmed at the meeting between the Prime Minister and the First and Deputy First Ministers on 26th March 2013, any devolution in Corporation Tax is not likely in the short to medium term (the latest line from Downing Street is that the issue will not be re-visited until after the Referendum on Scottish Independence in September 2014, which implies very limited scope to legislate for any change before the end of this Parliament).

Landfill Tax

Whilst this tax received a middling score of three, this tax is being devolved in the case of Scotland. If it were devolved it would allow the Northern Ireland Assembly to set it at a rate appropriate to regional environmental priorities, e.g. it could set it at a higher level than the UK average in order to give extra incentives for energy from waste schemes, for example. There are restrictions on the "export" of waste beyond the UK but past experience suggests that if the margins are high enough illegal displacement to the Republic of Ireland would occur. This is a constraint that policy makers would have to allow for.

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75 OECD 2007, "Tax effects on Foreign Direct Investment: Recent Evidence and Policy Analysis", *Report*, no. 17, Organisation for Economic Cooperation and Development, Paris.

76 Economic Advisory Group 2011, *The Impact of Reducing Corporation Tax on the Northern Ireland Economy*, EAG, Belfast, and Department for Employment and Learning 2012, op.cit.

77 F. Barry 2007, "Foreign direct investment and institutional co-evolution in Ireland", *Scandinavian Economic History Review,* 55:3, pp. 262-88.

Feasibility of adding flexibility to some of the Assembly's spending powers

It is far from clear that it would be feasible to add to such powers. The flexibility which used to be provided through EYF (see Part 3) has to a great extent gone. With austerity policies likely to apply until at least 2018 at the London level it is very unlikely that the Treasury would be willing to see fuller EYF restored. Admittedly, in 2011, the Chief Secretary to the Treasury did respond to a request from the Northern Ireland Finance Minister such that the devolved administrations would be able to carry forward underspends up to an agreed cap and, unlike their Whitehall equivalents, there would be no requirement to inform HM Treasury in advance of the expected scale of underspend.[78] The caps are 0.6% of current spending and 1.5% of capital. As we noted in Part 3, the Executive and Assembly can decide to switch from resource (i.e. current) spending to capital. No such discretion operates in the other direction and for the foreseeable future it is not clear that it would be a good thing to be able to move money away from capital spending to current.

Consideration of borrowing powers

Some of these issues have already been considered as we outlined the development of fiscal powers in Scotland and Wales (see Part 4). In principle, it could be argued that a devolved administration with some tax varying powers should also have some borrowing powers so that it can offset some of any volatility in devolved tax revenue streams. Also, in principle, such an administration could borrow in order to finance beneficial capital investment. A downside consideration is that it is almost certain that a devolved administration will be charged higher rates than the national government for its borrowing through bonds issuance.[79] Northern Ireland has an existing right to borrow at concessionary rates through the RRI (see part 3) and the Economic and Integration Pact announced by the Prime Minister on 14th June 2013 allows for a limited (£100m over two years) addition to this.[80]

Consideration of the costs of administering enhanced powers

So far, only very limited information relating to such costs are available in the public domain. However, we know that there would be such costs and they could be considerable.

A Freedom of Information request to the Scottish Government produced the following response (29 November 2012):

- To set up the land and property (i.e. Stamp Duty and Land Tax (SDLT)) tax and Landfill Tax assuming no change from existing UK policies and using the HMRC would cost £2.9m and the annual administration of such taxes would be £3.9m;
- To set up SDLT and Landfill Tax assuming differences from existing UK policies and using a new collection agency in Scotland would cost £2.5m and the annual administration of such taxes would be £2.8m.

It is worth noting, the Scottish Government was arguing that such taxes could be administered more cheaply using new Scottish tax administration (Revenue Scotland) as opposed to the established HMRC. The cost of administering the larger scale income tax was not indicated. In the HM Treasury consultation document (2011)[81] relating to possible Corporation Tax devolution in Northern Ireland an administrative cost of up to £50m annually was mentioned although without any supporting detail.

78 HM Treasury 18 July 2011, *op.cit.*
79 The reasons why this is likely are outlined in HM Treasury 22 June 2012, *op.cit.*
80 "Economic and integration pact for Northern Ireland: building a prosperous and united community", *Press release*, Gov.uk.
81 HM Treasury March 2011, *Rebalancing the Northern Ireland Economy: A Consultation,* HM Treasury, Belfast.

Azores Judgement related issues, the block grant and issues related to the Barnett formula

The Azores Judgement relates to a case at the European Court of Justice (ECJ) which indicated that sub-regional governments could operate different tax rates from the national authorities subject to the important condition that there could be no "subsidisation" by the national authorities, i.e. if the tax rate was reduced in the region, the block of spending allocated to that region would have to be reduced by an amount equivalent to the reduction in revenues raised. In the context of the debate around Corporation Tax reduction in Northern Ireland, there have been various attempts to estimate the scale of such a reduction.[82]

In terms of the block grant and Barnett Formula, the Holtham Commission included these issues within its terms of reference whereas the subsequent Silk Commission did not. Holtham indicated that when the actual level of spending in Wales was compared to an estimate of "relative need"[83] (115% of England), the implication was that the block grant allocation and working of the Barnett Formula had worked to Wales' disadvantage since the per head level of public spending in Wales was significantly lower than indicated need.

In the same report, the position in Scotland (estimated need 105% of England) was the reverse of Wales (i.e. per capita spending significantly above indicated need)[84] and that of Northern Ireland (estimated need, 121%) was unclear (per head spending and need appeared broadly similar). However, Holtham's basic point applies equally well to Northern Ireland; it is hard to discuss tax devolution in any meaningful way without some appreciation of what could happen in the medium to longer term future to the scale of the block grant. Thus, issues of the possible review or reform of the Barnett Formula, probably in the direction of a needs based formula, become very relevant.

Conclusions

There are the following conclusions regarding feasibility and desirability of enhanced fiscal powers:

- Whilst a number of high level options face the Northern Ireland Assembly regarding funding, the analysis previously conducted for Scotland and Wales implies that the option with the greatest potential is the one which combines some dependence on the block grant with some further fiscal devolution;
- Welsh experience suggests six broad principles to assess whether a tax is suitable for devolution:
  - Is accountability promoted?
  - Can harm to economic efficiency be avoided?
  - Can harm to administrative efficiency be avoided?
  - Is it relevant to any policy goals (e.g. economic, social, health or environmental)?
  - Is it compatible with legal constraints (e.g. EU)?
  - Does it have minimal impact on the tax revenue base in the rest of the UK?

82 HM Treasury 2011, op.cit., used postcodes of Corporation Tax returns to suggest a figure of about £275m but a later estimate by the Department for Finance and Personnel (using Northern Ireland's share of UK profits as indicated by national accounts data) implied a higher figure of about £400m.

83 Holtham constructed an index based on seven indicators: % of children, % retired people, % ethnic population, % on income-related benefits, % long term illness, % living in towns and a London cost weighting.

84 Unsurprisingly, other commentators have come to different conclusions about whether Scotland is "over funded" relative to need under Barnett; see Scottish Labour Devolution Commission April 2013, *op.cit*.

An answer of "yes" to all six of these questions would imply that the tax was likely to be suitable for strong consideration for devolution.

- Three taxes in Northern Ireland are major ones in terms of the scale of revenue raised; Income Tax, VAT and National Insurance Contributions (Corporation Tax is indicated as being in between the major and minor taxes);
- A scoring system (based on the six principles) produces a broadly similar outcome to what has happened so far in Scotland and Wales as to the taxes which are likely to be most suitable to be devolved, e.g. Income Tax, Stamp Duties, Landfill and APD;
- Any return to large scale End Year Flexiblity is unlikely to be granted by HM Treasury; so, there be may little value in asking for it;
- The Assembly could seek increased borrowing powers. The likelihood is that the Assembly would face borrowing rates above those paid by the UK national government;
- There are administrative costs relating to tax devolution. These are almost certainly not negligible but as of yet there is little precise information about their likely scale;
- Tax devolution will have to be compatible with EU law and the Azores judgement in particular. This will imply off setting reductions in the block grant;
- As a region with a relatively high level of public spending per head Northern Ireland cannot afford to ignore the implications which reform of the Barnett Formula could have for questions of enhanced fiscal powers.

6. Administrative aspects of additional fiscal powers

Introduction

We examine a number of questions relating to the administration of enhanced powers:

- Calculation of the initial adjustment to the Northern Ireland funding block;
- A method to adjust such block adjustments over time;
- Data considerations;
- Institutional reform.

In this Part of the report, we will consider each of these in turn.

Calculation of the initial adjustment to the Northern Ireland funding block

As we outlined in Part 5, the implication of the Azores Judgement is that in order to be compatible with EU law, any devolution of tax varying power to a regional government is conditional on there being *no* subsidisation from the central to the regional government to compensate for the impact of any tax reductions at the regional level. This in turn implies that if any tax is devolved and the rate of that reduced, a calculation must be made of the impact on tax revenues and the block grant adjusted by that amount.

Such a calculation and application of the initial adjustment to the Northern Ireland funding block is not straightforward and would involve the following three stages:

- Estimation of the total revenues raised by the tax at the regional level;
- Estimate of how such revenues would change as the tax rate changed;
- Further adjustment to the revenues to allow for indirect effects.

Taking each of these stages in turn, in Table 8 in Part 5 we presented estimates of how much revenue each type of tax raises in Northern Ireland. Whilst these figures are produced by government bodies, for the most part they are estimates (most taxes are administered on a UK wide basis so there is often no definitive answer to how much revenue comes from Northern Ireland or any other region). In general, Northern Ireland has been assigned some proportion, e.g. the Northern Ireland share in UK employment, wage payments, profits or sales.

In terms of the impact adjustment, if, say, the current tax rate was 25% and Northern Ireland cut the rate to 20% then it might be assumed that revenues raised would be reduced by (25-20)/25, i.e. 20% or one-fifth.

The Azores Judgement and the required adjustment to the block grant has been interpreted to mean that the region which is cutting its taxes must also carry the impact of *all* the indirect effects on revenues raised.[85] For example, in the case of the proposal to cut Corporation Tax in Northern Ireland, Corporation Tax receipts in GB would decline to the extent that GB based firms re-located to the low tax region and also to the extent that high earning individuals engaged in tax induced incorporation[86] and the Northern Ireland would be adjusted (negatively) to attempt to allow for both of these factors.

85 By the same logic it might be argued that the reduction in the regional block grant should be *reduced* to the extent that any increase in economic activity induced by the tax cut boosts other tax streams (even of those taxes not controlled by the regional government). In practice, it is not clear if such a further adjustment would be made.

86 That is, instead of earning an income and therefore paying Income Tax at, say, 45%, that income becomes the profit of a newly established business which would be taxed at the (currently) 23% Corporation Tax rate.

One other indirect effect would work in the opposite direction (i.e. would reduce the scale of the deduction from the block grant); to the extent that more non-UK FDI came into Northern Ireland and boosted Corporation Tax receipts.

Whilst there are, as of yet, few definitive measurements of the scale of initial adjustments to the block, we do have some estimates associated with the debate around whether to devolve Corporation Tax. HM Treasury[87] in their 2011 consultation document outlined an adjustment of £275m which would apply in the fifth year after the initial tax reduction, but that block reduction might increase by a further £85m once allowance was made for all the indirect effects.

The Treasury estimate was based on the addresses of tax returns; this implied that 1.5% of all Corporation Tax collected in the UK should be assigned to Northern Ireland. The Department of Finance and Personnel (DFP), however, used an alternative method; non-wage gross value added in national accounts data was used to proxy for Northern Ireland's share of total UK profits and, by implication, of tax collected.[88] Intuitively, the DFP method seems more robust (it does make allowance for the profits earned in the subsidiaries of multi-site UK firms) and, significantly, it produced a much higher estimate of total level of Corporation Tax arising in Northern Ireland (2.4% of the UK total). The DFP method implied that a "central figure" for the block adjustment might be about £400m rather than £275m.

Calculating the size of the block adjustment is crucially important. The figure arrived at will represent a large part of the immediate "cost" of any measure of tax devolution and should therefore be compared against the projected benefits of such a change.[89]

In the case of APD (specifically, the devolution of the rate relating to direct long haul routes) although partial devolution has now occurred, we do not yet have an official figure for the scale of the adjustment (negotiations between the Executive and HM Treasury continue). Previous indications suggested a figure of around £3m to £4m annually.

A method to adjust such block adjustments over time

A further challenge is that it is not sufficient simply to adjust the block in year zero (i.e. at the point in time when the tax is actually devolved) but some method should be used to estimate how much revenue would have been raised, in the absence of the tax change, at years in the future, e.g. after five years and after 10.

A number of approaches are possible. For example, adjust by a fixed and constant amount. This is administratively simple and if the tax is a minor one in terms of the scale of total revenues (see Part 5), this may be quite acceptable in practice. Alternatively, one could look at the history of tax revenues and project forward some trend (e.g. if revenues grew by 10% during 2003-13, one might assume they will grow by a further 10% during 2013-23). This approach is subject to the weakness that the past trend may not be indicative of what actually happens (especially given that the recent period, say, since the downturn of 2007-8 is far from typical).

In essence, the devolved administration has to hope that the outturn in terms of the increase in revenues actually collected will surpass the future assigned block adjustments. Implicit (or explicit) in a number of the cases made for fiscal devolution (e.g. with respect to Corporation Tax in Northern Ireland or Income Tax in Wales) is the assumption that this would actually be the case. If the "gamble" does not pay off then the regional government would find itself worse off in the future from a revenue point of view.

87 HM Treasury March 2011, *op.cit.*

88 Reported in Northern Ireland Assembly Research Information Service June 2011, "Devolution of corporation tax", *Paper 57,* 11, Northern Ireland Assembly, Belfast.

89 In his paper to the Annual Northern Ireland Economic Conference in September 2012, Professor G.Holtham estimated that to compensate for a reduction in the Northern Ireland block grant of, say, £300m would require an addition to corporate profits of about £2.4bn (i.e. assuming a 12.5% Corporation Tax rate was introduced, i.e. one eighth of any profits would translate into tax revenue, other things being equal). According to Holtham, £2.4bn of profits would, given certain approximate but realistic assumptions about profits share in national/regional income, imply an addition to regional GVA of about £10bn (compared to Northern Ireland's current regional GVA of about £30bn). (Accessed from: http://speri.dept.shef.ac.uk/wp-content/uploads/2012/07/Richard-Murphy-58KB.pdf, 24 March 2013, accessed 20 May 2013.) Holtham asked how plausible this implied one-third increase in Northern Ireland's GVA would be over any short to medium term time period? For a similar exercise relating to Scotland, see Scottish Labour Devolution Commission April 2013, *op.cit.*

The Holtham and Silk Commissions recommended that an indexed method of block adjustment be applied if any major taxes were devolved (although for taxes with smaller revenues streams, a fixed adjustment, i.e. a fixed absolute sum, say £20m, could be acceptable, albeit, presumably with periodic upgrades to allow for inflation).[90] Holtham, in particular, stressed the need to choose the indexing method with care in order to maximise the chance that the gamble involving actual revenues collected against index block adjustment turned out in the right direction. Holtham recommended that the adjustment is a fixed percentage of total UK tax receipts for that tax. There are some attractions to this approach. In other words, the block adjustment would increase (or decrease) in line with whatever had been the % change in the revenue of the specific tax *at the UK wide level*.

If, say, the UK economy experienced a period of low or negative growth and receipts are in general depressed, the scale of any adjustment from the Northern Ireland block grant would be similarly reduced (in other words, the regional government is largely insulated from risk arising from changes in the overall state of the UK economy). The other main advantage of this approach is that it does not transfer UK policy risk relating to UK wide changes in tax policy and structure. If in the case of Income Tax, for example, the UK government decided to change the structure of the tax by increasing the personal allowance then this would reduce Income Tax revenues in Northern Ireland but would also reduce the block grant deduction.

Given all of this, Holtham's approach for Wales was to try to assess the "risk" relating to the devolution of each tax by indicating the likelihood that the growth of revenues for that tax in Wales would indeed exceed the UK average (and hence the indexed deduction from the block). Past performance may not, of course, forecast future outturns (and there may be questions about the data) but the figures in Table 8 for the 2006-7 to 2010-11 period show that Northern Ireland had a growth in tax revenues above the UK average for APD and Landfill Tax but less than the UK average for Income Tax and Stamp Duties.

Data considerations

A recurrent theme in this report has been the weakness of the data base relating to taxation at the Northern Ireland regional level. We would, for example, like to see much better data on the amounts of taxes raised in Northern Ireland (some of the data limitations are wider than those relating to taxation; for example, the most up to date "final" data for the level of total output in the Northern Ireland economy is for the year 2010).

The Silk Commission made a number of recommendations which could apply to Northern Ireland as well:

- The independent Office for Budget Responsibility (OBR) should produce "official" forecasts of tax receipts at the regional level;
- There should be greater transparency regarding the financial relationship between the UK central government and the devolved administration;
- Meetings between the finance ministers of the devolved administrations and Treasury ministers should be formalised;
- The Chief Secretary to the Treasury should appear in front of the devolved assembly.

90 This may be the approach taken with respect to the devolution of the APD on direct long-haul routes which has already occurred to the Northern Ireland Assembly. The size of that adjustment is still to be agreed.

Institutional reform

One significant choice facing the Assembly would be where should the administration of devolved taxes occur? The Assembly could maintain the status quo, i.e. continue to use HM Revenue and Customs (HMRC) although this would probably imply formalising protocols as to how HMRC would relate to the devolved administration. Significantly, the Calman and Silk Commissions both recommended continued use of HMRC (Silk added, that HMRC should assign an accounting officer for Wales). In contrast, however, recent policy of the Scottish Government has been to favour a dedicated and autonomous tax agency; Revenue Scotland. The Northern Ireland Assembly should obviously observe the development of Revenue Scotland.

Tax devolution would probably imply that DFP would have to expand its capabilities and resourcing. Similarly, the DFP Committee in the Assembly would find that its scrutiny roles were expanded and had become more complex. The Assembly/Executive need to consider *how* the decision whether to enhance tax variation would be confirmed. Would the Assembly simply make the decision or would a prior referendum be necessary in order to enhance the legitimacy of any such change?

Conclusions

There are the following conclusions regarding administrative aspects:

- Devolution of any particular tax will imply the challenge of calculating the scale of an initial adjustment to the Northern Ireland spending block;
- Additionally, a calculation will have to be made of how that adjustment would change over time;
- If enhanced fiscal powers are to work well this will imply the need for further data relating to Northern Ireland's fiscal position;
- There are various aspects of institutional reform, notably, to what extent (and how) could Northern Ireland continue to rely on HMRC to administer the taxes which had been devolved and to what extent could or should Northern Ireland set up its own tax collect agency.

7. Overall conclusions

The following key findings emerge from this study:

- The Northern Ireland economy is characterised by chronic underperformance compared to its potential. This has serious consequences for the general well-being of Northern Ireland society.
- Recognition of economic underperformance helped to spark the debate around the possibility of devolving the power to reduce Corporation Tax.
- At the same, with the exception of APD (on trans-Atlantic flights) there has been little or no debate around any wider variation of fiscal powers. The Assembly has very limited control over the tax base (it can vary the Regional Rate and, now, the long-haul rate of APD and it could, theoretically, introduce some new taxes).
- In this, Northern Ireland contrasts with both Scotland and Wales where there has been a consideration of the advantages and disadvantages of fiscal devolution across the entire range of taxes. Such a consideration in Northern Ireland would be timely.
- The Northern Ireland Assembly is funded from a wide variety of sources (e.g. borrowing through the RRI, the EU, charging, and PPP/PFI/alternative finance). In practice, however, the Assembly is still predominantly dependent on the block grant from HM Treasury.
- The existing scale of borrowing (up to £200m annually) might appear small compared to total levels of annual spending of about £20bn. However, Northern Ireland's borrowing powers under the RRI are not dissimilar proportionally to those proposed for Scotland and Wales.
- A relatively small net addition to funding is received through EU funds (adding about 4% to the Departmental Expenditure Limit total). When comparison is drawn with elsewhere in the UK or EU, some scope to increase charges is implied but such policies could be unpopular. In some cases the policy change would be a reversal of a previous decision to remove charges.
- A number of high level options face the Northern Ireland Assembly regarding the approach to funding. The analysis previously conducted for Scotland and Wales implies that the option with the greatest potential is the one which combines some dependence on the block grant with some further fiscal devolution.
- A scoring system (based on six principles applied by Holtham to Wales) produces a broadly similar outcome to what has happened so far in Scotland and Wales in terms of the taxes which are likely to be most suitable to be devolved, e.g. Income Tax, Stamp Duties, Landfill Tax and APD.
- Of those four taxes, only Income Tax is as major tax in terms of the scale of revenues raised. Income Tax devolution could therefore contribute to increasing the accountability of the Northern Ireland Assembly. Any argument for devolving the three minor taxes (Stamp Duties, Landfill Tax and APD) is less about an impact on the economy in general and more about having levers for policy for particular sectors.
- At the same time, there are other significant considerations relating to whether Income Tax should be devolved. For example, there is considerable uncertainty about the extent of responsiveness on the part of employees to tax rates. Additionally, as in other cases of tax devolution, EU law would require a deduction to be made from the Northern Ireland funding block and for that deduction to be indexed over time. If the indexing method chosen was that of the % change in Income Tax revenues in the whole of the UK this begs the question whether the future performance of the Northern Ireland economy makes it likely the actual growth in Income Tax revenues would exceed the deduction. This creates the risk that Income Tax deduction would lead to the Assembly having less resources in the future.
- Enhanced fiscal powers could conceivably bring benefit to the Northern Ireland economy in terms of improving the accountability, and possibly quality, of policy making and providing additional levers for policy. Any move to further fiscal devolution is not without risk to the Northern Ireland block grant. Enhanced fiscal powers should be viewed not as a game changer, or as a solution in its own right, but as a potentially useful supplement to broader economic strategy.

Appendix: Analysis underpinning Table 9

Table 10: A tax by tax consideration for NI as to how the Holtham principles regarding suitability for devolution apply (ranked from the highest score)

Tax [91]	Accountability (see Table 7)*	Economic efficiency[92] (see Table 7)	Adminstrative efficiency
Stamp Duties[93] (4.3)	Partly, i.e.(a.) ? and (c.) ?	(a.) Yes (b.) Yes (unless very large change in tax)	No
APD (4.1)	Partly, i.e. (a.)?	(a.) Yes (b.) Yes (assuming tax decreased rather than increased)	No
NICs (3.8)	Partly, i.e. (a.) and (b.)	(a.) ? (b.) No	No *(NICs are currently so integrated with the entire UK benefit, i.e. NI could not really devolve unless it was prepared to have a welfare system substantially different from the rest of UK)*
Income Tax (3.5)	Yes	(a.) No (b.) No	?
Tobacco Duty (3.3)	Partly, i.e. (a.) ? and (b.)?	(a.) Yes re. UK but No re. RoI** (b.) Yes (assuming tax increase and demand fairly inelastic)	No
Fuel Duties (3.3)	Partly, i.e. (a.), (b.) and (c.)	(a.) Yes re. UK but No re. RoI** (b.) No	No
Alcohol Duty (3.3)	Partly, i.e. (a.)	(a.) Yes re. UK but No re. RoI** (b.) Yes (assuming tax increase and demand fairly inelastic)	No
Landfill Tax (3.0)	No	(a.) Yes re. UK but no re. RoI** (b.) No (assuming sizeable increase)***	No
Betting & Gaming Duties (3.0)	No	(a.) Yes re. UK but No re. RoI** (b.) Yes (assuming tax increase and demand fairly inelastic)	No
Insurance Premium Tax (3.0)	No	(a.) Yes (b.) Yes	No
Climate Change Levy (3.0)	No	(a.) Yes re. UK but No re. RoI** (b.) No***	No
VAT (3.0)	Partly, i.e. (a.), (b.) and (c.)	(a.) Yes re. UK, ? re. RoI# (b.) Yes (unless very large change in rates)	No
Vehicle Excise Duty (3.0)	Partly, i.e. (a.)	(a.) Yes re. UK, ? re. RoI# (b.) Yes (unless very large change in rates)	No
Aggregates Levy (2.5)	No	(a.) No re. UK, No re. RoI (b.) Yes (unless very large change in rates)	No
Corporation Tax (2.3)	Partly, i.e. (b.)	(a.) No (b.) No	No
Capital Gains Tax (2.0)	No	No	No
Inheritance Tax (2.0)	No	No	No
Customs Duties & Levies (1.0)	No	No	No

	Relevant to policy	Compliant with legal constraints (e.g. EU)	Limited impact on rest of UK tax base
	Yes	Yes	Yes
	Yes	Yes, if can satisfy Azores Judgement criteria	Yes
	Yes	Yes	Yes
	? (depending on extent of devolved powers)	Yes	?
	Yes	(how would EU view it?)	Yes (unless large scale diversion of sales from GB)##
	Yes	(how would EU view it?)	Yes
	Yes	(how would EU view it?)	Yes (unless large scale diversion of sales from GB)
	Yes	Yes	Yes
	? (unclear if Executive would wish to use tax to incentivise growth or limit growth of this sector)	Yes	Yes
	No	Yes	Yes
	Yes	Yes	Yes
	?	No *(a binding constraint, i.e. EU law appears to prohibit intra-State variations in VAT)*	Yes
	?	Yes	Yes
	Yes	No (the Relief formerly given to NI was legally challenged and is now suspended)	Yes
	Yes		No
	?	Yes	?
	?	Yes	?
	No	? (would EU allow intra-State variations in customs rates?)	?

*Note: “Partly”- where only some of the parts of the Accountability principle (see Table 7) (a.) to (d.) apply or may apply. Each of the parts (a.) to (d.) score as 0.25 or, if may apply (indicated by “?”), 0.125. We have rounded the total score across all six principles to the nearest 0.1.

**: In some cases tax devolution followed by an increase in the tax rate in Northern Ireland whilst unlikely to lead to diversion of economic activity from NI to GB, could lead to tax competition and diversion to the RoI, e.g. Fuel Duties, Landfill Tax, Tobacco Duty, Alcohol Duty, Betting and Gaming Duties, Climate Change Levy, VAT, Vehicle Excise Duty and Aggregates Levy. In these cases the Economic Efficiency Principle part (a.) was scored as zero (or one half if it was judged that NI to RoI diversion would require a fairly large variation in the tax rate).

***: Whether the impact of the tax is judged to promote behaviour which harms economic efficiency depends somewhat on how efficiency is defined. Here we are taking the view that “inefficiency” could result once the tax drives a wedge between relative prices and relative marginal costs and so changes resource allocation appreciably. However, if it is judged that before the tax was devolved the market started off from a position of market failure, e.g. because of possible failure of marginal costs to allow for the impact of environmental costs, then the tax could be seen as a beneficial correction. However, our view is that any such benefit of a tax will be captured under Principle “Relevant to Policy”, e.g. an environmental policy goal.

#: Economic efficiency likely to be harmed through tax competition with and trade and activity diversion to the RoI if there is a large tax increases in Northern Ireland.

##: Given the distances involved we think “booze cruises” etc. are unlikely to develop between England and NI even if the NI Assembly reduced the rates of tax below the level in England. Similarly, whilst the land border has facilitated smuggling/diversion of sales between NI and RoI when the rates of Fuel Duties differed significantly, the necessity of a sea crossing makes this less likely between NI and GB.

91 92 93

91 Score out of 6 as to strength of case for devolution; 6= highest, 0= lowest.
92 (a) avoids distorting NI-UK and (b) avoids promoting inefficiency.
93 Stamp Duty and Land Tax.

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