Llywodraeth Cymru
Welsh Government

WELSH GOVERNMENT

The Welsh rates of income tax ready-reckoner

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Welsh Rates of Income Tax Ready Reckoner (December 2022)

Introduction

What is it?

1. The ready reckoner for the Welsh Rates of Income Tax (WRIT) is a set of estimates for the revenue impact from a 1p (or one percentage point) change to each of the Welsh rates (basic, higher and additional).

2. The ready reckoner shows the effect of changes to the Welsh rates on devolved income tax revenues – those which contribute to the Welsh Government's budget. It does not include any impact on UK Government tax revenues or wider effects on the economy and other devolved or local taxes in Wales.

3. The ready reckoner includes estimates for all of the expected behavioural effects which may have a material effect on revenues. These include the possible impact on decisions about whether to work or not, how much to work, whether to incorporate (so individuals would be subject to business-related income taxes), and migration.

4. The ready reckoner was last published alongside the Draft Budget in December 2021. It has been updated using the most recent forecasts published by the Office for Budget Responsibility (OBR) in November 2022.

Who has developed it?

5. The WRIT ready reckoner has been developed by HMRC and the Welsh Government. This approach has taken advantage of HMRC's experience in producing costings for UK and Scottish income tax policy changes on behalf of HM Treasury for UK fiscal events and the OBR's fiscal forecasts. HMRC also has access to detailed tax data which is useful in the production of these estimates and is not available to others for confidentiality reasons.

6. The OBR has been consulted in the development of the WRIT ready reckoner. The OBR provides independent tax forecasts for the Welsh Government and its forecasts form the basis of the ready reckoner. In the event of a WRIT policy change, the OBR would be asked to scrutinise and approve the associated costing to be applied to the Welsh Government's budget. Under the legislation which established the OBR, it can only certify policy costings for stated Government policy. Its role in relation to the ready reckoner has been to review the methods used. It has deemed these to be reasonable, drawing on established models and methods wherever possible.

7. The OBR has highlighted what it judges to be the key sources of uncertainty which could lead an actual policy costing to differ from the ready reckoner. For example, it has noted behavioural uncertainties with respect to cross-border migration, particularly among additional rate taxpayers. Evidence on which to base estimates for these behavioural effects is limited.

Estimates

8. The table below shows the revenue forecasts based on the current tax rates and the ready reckoner estimates. These take account of the reduction to the additional rate threshold from £150,000 to £125,140, as announced in the UK Government's November 2022 Autumn Statement. This will take effect from April 2023.

Table 1: Ready-reckoner estimates for the Welsh rates of income tax (£ million)

		2023-24	2024-25
Basic Rate	Current rates	2,375	2,490
	+1p	237	248
	-1p	-237	-248
Higher Rate	Current rates	350	363
	+1p	33	35
	-1p	-34	-35
Additional Rate	Current rates	71	74
	+1p	3	3
	-1p	-4	-4

Estimates based on OBR's Economic and Fiscal Outlook (November 2022) and Welsh Taxes Outlook (December 2022).

How are the estimates produced?

9. The estimates are built up in two stages. First, the static costs from changes to the rates are estimated (these exclude behavioural responses). The static estimates are based on the OBR's Economic and Fiscal Outlook from November 2022 and the Welsh Taxes Outlook December 2022. As the WRIT rates used in these forecasts are 10p, a static cost of plus or minus 1p is just 10% of the WRIT forecast for the particular band.

10. The second stage includes the expected behavioural effects. Changing tax rates is likely to affect people's behaviour, which in turn may affect the amount of tax which is subsequently generated. These behaviours include decisions around whether or not to work, how much to work and the extent to which individuals engage in tax planning and avoidance. The extent of these effects depends on the taxpayer's income, so someone with a larger income is assumed to have a relatively greater response than someone with a lower income. With the exception of migration, the behavioural effects are estimated using the assumptions HMRC and OBR employ when costing UK income tax changes. These are known as taxable income elasticities.

11. The ready reckoner also includes the impact of rate changes on tax motivated incorporation. Changes to income tax rates affect the differential with corporation tax / dividend income tax rates and therefore alter the incentives for individuals to incorporate. Changes to incorporation behaviour will have an impact on income

tax revenues. HMRC models the incentive to incorporate based on UK non-devolved taxes and non-savings non-dividend income tax to provide an estimate of tax motivated incorporation which reflects Welsh individual and company populations.

12. In addition to the above, the ready reckoner includes an estimate of migration behavioural effects. Some cross-border migration is expected from divergences in income tax rates between Wales and elsewhere in the UK. Estimates are only applied to changes in the additional rate. The absolute impact of changes to the basic or higher rates is more limited than the impact of changes to the additional rate, particularly on those with very high incomes. There is also a body of empirical literature which finds that those with the highest incomes are most likely to migrate as a result of income tax changes[1].

13. The estimated migration effect depends on a number of factors. These include the size of the tax change, taxpayers' incomes, existing migration flows between locations and the size of the behavioural response or elasticity. Higher income earners are able to reduce their tax liabilities by a larger amount by migrating to or from Wales, depending on the tax change. Therefore, the higher the income, the more likely a taxpayer is to migrate in response to a tax change. It is also possible that those with more than one residence may be able to switch their main residence for tax purposes with relatively little disruption to their lifestyle.

14. Migration flows and population estimates can be used to calculate the existing likelihood of moving into and out of Wales by location. The data show that individuals who live in communities close to the border are more likely to migrate. This may be because moving shorter distances results in minimal changes to lifestyle, social networks and work arrangements. In general, the further people live from the border, the less likely they are to migrate between Wales and other parts of the UK.

15. The size of the behavioural response, or elasticity, captures to what extent the existing migration flows are expected to alter from a tax change. This is taken from the empirical literature. The estimate is taken from a study in Switzerland[2] which reports findings on the changes to migration flows due to income tax changes. This study is based on income tax data, so will capture those with more than one residence, switching their main residence for tax purposes. However it is possible that the ease of such switching, or paper migration, in the UK is different from Switzerland.

[1] For a summary see Welsh Tax Policy Report 2018, Welsh Government (2018) from page 55, available from here; https://gov.wales/sites/default/files/publications/2018-10/welsh-tax-policy-report-2018.pdf

[2] Martínez, I Z (2022), "Mobility responses to the establishment of a residential tax haven: Evidence from Switzerland", *Journal of Urban Economics* 129(103441)

Limitations and areas of uncertainty

16. The estimates show the expected revenue impact from a 1p (or one percentage point) increase or decrease to each of the WRIT rates, independent of each other. Given the way income tax has been devolved to the Welsh Government, different rates may be altered at the same time, and perhaps in different directions and to different degrees. For example, a 1p reduction in the basic rate could be combined with a 2p rise in the additional rate. Separate estimates of the revenue impact from different combinations of rate changes have not been produced. Changes can be combined across bands and scaled up or down to provide a guide to the potential effects of larger rate changes. For example, a reduction of 2p in a tax rate is likely to cost around twice as much as a reduction of 1p. This approximation is reasonable for changes of up to a few percentage points in either direction.

17. The ready reckoner makes use of the current prevailing and stated future policy of UK income tax rates and bands. It therefore assumes these will remain unchanged for the years which apply for the ready reckoner. The UK personal allowance, higher rate threshold and additional rate threshold (at its new lower level) are all frozen over the years covered by the ready reckoner.

18. As noted, the estimates provided here are consistent with the OBR’s Economic and Fiscal Outlook November 2022 and Welsh Taxes Outlook December 2022. Those forecasts are characterised by a high degree of uncertainty due to current economic circumstances. The estimates are therefore likely to change with future OBR forecasts.

19. In addition, and in common with most other tax policy costings, the behavioural effects included in these estimates are considered highly uncertain. Where possible, established estimates have been used. Where new methods have been applied, as with intra-UK migration, the best available evidence and information has been utilised. However, the evidence base is limited and of uncertain relevance to Welsh circumstances.

20. The ready reckoner provides a robust costing of potential WRIT changes based on current information. However, given the risks and limitations outlined above, the costing of any future WRIT changes applied to Welsh Government budgets may differ from the estimates in this document. No account is taken of any potential forestalling effects, which could affect the profile of revenue in the short term. However, non-savings non-dividend income is subject to less control by the taxpayer than other forms of income. This makes bringing forward earnings or delaying earnings more difficult.

21. The estimates include behavioural effects as outlined in paragraph 3. For both years in the table, the estimates represent the year one impact of a rate change. Some taxpayer behaviour in response to rate changes (such as whether to incorporate) is likely to take time to impact WRIT receipts and will not be seen in the first year. It is estimated that in the years following the introduction of a rate change, the respective year one yield or cost in each band will decrease as a result of behaviours such as tax motivated incorporations.

What other ready reckoners already exist?

22. This ready reckoner for the Welsh Rates of Income Tax adds to the existing set of ready reckoners for UK Government tax changes produced by HMRC.

23. HMRC's latest ready reckoners provide estimates of the revenue effects of illustrative changes to UK Government taxes between 2023-24 and 2025-26, including each of the UK Government income tax rates. These are available from here; https://www.gov.uk/government/statistics/direct-effects-of-illustrative-tax-changes

24. The Scottish Government also produces a ready reckoner for Scottish Income Tax. Their most recent version shows the estimated revenue impact of illustrative changes to Scottish Income Tax in 2022-23 and can be found here;
Scottish Income Tax: ready reckoners 2022 to 2023 - gov.scot (www.gov.scot)

Next steps

25. The Welsh Government will continue to publish updates of the ready reckoner to keep the estimates relevant. In the meantime, it will continue to work with HMRC, the OBR, the Scottish Government, and the Scottish Fiscal Commission to ensure a collaborative approach for gaining more insights into UK income tax, especially the elements which relate to the devolved revenue streams. It is hoped that this will enable better understanding of the tax base and its dynamics, which may in turn improve the estimates in the ready reckoner and future potential WRIT policy costings and forecasts. The key assumptions and judgments will also be kept under review and any new evidence which may help inform the estimates will be considered and reflected in future updates.