

The “Fiscal Deficit” in Wales: why it does not represent an accurate picture of the opening public finances of an Independent Wales

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ABSTRACT

The figure of £13.5bn, frequently quoted as representing the UK government annual subvention to Wales, is a UK accounting exercise, and not a calculation of the fiscal gap that would exist in the early days of an independent Wales. The total includes central UK government costs allocated to Wales that would not be relevant to an Independent Wales. This article analyses the most significant elements of the calculation of this published deficit, utilizing the last figures before the impact of Covid 19 on public finances across Europe – pensions, UK national debt repayments, defence expenditure, other non-identified expenditure, and under-estimates of Wales’ share of UK tax revenues. It concludes that those elements of the current subvention that are likely to transfer to an independent Wales, would represent a deficit of approximately €2.6b, before any other changes to taxation, public expenditure or projected economic growth.

INTRODUCTION

The public debate on the economics of an independent Wales has been dominated by constant references to the UK financial ‘subvention’, or the fiscal deficit or gap in Welsh public finances. UK government statistics report the gap between taxation raised in Wales and public expenditure in and on Wales at £13.5 bn, which has raised questions about the financial sustainability of an independent Wales. However, the frequently quoted figure of £13.5bn has not been analysed from the perspective of its relevance for the debate around independence. This figure for the deficit is calculated by the UK

Office for National Statistics, and is an accounting exercise for the UK state. Its three essential components are, taxation raised by the UK in Wales, public expenditure in Wales and an allocation to Wales, largely on a per capita basis of central UK expenditure including defence, national debt repayments, central government and British embassies abroad. Therefore, an analysis of the possible impact of the deficit in the early years of an independent Wales requires a detailed consideration of the different elements within it, and also a political judgement as to which would carry over to an independent Wales, what would be irrelevant, and what might be funded transitionally by the UK as an ongoing legacy commitment.

To understand how the publicly used figure for the fiscal deficit has been constructed, this paper will firstly deconstruct the deficit, as reported in UK financial statistics to clarify how it is calculated. It will then analyse its largest individual elements and discuss the extent to which they would be likely to transfer to an independent Wales.

CALCULATING THE FISCAL DEFICIT

It is worth recalling that regional fiscal gaps are not only normal but an almost inevitable part of any economy with a significant level of central control over taxes and expenditure. If, tax rates and the tax system is largely centrally controlled and many aspects of expenditure, such as benefit levels (and in some countries public sector salaries) are set by central government then in any one region of a state, there will be variation, which a regional government does not have the legal authority or policy tools to balance out. The UK is a highly centralized economy, measured using the approach adopted by the Office for National Statistics. Only London and the South East run a consistent and large surplus. Scotland, Wales, Northern Ireland and the other regions of England almost always return a fiscal deficit in recent decades, balanced out by tax revenues raised in London.

This paper will not further analyse the reasons for the London-centric nature of the UK economy, or the policy responses that might close that deficit – either via devolution of further powers, or independence. It will focus on the first step only - what part of this deficit would transfer to an independent Wales at the point of independence?

The ONS fiscal gap is not an estimate of the deficit that would exist on day one of an independent Wales, even though it is frequently used as though it is. It is not calculated by the UK Office for National Statistics for that purpose. The UK Office for National

Statistics publishes a figure annually as part of its Net Public Balances Report (NPBR)¹ and its most recent report before the Covid-19 pandemic, stated that the gap between revenue raised in Wales and public expenditure in Wales, plus an allocation to Wales of a share of central UK public expenditure, was £13.4 billion for the year ended 2019.² This paper used data for 2019 as being the last figures before the impact of Covid 19 on public finances across Europe. They are therefore a more reasonable representation of the long-term trend. The next section unpicks this calculation of the deficit, discussing the nature and accuracy of the estimates used. This is an essential first step to a discussion of which elements of the fiscal gap are likely to be relevant in the context of independence.

The Office for National Statistics (ONS) also regards these Net Public Balances Report figures as ‘experimental statistics’, that is, statistics that are still in their ‘development phase and are published to involve potential users at an early stage in building a high-quality set of statistics’.³ Determining what revenue is raised in Wales and what public expenditure should be allocated to Wales is not a simple task and the ONS acknowledge that different methodologies will give different results. However, taking the ONS figures as the best available, it is possible to examine what would be relevant to an independent Wales, as the methods by which this accounting exercise is carried out both underestimate the levels of taxation that would be collected by an independent Wales, and over-state the expenditure that would transfer to the new state.

Table 1 gives details of the different categories within the fiscal gap calculation, which are then discussed below.

Table 1—Summary of **Wales’ fiscal** deficit, for year ended 2019, as reported by ONS⁴

¹ ONS, Net Public Balances Reports.

² ONS, Net Public Balances Reports, 2019. Available at: <https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/articles/countryandregionalpublicsectorfinances/financialyearending2019#public-sector-net-fiscal-balance> .

³ ONS methodology note on NPBRs. Available at: <https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/articles/countryandregionalpublicsectorfinances/financialyearending2019#public-sector-net-fiscal-balance> .

⁴ HM Treasury Country and Regional Analysis, November 2019. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/847025/CRA_2019_-_main_text.pdf and webpages with links to raw data. <https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/articles/countryandregionalpublicsectorfinances/financialyearending2019>

	£m	£m
Total revenue Wales		29,532
Made up of		
<ul style="list-style-type: none"> Taxes raised in Wales and estimates of other taxes / revenue related to activity in Wales 	26,901	
<ul style="list-style-type: none"> GOS accounting adjustments (largely related to depreciation) 	2,631	
Current expenditure		38,516
Capital expenditure		4,478
Break-down of expenditure		
<ul style="list-style-type: none"> 'Identifiable' expenditure 	33,447	
<ul style="list-style-type: none"> Outside UK expenditure (allocated to Wales on population basis) 	1,240	
<ul style="list-style-type: none"> 'Non-identifiable' expenditure (central UK spending allocated to Wales on population basis) 	4,626	
<ul style="list-style-type: none"> Accounting Adjustments (largely depreciation) 	3,681	
<ul style="list-style-type: none"> Total published (managed) expenditure 	42,994	
Published Fiscal Deficit		-13,462

Taxation raised in Wales

Taking the issue of taxation first, some elements of the estimation of revenue raised in Wales are relatively straightforward. For example, income tax and domestic rates paid by individuals who are resident there, and VAT and business taxes for firms based exclusively in Wales. However, many other taxes can only be estimated. VAT, Capital Gains Tax and corporation taxes paid by companies with activities throughout the UK are almost always paid through their head office address, and there is a significant bias towards London as the HQ of so many companies. It is not possible to tell from business's VAT returns how much VAT has been paid in a given region, which needs therefore to be estimated. Beyond income tax, based on supplied addresses, much of Wales's tax revenues are allocated based on UK-wide survey data, where the sample size in Wales is relatively small and open to unknown error. Corporation tax is a particular issue in Wales, where profit and tax is assumed to follow the proportion of employees in each nation or region, which exaggerates the allocation to the region where the HQ is located.

Work on taxation by FitzGerald and Morganroth on taxation raised in Northern Ireland, compared to that returned on ONS data, argued that that Northern Ireland's corporation tax was significantly underestimated in ONS data.⁵

Identifiable expenditure in Wales

The first element of expenditure used in calculating the fiscal gap is public expenditure in Wales; that is, spending on health, education, policing etc. This is called 'identifiable expenditure' by the ONS. In many cases this can be accurately calculated, for example, the costs of education, or local government in Wales. However, even though the term 'identifiable expenditure' used by ONS, suggests a high degree of accuracy, where expenditure is mixed between Wales-based institutions and central UK institutions such as the National Health Service, the spending allocated to Wales is simply a convention of UK Treasury accounting rather than the actual level of spending' as the detail required to accurately identify health spending in and for Wales is not available. While accurate for the UK as a whole, the figures do include estimates, when they are broken down by region, whose accuracy for Wales it is not possible to test at this time. The figures used in the analysis below are the best available, but subject to this qualification.

Non-identifiable expenditure and expenditure outside the UK allocated to Wales

A key element of expenditure within the fiscal gap calculation is the allocation of almost over £4,626m of central UK expenditure to Wales, primarily on a per capita basis, without any significant analysis of where the benefits of that expenditure might appropriately lie. This 'non-identifiable' expenditure includes areas of expenditure that might not transfer at all, or at the same level to an independent Wales. For example, the 'non-identifiable' expenditure allocated to Wales includes £1,902m for UK defence. Only a tiny amount of this expenditure takes place in Wales, and it includes expenditure that an independent Wales would not incur at all, such as the cost of the Trident nuclear weapons programme.

⁵ John FitzGerald and Edgar L.W. Morgenroth ,The Northern Ireland Economy: Problems and Prospects TEP Working Paper No. 0619 July 2019.

Central UK expenditure that is incurred outside of the UK is itemised separately in ONS figures and in 2019, £1,240m was allocated to Wales on a per capita basis. This would include costs such as the UK diplomatic service and aid budgets. Again, this is a decision for a future government and not an inherited liability.

Accounting adjustments

Like all published public financial data, the figures produced for Wales include a number of accounting adjustments. Primarily these relate to how depreciation is treated and some technical issues related to VAT.

There are three key difficulties in using the published net fiscal balance figure as a proxy for the fiscal gap facing an independent Wales. First, the data as published has very large components that will be the subject of the negotiations that would take place between the British and Welsh governments following an agreement to create an independent Wales. These negotiations will include, key issues such as trade, mobility and the division of public services, but financially, the most important questions will be the liability for state and public sector pensions, where people have made contributions to the UK, during all or part of the working life and the question of the sharing of UK public debt and UK assets. There is little legal guidance on these issues and no relevant precedents. Therefore, a political judgement is required as to the likely outcome of such negotiations. Second, adjustments need to be made to reflect public policy decisions on issues such as defence, or the relative size of an independent Wales's diplomatic service where there is no likelihood that an independent Wales would decide to have nuclear weapons for example, or a diplomatic service on the scale of the UK's. Third, as discussed, the data has limitations, and it is possible to estimate some of the other adjustments that need to be made to better reflect the relevant costs. The following section deconstructs the largest elements within the fiscal gap calculation, on the basis of these three issues, and discusses the extent to which they would be relevant to an independent Wales.

THE POTENTIAL DEFICIT FIGURE INHERITED BY AN INDEPENDENT WALES

The public finance deficit that would be likely to transfer to an independent Wales is significantly less than £13.46b per annum, shown in ONS data. The following section explores some of the biggest elements of the published accounts, discussing their

continuing relevance in the context of an independent Wales. It looks in turn at pensions, a possible contribution to UK national debt repayments, defence expenditure, accounting adjustments, outside of UK expenditure, and under-estimates of Wales's share of UK tax revenues. Table 2 then recalculates the subvention based on the costs that would be likely to be assumed by an independent Wales.

Cost of pensions

One of the biggest issues to be negotiated between the UK and Welsh governments, following a decision to create an independent Wales would be liability for pensions. The published figures for Wales in 2018-19 give a total pensions cost of £5,906 million.⁶ This is the comprehensive cost of pensions benefits, paid to people whose address is in Wales, and it includes both the net cost (that is the net cost of expenditure after allowing for income from pension contributions) of public occupational pensions that are not covered by a separate pension fund, and also state pensions.

This level of expenditure would be unlikely to immediately transfer to an independent Wales. At present, the UK pays pensions to people who have worked some or all of their lives in the UK, but now live elsewhere. Many Irish citizens, for example, in retirement in Ireland, receive their UK pension seamlessly, and the two tax and benefit systems have a well-developed model of cooperation. Following Brexit, the UK and Ireland, signed a new bilateral Convention on Social Security in 2019 which came into effect on 31 December 2020. This, more or less, replicates EU regulations for determining pensions in cases where people have worked in different countries or have retired to a different country than they worked in, essentially confirming that costs will be shared, based on the ratio of years worked in each jurisdiction.

It seems consistent that the UK would pay pension liability that had been built up, based on individuals' tax and social insurance contributions or caring responsibilities, during Wales's membership of the United Kingdom, leaving the new Welsh state to take over that liability which builds up from the date of the creation of the new state. Therefore, someone who is already retired and has a state pension based on UK national insurance contributions (and caring responsibilities), or a retired public servant who made additional pension contributions during their working life should continue to receive their UK pension, in an independent Wales, paid by the UK. If someone was half-way through their working life at the time of independence, then the

⁶ HM Treasury, Public Expenditure Statistical Analysis 2020.
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/901406/CCS207_CCS0620768248-001_PESA_ARA_Complete_E-Laying_002_.pdf

UK would at the time of their future retirement pay them half a UK pension at that time, and an independent Wales would be responsible for paying the balance, based on Welsh policy and rates.

All UK state pensions and most public sector employment-based pensions are paid from general taxation and not from a legally separated fund. However, there is a strong sense of pension 'entitlement' in the UK, based on National Insurance Contributions, pension contributions made, and caring responsibilities, during a person's working life, notwithstanding the absence of legally separate pension funds. While the UK could reject any obligation to pay such pensions, following Welsh independence, a refusal to acknowledge lifelong contributions through social insurance (or equivalent caring responsibilities) would lead to very inconsistent outcomes. A person who worked in the UK and retired to Spain, would get a UK pension, in the current practice, but if they lived and stayed in Wales they might not. If people had worked for some of their life in England and some in Wales (but with all contributions paid to the UK Treasury), how would their contributions be divided up as between the years spent working in Wales compared to in England?

Any attempt to walk away from pension responsibilities would be very likely to lead to a significant response from trade unions, due to the precedent it would set. If a UK government can simply refuse to pay a military veteran or a nurse their pension in the case of Welsh independence, could they also do so to cut public spending, or in the case of privatization of a service. Accepting the precedent that there is no entitlement to a state or public sector pension, would be a dangerous precedent and would inevitably be resisted by trade unions.

Accepting liability for pensions built up while working in the UK would also be consistent with the approach taken during the UK's withdrawal from the EU.⁷

Writing about Northern Ireland, Mike Tomlinson, argues that the UK is duty bound to pay the full cost of public sector pensions, not just the net cost (i.e. net of pension contributions received from public service workers) included in ONS figures. Tomlinson's argument is based on the fact that public servants living in Wales have paid pension contributions and/or national insurance contributions, during their working lives in the expectation that they are building up a pension 'entitlement'. If the UK chose to treat this as current income and not invest it against future liabilities, that was their choice, made at central UK level, since public pensions began. However just because the UK made that choice, does not mean that Wales should accept that

⁷ See Federico Fabbrini (ed.), *The law and politics of Brexit, Volume II. The Withdrawal Agreement* (Oxford, 2020).

all those contributions have simply dis-appeared and that a future Welsh Govt has to pay pensions without having received the contributions. The contributions being collected by Wales in year one are matched against future pension liability and not that year's costs – based on liabilities built up inside the UK. If the UK paid the full cost of state and employment based public sector pensions this would increase the cost to the UK from £5.9m to approximately £9m, and correspondingly reduce the deficit by a further £3b. Of course, the pension liabilities of an independent Wales would then start to build up, from that date, as the liability of the UK reduced every year, but an independent Wales in its early years would be the net beneficiary of pensions contributions, being paid by current public servants, with very little expenditure in the short term.

While pensions will ultimately be a matter for bi-lateral negotiation between the two governments, it is consistent with other practice that the UK would accept such obligations, which had been built up through tax and social insurance contributions, and caring responsibilities up to the date of Wales leaving the UK, while an independent Wales would take over such future liabilities building up from day one of the new state.

Table 2 below, reduces the fiscal gap by the figure of £5,906, but does not make any further reduction based on the pension contributions received – which are potentially very significant in the early years of the state – an estimated £3.2b+ pa to build in some caution to these figures. Based on the practice of prior contributions funding pension entitlement – it would be logical that the UK would meet the full £9b cost of pension entitlement built up to the date of independence. However, as negotiations will cover a wide range of issues, it may well be overly optimistic to expect the UK to fully honour these costs, even though it would be fully logical for a future Government of Wales to insist that they should. Therefore, the re-calculated fiscal gap below, is based on an outcome where the UK pays the full cost of state pensions, but only the net current expenditure on employment-based pensions.

UK public debt

The second largest element of the fiscal gap relates to the share of UK public debt, which has been 'allocated' by the Office for National Statistics to Wales on a per capita basis. This debt is the legal responsibility of the UK, and any agreement from the future Welsh Government to take over some of the debt could only be agreed voluntarily, as part of wider negotiations. In reality, because of the scale of the public deficit over decades, 'Wales' has not made any contribution to UK debt repayments in many years as it runs a fiscal deficit in Treasury terms. In practice, an amount of debt repayment

expenditure is allocated to Wales, whose only effect is to increase the fiscal gap. This cost is actually covered by the UK Treasury. Therefore, there would be no real additional cost to the UK, compared to what they have been paying over many years. In the historic case of the creation of the Irish Free State, the allocated share of UK debt was written off in 1925 when the Free State accepted the boundary commission report, which the UK regarded as the finalisation of the transition from the point of view of UK law.⁸ In the event of a vote to create an independent Wales, it is very likely that, Wales would be leaving the UK in accordance with the provisions of UK law, and therefore the Irish Free State precedent is relevant.

In comparable international cases, assets as well as liabilities were distributed between two successor states, and the political context for these negotiations has been important.⁹ International precedent suggests that if in negotiations during transition, the UK government pushed to have Wales take over a share of UK debt, Wales would then be entitled to a proportionate share of UK assets outside of Wales—both national institutions based throughout the UK, and embassy and state properties outside the UK territory. While it is possible to value Wales's share of UK assets outside of Wales, it is much more probable that some form of stand-still agreement would be reached, whereby the new independent Wales would waive its rights to a share of UK 'national' property, outside of Wales, and of UK assets abroad, and in return the UK would not seek to transfer a proportion of the UK national debt to an independent Wales.

In some public commentary it has been argued that as the Scottish Government led by the Scottish National Party (SNP) agreed to take on a pro-rata share of both pensions and debt then an independent Wales (or indeed a United Ireland) would have to do the same. No credible analyst in Ireland, believes that a United Ireland would volunteer to pay back debt which was legally the responsibility of the UK and there is a compelling case that this would not be the case in Wales, and indeed that Scotland did not need to make this offer. The 'remaining UK' would clearly be what is called the "successor" state of the UK in international law. They would absolutely want to maintain this legal position. The 'remaining UK' would for example, wish to keep the UK seat and the UK veto on the United Nations Security Council, and would obviously wish to do so without having to negotiate such a transition, with the USA, France, China and Russia. Therefore, as the successor state they will have full legal liability for the national debt of the UK. There is no legal requirement for a new Welsh state to accept any liability for this debt. In fact, though not commonly discussed, the UK Government accepted during the 2014 Scottish referendum that "In the event of Scottish independence from the United Kingdom (UK), the continuing UK Government

⁸ Donnacha Ó Beacháin, *From Partition to Brexit*, 27-28.

⁹ Alan Freeman and Patrick Grady, *Dividing the House: planning for a Canada without Quebec* (New York, 1995).

would in all circumstances honour the contractual terms of the debt issued by the UK Government... a share of the outstanding stock of debt instruments that have been issued by the UK would not be transferred to Scotland". Of course, the UK Government took the view that "an independent Scottish state would become responsible for a fair and proportionate share of the UK's current liabilities" – but that was on the basis of a bilateral agreement between Scotland and rUK – and was not based on any legal liability by an independent Scotland.

An independent Wales may, of course, volunteer to take on debt as part of a wider package, if the UK made a strong counter-offer on some other issue, but it would obviously need to be financially worthwhile for the new state and there would be no legal liability to do so.

ONS data gives a figure of £2,672m as Wales's 2019 contribution to re-payments on the UK national debt.¹⁰ Table 2, below, entirely excludes this figure, as Wales would have no legal liability to pay any part of it. If negotiations on a transition to an independent Wales conclude with the government of Wales agreeing to voluntarily take on some element of UK public debt, as part of a wider agreement, the inclusion of Wales's potential share of assets would significantly reduce the amount at stake compared to the subvention calculation at present. Certainly, if the UK simply reneged on any responsibilities for pension payments it would seem highly unlikely that a future government of Wales would agree to repay any loans for which they had no legal responsibility. Therefore, it is impossible that the level of the fiscal gap impacting an independent Wales would include both pensions and debt.

Defence

The third largest element of the fiscal gap allocated to Wales is an amount of £1,902m per annum which is allocated to Wales as its share of UK-wide defence expenditure. This is entirely separate from other security-related costs, such as the police, courts, and prisons which are clearly identified separately. Only a tiny proportion of this expenditure takes place in Wales and it includes, for example, a pro-rata contribution to the UK nuclear weapons programme and the UK's international commitments in Iraq and Afghanistan. To put this figure in context, the average EU expenditure on

¹⁰ ONS Expenditure data 2019. Available at: <https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/articles/countryandregionalpublicsectorfinances/financialyearending2019#public-sector-expenditure> (25 May 2021).

defence is approximately 1.3% of GDP but many smaller countries, spend far less than that. The level of Defence spending in an independent Wales, is obviously a matter for a future government, but allocating 1.3% of GDP would see a budget of around £980m which would represent a saving of £922m from the allocation included in the 2019 ONS fiscal gap data for Wales, and that reduction is included in Table 2. Even so, 1.3% of GDP, would still be a very significant defence budget. For comparison, the current defence budget of Ireland is one billion euros (0.50% of GNI) – with a population 42% higher and a much larger sea area to patrol. While the Irish Government has just agreed a significant increase in the defence budget it is likely to remain well below 1% of GNI/GDP – perhaps equivalent to Austria at 0.8% of GDP.

Accounting adjustments

Accounting adjustments increased the expenditure allocated to Wales by £3,681m in 2019. This figure is primarily an accounting treatment of capital depreciation and of VAT refunds and is off-set on the revenue side in de facto terms by the ONS, as part of the Gross Operating Surplus (£2,631). While the net impact of such adjustments on both the revenue and expenditure side, is to increase the fiscal gap by just over £1b, the detail of the balance is hard to untangle, and therefore no further reduction in the projected fiscal gap is made on this basis in Table 2 below, and any additional saving to a future independent Wales are likely to be limited.

Outside of UK expenditure

£1,240m of expenditure is allocated to Wales, by the ONS, as a pro-rata contribution to UK state expenditure outside the territory of the UK.¹¹ There is a very limited breakdown of this expenditure, but it includes Wales's share of the UK's EU contribution under the Withdrawal Agreement', along with the internationally incurred costs of the Foreign Office and overseas aid. However, the costs of international diplomatic missions and development aid are future policy choices, competing with domestic programmes. They are not legacy public spending that would have to be met on day one. As such they should not be considered part of the fiscal gap to be inherited, but rather one of the many policy choices facing a newly independent Wales. Even allowing for a future government decision, it seems unlikely that such costs would be of this order of magnitude, given Wales's size. It would be quite unusual for the internationally based costs of the diplomatic and aid budget to be significantly larger

¹¹ ONS Country and Region Expenditure Tables. Available at: <https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/datasets/countryandregionalpublicsectorfinancespendituretables> (25 May 2021).

than a country's defence budget and it is unlikely that a future government would actually incur this level of cost, and therefore it would be reasonable to reduce this cost in line with the figures for defence (for which more comparable international data is available). Table 2 below therefore reduces this 'outside of UK' expenditure by 50%, or £620m per annum.

Of course, a smaller state such as an Independent Wales loses some economies of scale compared to a larger state, in both the cost of running embassies abroad, or indeed in creating new state departments and agencies for areas that are not currently devolved. However, this would not add to the fiscal gap. Wales already pays a pro-rata share of these expenses – for the central costs of both domestic agencies and international spending. Wales's embassy in Washington or Berlin will be smaller, and there will be fewer embassies around the world. There is a strong argument that smaller polities, closer to their citizens, may well be able to deliver public services more efficiently, with less bureaucracy or administrative overhead. However, even if there was no improvement in administrative efficiency, while Wales's at present contributes to such central UK costs, the employees are almost always based outside the country and therefore pay income tax in another part of the UK. This reduces both the direct tax revenue and other economic benefits, compared to a situation where those employees would be based in Wales, and paying tax in Wales. This is discussed further below as part of the analysis of taxation.

Under-estimates of Wales's share of UK tax

As discussed above, taxes such as corporation tax, CGT and VAT are generally paid by companies from their head office regardless of where that profit was earned, or activities conducted. This exaggerates the tax earned in London, on ONS accounts, as London is the head office address of many companies, which have operations throughout the UK, whereas there are far fewer companies headquartered outside London which make most of their profit in London. The impact of this is to under-report the relevant taxes for Wales and other regions. FitzGerald and Morgenroth have recalculated these taxes for Northern Ireland based on Northern Ireland ratio of UK Gross Operating Surplus, rather than per capita, to better estimate Northern Ireland tax revenues.¹² Utilising GDP figures would give a similar result.

¹² FitzGerald and Morganroth, The Northern Ireland economy:

If National Gross Operating Surplus was used, they argued, as a measure of economic value and Northern Ireland's share was used to calculate its share of corporation tax, this would increase the Northern Ireland 'allocation' of centrally raised corporation tax by just over £500m. Northern Ireland was allocated only 1.4% of the UK's corporation tax revenue in ONS data, whereas Northern Ireland's Gross Operating Surplus was 2.3% of the UK figure (roughly equivalent to Northern Ireland's GDP as a percentage of the UK's which is 2.2%).

ONS data, allocates Wales just 1.8% of UK Capital Gains taxes and 2.5% of UK Corporation taxes. Making the same adjustment for Wales, so that corporation tax and Capital gains taxes are assumed to reflect the relative GDP of Wales and the UK as a whole, would see the revenue allocated to Wales statistically by the ONS increase to 3.5% of each tax. This would increase revenue allocated to Wales by £735m in year ending 2019.

The Sustainable Growth Commission in Scotland, examined the issue of revenues associated with transferred employees and the cost of new employees associated with the establishment of new departments and agencies to deal with issues not currently devolved. They concluded that there would be transitional costs of £450m over a five-year period immediately before and after independence, over and above costs which were being paid already – or approximately £90m pa. However, they calculated these costs would be more than off-set by other long-term benefits.¹³

The Commission estimated that there would be savings of £400 million pa, compared to ONS data, in areas that Scotland contributes to UK costs that will no longer be required, such as costs allocated to Scotland associated with running costs of the House of Commons and House of Lords, the Scotland Office and Whitehall Department running costs that will not need to be duplicated in Scotland. A similar saving for Wales would reduce the fiscal gap by approximately £230m. The Commission also estimated that approximately £2.4 billion of central expenditure which is currently allocated to Scotland, but actually spent elsewhere, for example on staff costs in London, would transfer to Scotland after independence and so generate taxation revenues. Almost 70% of this expenditure would be on staff wages and purchases of goods and services and of this, almost 37% would be expected to be taxation revenues, so giving a boost to Scottish tax revenues of £600m pa.¹⁴ A similar boost to Welsh revenues from the transfer of staff (or hiring of new staff) for which Wales is already paying, would see taxation increase by approximately £350m a year.

¹³ Para B5.17 to B5.26, Report of Scottish Sustainable Growth Commission, <https://static1.squarespace.com/static/5afc0bbbf79392ced8b73dbf/t/5b0a988c352f53c0a5132a23/1527421195436/SGC+Full+Report.pdf>

¹⁴ Para B4.58, Report of Scottish Sustainable Growth Commission,

This would more than comfortably pay for any transition costs or any loss of economies of scale. The calculation of the fiscal gap does not make any further amendment to reflect these savings and additional taxation, but it does give a financial buffer of some significance – of approximately £580 a year, even allowing for some transitional costs.

Table 2—A recalculated fiscal gap to reflect those elements relevant to an Independent Wales

	£m	£m
Published UK deficit by UK's Office of National Statistics, 2019		13,462
Saving from this figure as discussed above		
• UK pensions	5,906	
• Allocated UK debt charges	2,672	
• Reduction in UK Defence allocation to average EU figure of 1.3% GDP.	922	
• Outside of UK expenditure, reduction of scale	620	
• Tax underestimate due to 'HQ' effect of London-based companies	735	
Total adjustments to fiscal gap carrying over to a independent Wales		10,855
Remaining fiscal gap, before policy decisions		2,607

Table 2 includes no adjustments to account for possible economic growth. These are matters for future policy decision and not part of the fiscal gap that would be inherited. What is very clear, however, is that the published fiscal gap figure of £13.4bn is almost irrelevant for the purpose of estimating the likely costs of an independent Wales. There will be an inherited deficit of approximately £2.6bn. However, there are important factors that will impact on that figure, both positively and negatively, most crucially economic performance and public policy decisions, along with the UK decision on pensions.¹⁵

CONCLUSION

The way in which the fiscal gap for Wales is calculated by the UK's Office for National Statistics is sufficiently clear for a political analysis to determine which aspects of this subvention will be relevant for an independent Wales. This analysis has determined that the figure will be approximately €2.6bn, significantly lower than the figure of £13.4bn, frequently quoted in the media.

The economic impact of an independent Wales is therefore not hugely constrained by the existing fiscal situation. Wales GDP per capita has been consistently close to 75% of average UK levels. There has been no significant convergence of the economic performance of the UK's nations and regions in recent decades, in contrast to the quite

¹⁵ Paul Gosling, *A new Ireland, a new union, a new society: a ten year plan* (Derry, 2020), starts an interesting discussion on the public policy choices; see John Doyle, Cathy Gormley-Heenan and Patrick Griffin, 'Editorial: Introducing ARINS—Analysing and Researching Ireland, North and South', *Irish Studies in International Affairs* 32 (2) (2021), vii–xvii for an outline of the ARINS project.

significant convergence between EU member states. Economic analysis needs to move on from a focus on the fiscal gap to an exploration of the reasons for that lower economic performance in Wales and the lack of convergence more generally between the different parts of the UK. Wales's geographic position and the decimation of its traditional industries are often offered as explanations, but if geography is a determining factor, why is Wales's performance, close to that of Northern Ireland rather than the performance of the Republic of Ireland – both more geographically peripheral than Wales?

The debate on the fiscal gap is therefore linked to the debate on economic performance. The classic cautious approach has been to argue that the Welsh economy, Welsh productivity, and Welsh incomes need to grow in order to close the fiscal gap and to make independence more 'practical'. But this is a classic 'chicken and egg' argument. What if it is not possible to grow Welsh productivity and the economy without the policy levers available to an independent state? For 50 years Welsh GDP per capita, has remained relatively fixed at 75% of UK average GDP per capita, with little sign of the type of convergence seen in Europe between the income levels of EU member states. It would take a very radical policy change to make a credible argument that the next 20 years are likely to deliver a different outcome for Wales. It would certainly be worth exploring in some detail, what policy instruments were deployed by small EU member states who have been the beneficiaries of such convergence with wealthier economies. To what extent could Wales draw on a mix of appropriate international comparisons to outline a sustainable growth strategy, and which of the necessary policy instruments would only be available to an independent Wales?

Looking at the scale of the deficit in a different way, Ifan, Sion and Wincott calculate that approximately 2/3rds of the current fiscal gap is related to lower tax revenues, due to lower incomes, combined with higher levels of poverty in Wales and therefore higher expenditure on social benefits.¹⁶ Tax and benefit policies are set by Westminster, and either independence (or indeed enhanced devolution) would allow other possibilities. Tomlinson calculated the impact in Northern Ireland of moving to the tax system used in the Republic of Ireland, for each decile of income earner.¹⁷ Employees earning up

¹⁶ Ifan, Guto, Sion, Cian and Wincott, Daniel (2022). *Devolution, independence and Wales' fiscal deficit*, National Institute Economic Review.

https://orca.cardiff.ac.uk/id/eprint/150792/1/NIER_postprint_june2022.pdf

¹⁷ Tomlinson, Mike. "Social Security in a Unified Ireland." *Irish Studies in International Affairs* 33, no. 2 (2022): 227-245.

to the 70% percentile would take home more of their earning – on average about £15 per week, but the top 30% of earners would pay more and employers would contribute more to social security, so even though 70% of employees would be better off under the Irish tax system, the state would still collect almost 770m euros more in tax per annum. Ireland's tax code is by no means a Scandinavian model, but the experiment conducted by Tomlinson shows that fiscal deficits are also a product of decisions on taxation, in particular taxation of high earners. UK decisions to implement a regressive tax system, where high earners are given the disproportionate benefit of tax cuts, have the direct effect of increasing the fiscal deficit for Wales.

It is beyond the scope of this paper to explore either an alternative tax policy or industrial policy for an independent Wales. The underlying economy, taxation system and the type of public services that are provided, will be the real determining factors of the costs and benefits of an independent Wales. The conclusion of this paper is that the current fiscal gap, is not sufficiently large to close off the possibility of a viable Wales. The fiscal gap could be closed by relatively modest economic growth (convergence), and / or by a different tax policy. Those are the areas where the public debate on the public finances of an independent Wales should focus.