

Final report

**Fairness and accountability:  
a new funding settlement  
for Wales**  
summary

July 2010



ISBN 978 0 7504 5614 2

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WAG10-03153

F0971011

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## Preface



On behalf of my fellow Commissioners, David Miles and Paul Bernd Spahn, I have pleasure in presenting our second and final report.

The themes of the report are fairness and accountability, the two areas where we believe existing arrangements for financing Wales require improvement. Fairness is not simply due to Wales but to all constituent parts of the United Kingdom and we have tried to make proposals that are fair to all parties and not at all special pleading in the Welsh interest. Devolution inevitably brings new elements into the relationship between the state and the citizen but we believe clear responsibilities and the powers to discharge them are

necessary to any arm of government and we conclude that improvements in the accountability of the Welsh Assembly Government are possible that strengthen, not weaken, the coherence of British government as a whole.

In our first report we looked at “the pros and cons of the present formula-based approach to the distribution of public expenditure resources to the Welsh Assembly Government”, as we were charged to do. In this, our final report, we have attempted to “identify possible alternative funding mechanisms including the scope for the Welsh Assembly Government to have tax varying powers as well as greater powers to borrow.”

Identification is one thing, recommendation is another. No area could be more essentially political than taxation. Therefore this report has been more difficult for a technical body like the Commission to write than was its predecessor report. We have found it relatively easy to say, on the basis of constitutional considerations and public finance best practice, that a body like the Welsh Assembly Government should bear the responsibility for raising some of its own revenue through taxation. The devolved government starts from a position where virtually all its resources come from a grant from central government; almost none comes directly from the people who elect it. Enhancing the accountability of the devolved government to the people of Wales by reducing reliance on a grant from the UK Government and increasing reliance on revenue that comes directly from its voters has advantages - both to the people of Wales and to the rest of the UK. But how much revenue, which taxes, levied on whom - those are all political matters that must be settled by democratic decision.

To be sure, economic reality and the integrity of the UK impose constraints on what it is practical or advisable to devolve. We have done our best to examine those constraints and sift the various possibilities for devolving tax powers. Indeed, we have asked whether the constraints rule out any devolution of taxation at all. The sifting process has led us to reject some strategies while identifying others that look more promising. In some cases, we have felt able to recommend a particular course of action. In other cases we have confined ourselves to pointing out the alternatives and some of the implications of following any particular approach. In that way we hope to have guided discussion into fruitful channels without pre-empting any essentially political debates or decisions.

Borrowing is to some extent a subsidiary issue. Once spending responsibilities are set and the arrangements for financing them, including any taxation powers, are established, the consequences for sensible borrowing powers tend to follow. We have attempted to set out the appropriate borrowing arrangements that are consistent with the current devolution settlement and with the one that would follow from the implementation of our other recommendations.

As well as examining taxing and borrowing, we have done further detailed work on a needs-based approach to determining the block grant since that will remain the major part of finance for the Welsh Assembly Government in the foreseeable future. Reform of the block grant system is essential if the financing of devolved government is to be fair and seen to be fair by everyone in the United Kingdom. Demonstrating a practical means of developing needs-based formulae represents a substantive part of this final report.

Once again, the Commission warmly thanks all those people and organisations who have supported our work by submitting evidence and attending meetings. The report would have been immeasurably poorer without their contributions. Fuller acknowledgment is made in Annex 10 of our full report. We should also thank the many others who have met or corresponded with one or more of the Commissioners and answered our questions on a host of topics, giving freely their time and expertise. Particular thanks are due to the Commission secretariat who have sustained us with great professionalism, competence and good humour throughout a hard-working period of almost two years.

Finally I should like to extend personal thanks to my fellow Commissioners for their acuity and diligence and to the Welsh Ministers and the former First Minister, Rhodri Morgan, for giving me the opportunity to try to be of service to our country.

For all that, the conclusions and recommendations of this report remain the sole responsibility of the Commission itself.



**Gerald Holtham**

Chair

Independent Commission on Funding and Finance for Wales

# Chapter 1: Introduction

## Approach to the terms of reference

1.1 The Commission's terms of reference were to:

- i) look at the pros and cons of the present formula-based approach to the distribution of public expenditure resources to the Welsh Assembly Government; and
- ii) identify possible alternative funding mechanisms including the scope for the Welsh Assembly Government to have tax varying powers as well as greater powers to borrow.

1.2 We were asked to address those issues sequentially. Accordingly, our first report focused primarily on the operation of the current funding regime and set out the case for replacing the Barnett Formula with one that is based on needs. In this report, we provide evidence of how a needs-based funding system could be made to work in a way that is fair to all parts of the UK. We also turn our attention to the case for devolution of tax-varying and borrowing powers to Wales.

## Summary of the current funding regime

### Structures of devolved government in Wales

1.3 Following a referendum in September 1997, the Government of Wales Act 1998 led to the creation of the National Assembly for Wales ("the National Assembly"), which inherited the executive powers of the Secretary of State for Wales. As a result of the Government of Wales Act 2006, the executive functions were separated from the other functions of the National Assembly, creating the Welsh Assembly Government ("the Assembly Government"), with the executive powers now being exercised by the Welsh Ministers.

### The Welsh block grant

1.4 There are several stages in the process by which the Assembly Government receives its funds. Firstly, Parliament votes monies to the Secretary of State for Wales. The amount of this grant is almost entirely determined by the Barnett Formula.<sup>1</sup> The Secretary of State transfers those funds into the Welsh Consolidated Fund after first deducting the running costs of the Wales Office.<sup>2</sup> In this report, the bulk of those funds are referred to as "the Welsh block grant". The National Assembly then adopts a budget motion that provides resources to the Assembly Government. Welsh Ministers are

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<sup>1</sup> Strictly speaking, the Barnett Formula is merely the mechanism by which adjustments to the grant are calculated (Heald, 1980). However, in this report, the term is also used more generally as a shorthand way of referring to the overall funding system.

<sup>2</sup> The Welsh Consolidated Fund acts as a pot where the money voted by Parliament for Wales is held. In addition to the budget provided to the Assembly Government, the expenditures of each of the Assembly Commission, the Auditor General for Wales and the Public Services Ombudsman for Wales also come out of the Welsh Consolidated Fund. The National Assembly is responsible for approving the budget motions and supplementary budget motions proposed by the Welsh Ministers. The Auditor General for Wales authorises payments out of the Welsh Consolidated Fund to the Welsh Ministers if the expenditure has been approved by the National Assembly.

free to allocate this grant in line with their priorities, subject to approval from the National Assembly.<sup>3</sup> The National Assembly has no tax-varying powers that could alter the overall size of the Welsh Consolidated Fund and Welsh Ministers have only limited borrowing powers.<sup>4</sup>

## The Barnett Formula

1.5 The Barnett Formula is used to determine changes to the block grant. In determining those changes the formula combines three factors, namely:

- i) changes to spending in England on services that are devolved to Wales;
- ii) the extent to which the spending area is wholly or partly devolved (the so-called “comparability factor”); and
- iii) the population of Wales relative to the population of England.

1.6 Under the formula, changes in the funding allocated to Wales are therefore explicitly linked to spending decisions in England. Changes in English expenditure on matters that are wholly devolved to Wales will result in changes to the Welsh block that are in line with the Welsh population as a proportion of the English population. In 2008, the population of Wales was 5.82 per cent of the population of England. This means that Wales receives 5.82 per cent of any change to spending in England on matters that are devolved to Wales.

1.7 In summary, changes to the Welsh block grant equal the change in spending in England, multiplied by the comparability factor for that spending, multiplied by the Welsh population share.

1.8 A significant proportion of public spending in Wales is outside the scope of Barnett and outside the authority of the National Assembly. In 2007-08 the Welsh block grant, at £13.5 billion, was the largest single source of public expenditure, but accounted for only 54 per cent of total public spending on services in Wales (known as Identifiable Expenditure on Services, or IES).<sup>5</sup> The remaining 46 per cent of public spending on services in Wales was determined outside the Welsh block grant. The UK Government spent around £1.6 billion in Wales on a range of programmes inside the Departmental Expenditure Limits (DEL) of various Whitehall departments, covering non-devolved areas such as policing and justice. The UK Government also spent £8.5 billion in Wales on Annually Managed Expenditure (AME) programmes. The bulk of this spending relates to social security benefits and tax credits managed by the Department for Work and Pensions (DWP) and HM Revenue and Customs (HMRC) respectively. Additionally £1.6 billion of AME in Wales mainly reflects spending financed by local authorities via the council tax.<sup>6, 7</sup>

1.9 While resources allocated through the Barnett Formula are therefore the largest single component of public spending in Wales, a substantial proportion of Welsh public spending is determined by other means.

<sup>3</sup> In addition to its block grant, the Assembly Government receives very limited income from other sources such as fees and sales of capital assets. It also receives funds for volatile annually managed programmes and for European programmes.

<sup>4</sup> The Assembly Government’s limited ability to borrow is described in Annex 3.

<sup>5</sup> IES is the total public expenditure in Wales that is recognised as being for the benefit of individuals, enterprises or communities in Wales. It excludes certain expenditures incurred in Wales, because they are deemed to be for the benefit of the UK as a whole, for example defence. The latest year for which full outturn data are available is 2007-08.

<sup>6</sup> This amount also includes adjustments to allow for differences in accounting treatment and coverage between DEL and IES.

<sup>7</sup> In Wales, all local authorities are unitary authorities.

## Summary of recommendations in the first report

1.10 In our first report, we concluded that the Barnett Formula lacked any objective justification and had survived for 30 years solely for reasons of political and administrative convenience. As a direct result of the formula, the relative funding per capita for devolved activities in Wales has converged markedly towards the average level of funding in England over the past decade. We found that this process of relative decline (the so-called “Barnett squeeze”) has caused the funding of devolved activities in Wales to fall below what Wales would receive were its budget determined by the various formulae that the UK Government uses to allocate resources to comparable functions in England. If the Barnett Formula remains in place, this convergence will continue over the medium term, with the funding of devolved public services in Wales moving ever closer to the average English level of funding per capita, irrespective of higher Welsh relative needs.

1.11 In order to establish a fair and rational basis for determining the size of the Welsh block grant, the Commission recommended that in the medium term the funding arrangements for Wales should be based on relative needs. However, we also acknowledged that this could take time. As an interim measure, we recommended a simple modification to the existing formula that would place a “floor” under the block grant at a level indicated by English needs formulae and would prevent any further convergence, pending wider reform.

1.12 We also made a number of recommendations regarding operational issues, including the desirability of handing responsibility for technical aspects of the funding regime to a body that is at arm’s length from both the UK Government and the devolved administrations. In addition, we recommended that the Assembly Government should be able to draw forward its capital budget across the period of a spending review and that the constraints on the ability of Welsh Ministers to move funds between capital and revenue budgets should be reduced. We proposed giving Welsh Ministers a free hand in accessing accumulated End Year Flexibility funds. Finally, we recommended greater transparency in the publication of data of relevance to the operation of the funding regime and suggested that UK Government Ministers should be invited periodically to attend the National Assembly’s Finance Committee to discuss the funding of Wales.

## Funding devolved government: the state of the debate across the UK

1.13 After our first report went to press, the House of Lords Select Committee on the Barnett Formula reported, and the final report of the Commission on Scottish Devolution (the “Calman Commission”) was published.<sup>8</sup> The Select Committee recommended that Barnett should be replaced by a simple needs-based mechanism for allocating resources to the devolved administrations that would be implemented by a body that operated at arm’s length from the UK Government and the devolved administrations. The Calman Commission agreed that the Scottish block grant should be based on need, and proposed a package of further fiscal reforms for Scotland that included devolution of additional tax-varying powers and limited borrowing powers to fund capital spending. In particular, the Commission recommended that Scotland’s current powers over income tax should be substantially enhanced, while powers over landfill tax, aggregates levy, stamp duty land tax and air passenger duty should also be devolved. The former UK Government published a White Paper in November 2009 that set out how it planned to take forward the Calman Commission’s recommendations.<sup>9</sup> The UK Government that was formed following the May 2010 general election has stated its intention to implement the proposals of the Calman Commission.

<sup>8</sup> House of Lords Select Committee on the Barnett Formula, 2009, and Commission on Scottish Devolution, 2009.

<sup>9</sup> Scotland Office, 2009.

# Chapter 2: The options for fiscal devolution in Wales

## Funding devolved government in Wales: a range of models

2.1 In our first report, we described a spectrum of options for funding devolved government in Wales, ranging from very limited to very extensive fiscal autonomy. Four main models can be envisaged.

- i) **Block grant funding.** This is the current system. Taxes raised in Wales (excluding council tax and non-domestic rates) are pooled at the UK level, from which the UK Parliament provides a sum of money to the Assembly Government to fund devolved activities. Welsh Ministers have discretion over how these funds are allocated but are not able to alter the overall size of the budget by raising or reducing taxes. Some clarification and enhancement of the Assembly Government's current limited borrowing powers could be consistent with such models, though they would have to operate within a clear framework overseen by the UK Government.
- ii) **Block grant plus tax revenue assignment.** Under this model, the block grant would be reduced and instead part of the budget allocated to Wales would be directly dependent on taxes raised in Wales. There would therefore be a stronger link between what is spent in Wales and the resources provided by Welsh taxpayers than is currently the case. However, under tax revenue assignment models, control of the assigned taxes would be retained at the UK level; Welsh Ministers would not be able to vary the size of their total budget by varying the rates on the assigned taxes. Replacing a portion of the block grant with a stream of assigned tax revenue would introduce an element of volatility into the Welsh budget, and would therefore be likely to require some enhancement of devolved borrowing powers in order to manage this volatility. Tax revenue assignment appears relatively unattractive for Wales, since it would replace an element of block grant funding with an uncertain stream of tax revenue, without providing Welsh Ministers with the extra powers that would enhance their accountability to the electorate.
- iii) **Block grant plus tax devolution.** This involves linking part of the funding that is provided to Wales directly to certain taxes that are raised in Wales, as would occur with tax revenue assignment. However, under tax devolution Welsh Ministers would also acquire powers to vary the devolved taxes, making it possible to increase or reduce the total resources available to spend on public services in Wales. Revenue raised in Wales by non-devolved taxes would be pooled at the UK level as at present, and Wales would therefore still receive a block grant from the UK, although the grant would be reduced by an appropriate amount. As with tax assignment models, there would be a case for some enhancement of current borrowing powers in order to offset the budgetary volatility that could result from tax devolution.
- iv) **Towards full fiscal autonomy.** These models would devolve responsibility for all taxes raised in Wales to finance devolved expenditures. This system of finance could involve a range of possible transactions between the Assembly Government and the UK. There would be a transfer between Wales and the UK Government, being the net of a payment by

Wales for non-devolved government services, like defence and social security, and the payment to Wales of an equalisation grant to bring its per capita tax receipts or public expenditure to an appropriate union-wide level. At the limit, Wales would be wholly reliant on its own resources, with no transfers between the Welsh and UK levels of government (“full fiscal autonomy”).

## The constitutional context

### The Commission’s approach to issues that have a political dimension

2.2 While it is certainly arguable that in a state of over 60 million people some devolution is conducive to political responsiveness and administrative efficiency, choosing the extent and form of devolution is a matter of political preference.

2.3 As an apolitical Commission, independent from the Assembly Government, it would be inappropriate for us to make recommendations on the funding model for Wales that are grounded in our political preferences. Instead, we take the current constitutional position of Wales as a given. Our recommendations are intended to be appropriate for devolution as it currently operates in Wales, or as it may operate in the event of a referendum vote in favour of greater law-making powers.<sup>10</sup> If, at some time in the future, Wales were to acquire a significantly different degree of autonomy, our recommendations would need to be reassessed in the light of those new constitutional circumstances.

2.4 Ever since the Scottish referendum of 1997, when voters gave a larger majority for law-making powers than for taxing powers to the Scottish Parliament, Welsh gradualism has seen legislative powers for the National Assembly as something that would precede powers over taxation. The Commission on the Powers and Electoral Arrangements of the National Assembly for Wales (the “Richard Commission”) lent support to that view.<sup>11</sup> From our perspective, while primary legislative powers are an evident development or a step towards greater devolution, one can ask of any devolution settlement, wide or narrow, how it should be financed. Some element of self-financing may well be appropriate at any stage. After all, local authorities have to raise some of their own revenue from council tax and even parish councils can set a precept, although no-one suggests either should have primary legislative powers. It is indeed widely accepted in public finance theory that the divergence between the spending power and the revenue-raising power of any public authority should be limited as far as possible.<sup>12</sup> That is to say, bodies which spend the public’s money should at least share the pain of extracting it from them. A situation of legislative powers without taxing powers is unusual internationally; having tax powers without primary legislative powers, on the other hand, is extremely common in this country and abroad.

<sup>10</sup> The Government of Wales Act 2006 provides for a referendum on an extension of legislative powers that would enable the National Assembly to legislate by Act in relation to a much broader range of subjects set out in the Act.

<sup>11</sup> Commission on the Powers and Electoral Arrangements of the National Assembly for Wales, 2004.

<sup>12</sup> Oates, 1972 and 1999, argues that there will be externalities so that tax prices diverge from social marginal costs where taxes do not reflect benefits from public spending.

## The dimensions of the union between Wales and the rest of the UK

2.5 While the union with the rest of the UK undoubtedly provides benefits to Wales, it also imposes constraints on the type of powers that could feasibly be devolved. The Calman Commission provided an analysis of the different dimensions of the union that exists between the constituent parts of the UK: the political, economic and social union.

2.6 In the **political union** the UK Parliament is sovereign. Political union, in our view, implies that it is inappropriate to seek advantages for one part of the union that come purely at the expense of another part. However, the UK Government would have no reason to resist changes that would make Wales potentially more prosperous if those changes would not be detrimental to another part of the union. This may seem an obvious point but it is often ignored in practical proposals that are made for fiscal devolution. For example, devolution of a specific tax is sometimes proposed so that a devolved administration can reduce tax rates and attract economic activity to its area. If that economic activity comes from elsewhere in the UK, there may well be no net gain to the UK as a whole and it is understandable that it would be regarded sceptically by the UK Government. At the limit, tax devolution that leads to tax competition may undermine a tax base and lead to too-low levels of tax for the union as a whole.

2.7 A necessary, if not sufficient, condition for avoiding those outcomes is that any proposal for devolving a tax-varying power should be able, at least in principle, to pass a compensation test. If a tax is devolved and altered by the devolved administration, and if that has deleterious spill-over effects elsewhere in the UK, could the devolved administration in theory compensate the rest of the UK for its revenue losses and any other costs and still remain in benefit? If the answer to that question is "yes", the tax is a candidate for devolution. If the answer is "no", the tax is an inappropriate one to devolve within a union state. We do not propose that the compensation test should be applied in practice as relatively poor areas in a union state frequently receive transfers over and above the payment of income benefits to individuals. Arguably, negative spillovers on the union budget are acceptable provided that they do not exceed the transfers that might otherwise be made to combat relative poverty or to foster economic development.

2.8 The **economic union** has both macroeconomic and microeconomic aspects. It means that at the level of the macroeconomy, there is a legitimate role for the UK Government in determining overall spending and borrowing limits, and that any devolved fiscal powers will have to be embedded in a UK-wide management framework. At the microeconomic level, the union means goods and services are freely traded across the borders of its constituent parts within a framework of a common capital market and uniform labour laws. Just as in the European context restrictions on tax variation are applied in order to underpin the single market, so tax devolution within the UK should not threaten the integrated UK market. Tax changes that would seriously disrupt the economic union of the UK are, in any case, likely to be impractical and impossible to enforce at reasonable cost. For example, it would be very difficult for Wales to impose a substantially different rate of fuel duty from England, given the ease with which vehicles could cross the border to take advantage of price differentials.

2.9 The **social union** produces expectations that benefit payments should be available on an equal basis across the UK, and that tax revenues should be allocated in a way that takes account of need. It follows from the social union that the elements of the social security system, including the taxes notionally earmarked for financing it, are not candidates for devolution.

2.10 In sum, we accept the restrictions on fiscal devolution that arise from the political, economic and social dimensions of the union. Since tax revenue assignment is unattractive and fiscal federalism or full autonomy are inconsistent with the current constitutional settlement, we shall focus primarily in this report on block grant funding and block grant funding combined with selective tax devolution as the most plausible funding models for Wales. We view both of those approaches as being consistent with Wales's current constitutional status.

## Principles for reform

2.11 Our first report endorsed the ideal characteristics of a funding system for sub-national governments that were proposed by the Calman Commission:

- i) **stability / predictability:** so that public spending can be managed properly;
- ii) **simplicity / transparency:** so that it is readily implemented and the justification is evident;
- iii) **autonomy:** so that the sub-national government can decide how to allocate its resources;
- iv) **efficiency:** so that economic distortions created by incentivising movements of people and the factors of production simply to avoid taxes are avoided;
- v) **equity:** so that resources are allocated in a way that takes account of relative need, making it possible to provide a standard level of service in all parts of the UK; and
- vi) **accountability:** so that the link between decisions made at the regional level and the tax paid by voters is clear. In addition, the tax take within a region should impact on the budget available to the sub-national government, thus ensuring that the utility of public expenditure at the margin is balanced against the cost to taxpayers.

2.12 No real funding system wholly achieves those objectives. The current block grant regime that is applied in Wales and the other devolved administrations scores relatively highly on stability and simplicity. It also provides a high degree of autonomy to Welsh Ministers in deciding their own spending priorities, although there is no scope to influence the overall size of the budget.

2.13 Efficiency has a number of different aspects. Uniform tax rates and structures might appear efficient in that people are not induced to make inferior choices simply to avoid taxation. Nevertheless, there may sometimes be efficiency arguments for having different rates of tax in different localities. If preferences differ, for example between public and private goods or between saving and spending, then the optimal tax structure will differ too. Devolution of tax-varying powers creates the possibility that tax rates might be set in a way more appropriate to local conditions than the rates that represent the best compromise for a larger geographical entity. Since different taxes might create more distortions than efficiency gains, one must make a judgment on the scope for efficiency gains and losses. Uniformity undoubtedly reduces the administrative cost of levying and raising taxes, which is another aspect of efficiency. Devolving the power to alter tax rates does not necessarily mean altering the agencies or methods of tax collection but administrative efficiency is a factor to be born in mind.

2.14 The Barnett Formula performs very poorly on equity, since there is no link between the relative funding allocated to Wales and the relative need to spend on devolved services. Our proposal to replace Barnett with a needs-based funding regime would address this fundamental problem.

2.15 That leaves accountability as the main weakness of the current funding regime. As things stand, the size of the block grant is set by the UK Government using the Barnett Formula, leaving politicians in Wales unable to offer voters any choice over tax and spending trade-offs. Moreover, the relative performance of the Welsh economy has no impact on the budget, with the result that the Welsh public sector is, in some ways, detached from the economic circumstances of the citizens it serves. The absence of clear linkages between Welsh taxpayers, the Welsh economy and the resources available to the Assembly Government is a major weakness of the current funding regime, and is highly anomalous from an international perspective. Devolution of tax-varying powers would rectify those problems. Politicians would surely have a more careful and considered view of public expenditure at the margin if they knew it had a bearing on the taxes their electors would pay. It is possible too that Welsh discussion about issues of priority in public services would be more developed if everyone knew that there was a choice about paying more or less tax for more or less service, rather than simply blaming Westminster for inadequate resources. In principle, therefore, we favour some tax devolution to Wales.

2.16 A funding regime that combined a needs-based block grant with a degree of tax devolution would have several appealing elements. By ensuring that the block grant was aligned with relative needs, governments across the UK would have the ability, but not the obligation, to provide a standard level of public services to all their citizens. However, citizens would be able, through their governments, to make trade-offs at the margin between taxes and spending and so to have an influence over the size of the devolved budget, as well as the ways in which it was spent. That would lead to a diversity of provision across the country but one that reflected democratic preferences. A different constellation of tax rates in a devolved administration might enhance economic efficiency, given local conditions and preferences. In any event the accountability of the devolved administration would be greatly enhanced. Moreover, by making the devolved budget at least partially dependent on the tax base of its own territory, it would strengthen the incentives for a devolved administration to act in a way that enhanced economic development. Tax devolution could also create laboratory conditions for improving a tax as a pilot for the UK as a whole.

2.17 Tax devolution can provide an important element of accountability at the margin but a block grant, combined with substantial sharing of tax revenue at the UK level, will remain central to the funding regime in Wales under all the options that we shall consider in this report. In the next Chapter, we set out our proposals for how best to ensure that the block grant element of a future funding regime is calculated in such a way as to align relative funding with relative needs, and we discuss how a needs-based system could be made to work in practice.<sup>13</sup>

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<sup>13</sup> "Relative funding" means spending per head on devolved activities in Wales, relative to the amount spent on comparable activities in England.

# Chapter 3: Replacing Barnett with a needs-based formula

## Rationale for this analysis

3.1 Any new funding arrangement must be implemented on the basis of mutual agreement by the governments of the UK and the devolved administrations, and a conference of politicians and experts may be necessary to achieve agreement.

3.2 However, in order to move the debate forward it is necessary to go beyond a discussion of general principles and to produce a proposal that would work in practice and could form the starting point for a debate between governments. In order to do this, we employ a methodology for developing a needs-based formula where the weighting given to different types of need is derived from spending decisions made by Ministers in England, Scotland and Wales. We set out how this formula could be used to determine budgets across the nations of the UK, and we consider what the implications of this new funding system would be for the devolved administrations. A detailed description of our methodology is provided in Annex 4 of our full report. We have kept the imposition of our own judgment to a minimum in the interests of deriving a formula which encodes the “revealed preference” of current governments. The estimates of relative need that our model provides for Scotland and Northern Ireland should be seen as only broadly indicative, given issues of coverage, but we have greater confidence in the accuracy of the estimate for Wales given its consistency with the findings of our first report.

3.3 This Chapter is therefore not intended to be the final word on how a needs-based formula would operate; rather, its purpose is:

- i) to demonstrate that a needs-based funding regime is eminently and imminently achievable given the political will;
- ii) to show that such a formula need not be prohibitively complicated; and
- iii) to provide a starting point for discussion about how a needs-based replacement for Barnett could be put into practice.

## Towards a new formula: trade-offs between simplicity and completeness

3.4 The two main characteristics of an ideal needs-based funding formula, are:

- i) **simplicity:** a formula should be simple to operate and understand; and
- ii) **completeness:** a formula should take account of all relevant dimensions of relative need.

3.5 The objectives of simplicity and completeness are in competition with each other to a certain extent - a simple formula will tend to be incomplete, while a complete formula is likely to be complex.

## How simple could a needs-based formula be?

3.6 In order to assess whether it could be possible to develop a simple funding formula that retained a high degree of completeness, we commissioned an econometric study that attempted to mimic the outcomes of complex funding formulae that are being employed at present in the UK using only a few needs variables.<sup>14</sup> This analysis aggregated the actual funding allocations for health, local government and schools expenditure in England (each of which is determined by a complex needs-based funding formula), and attempted to replicate their outcomes at a sub-regional level across England using as few needs indicators as possible.<sup>15</sup> Since these public services account for the bulk of devolved spending in Wales, in aggregate the budgets provide a reasonable proxy for the activities that are funded from the Welsh block grant.<sup>16</sup>

3.7 The study demonstrated that it is possible to replicate to a surprisingly high degree of accuracy the funding allocations of very complicated needs-based formulae using only a few key needs indicators. The implication of this finding is that it should be possible to generate a simple needs-based formula to replace Barnett that also retains a high degree of completeness.

## Needs indicators: selection criteria

3.8 Our first report considered the various competing definitions of equity that could be adopted when allocating public resources. While this debate is a political one that we cannot resolve, there is a broad consensus that, at a minimum, funds should be allocated in a way that makes it possible to provide a standard level of public services in all parts of the UK.<sup>17</sup> There is, however, no agreed set of needs indicators waiting to be taken off the shelf and plugged into a formula.

3.9 It is nonetheless possible to identify in broad terms the type of needs that are relevant to the provision of devolved services and to find objective proxies for them. Population size is one obvious such driver - the more people that live in a locality, the greater the need for public services. In addition, our first report argued that the three factors most relevant to the financing of devolved activities in the UK are:

- i) **Demographics:** a higher prevalence of school age and retired people in the population will tend to increase the need for public services. Similarly, certain minority ethnic groups are disproportionately likely to experience disadvantage, so greater ethnic diversity will also be likely, other things being equal, to generate a higher need for public services.
- ii) **Deprivation:** individuals who are disadvantaged in various ways will have a greater need to access public services. For instance, a high prevalence of ill health will generate increased pressure for health-related services, while people who are not in employment or who are

<sup>14</sup> LE Wales, 2009.

<sup>15</sup> Schools expenditure in England was determined by a needs-based formula until 2006-07. Since that date, school budgets have been based largely on historic spend. In effect therefore, the relative allocations continue to reflect the outcomes of the pre-2006-07 needs-based formula.

<sup>16</sup> The scope of devolved responsibilities is not identical in Wales, Scotland and Northern Ireland. The implications of this for our proposed approach are discussed in Annex 4 of our full report.

<sup>17</sup> For example, this definition was adopted by HM Treasury in its 1979 needs analysis (HM Treasury, 1979). Alternative definitions of need and equity are discussed in detail in Chapter 3 of our first report.

claiming income-related benefits are also likely to have a relatively high need for devolved public services such as personal social services and early years support.

- iii) **Costs:** the cost of delivering public services tends to be greater in areas where the population is relatively sparse. In addition, labour costs are generally higher in London than in other parts of the UK. This increases the relative cost of delivering public services in London.

3.10 In developing an alternative to Barnett, the goal should be to capture the variations in relative need that are driven by demographics, deprivation and costs in the simplest formula possible.

3.11 For any formula to be of practical use, it must be based on data that are available on a consistent basis across the UK. Moreover, the needs indicators selected should not be under the direct influence of any devolved administration, in order to avoid incentives for “gaming” the funding system. The indicators should also be simple to understand, measured to a high degree of accuracy and subject to periodic review. For these reasons, we have a preference for using census data where possible.

3.12 Table 3.1 summarises our proposed needs indicators, which in each case are defined relative to the average value for England.<sup>18</sup> Three of the indicators (ethnicity, ill health and sparsity) can be captured using census data. A further two indicators (the number of children and the number of retired persons) are estimated annually by the ONS, but those estimates are benchmarked to census data. The census does not include a question on earnings or wealth. A robust indicator of low income can be derived from statistics on social security and tax credit claimants. These are based on records of all claimants and are available on a consistent basis throughout the UK. We have therefore used this data source for our measure of income poverty.

3.13 While the set of indicators shown in Table 3.1 is both intuitively plausible and consistent with our selection criteria, we do not claim that it is the only basket of proxies that could be developed for the purpose of measuring relative need across the nations of the UK. That said, it is the best small set we have found in explaining actual expenditure variations while being intuitively comprehensible. We do not believe that any alternative set of proxies that complied with our selection criteria would produce radically different results from those presented in this Chapter.

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<sup>18</sup> The total population of a country is obviously the single most important factor in determining its budgetary allocation. Our analysis is conducted on a “per head” basis so it implicitly takes account of population.

**Table 3.1: Summary of indicators included in our assessment of relative needs (measured relative to the English average)**

	Need indicator	Description of variable	Source
Demographics: indicator 1	Number of children	Under 16 dependency ratio	Mid-year estimates
Demographics: indicator 2	Number of older people	Retired persons dependency ratio	Mid-year estimates
Demographics: indicator 3	Ethnicity	Percentage of the population that is from a minority ethnic group	Census
Deprivation: indicator 1	Income poverty	Percentage of the population claiming income-related benefits	DWP benefits database
Deprivation: indicator 2	Ill health	Percentage of the population with a long-term limiting illness	Census
Cost: indicator 1	Sparsity	Proportion of people living outside settlements of 10,000 people or more; in addition, our equation contains a variable to take account of the remoteness of the population of the Scottish islands	Census
Cost: indicator 2	London weighting	A variable that identifies inner London areas	N/A

## Developing a needs-based formula: an impartial approach

3.14 In order to use the needs indicators in Table 3.1 to calculate funding allocations for the different countries of the UK, it is necessary to decide how much importance should be attributed to each indicator. While we could as a Commission select weights that reflected our own views as to how much importance should be placed on a region's sparsity, how much on its prevalence of ill health and so on, we would quite reasonably be accused of making judgments that lack any empirical justification or political legitimacy.

3.15 Instead, we have taken as our starting point the actual budgetary allocations that are made to fund devolved activities across the countries of Great Britain.<sup>19, 20</sup> These real funding decisions are based on assessments of need that have been thrashed out over years and reflect decisions that are the responsibility of elected officials. We therefore take them as representing the "revealed preference" of governments.

<sup>19</sup> The analysis covers the combined budgets for health, education, local government, Sure Start and Supporting People. In aggregate, these activities account for approximately 80 per cent of the budget that is devolved to Wales.

<sup>20</sup> While our analysis of expenditure covers Wales, England and Scotland, the methods could also be extended to Northern Ireland.

3.16 Where possible, we have used funding allocations before the application of smoothing or damping procedures. This is because we are trying to identify budgetary decisions made on the assessment of need, rather than the practical reconciliation of such assessments with historical allocations.

3.17 Using regression analysis, we are able to calculate how important each of the indicators in Table 3.1 is in determining the budgetary allocations. This technique generates a weight for each needs indicator that is based on its importance in explaining spending decisions made by the UK Government in England and by the devolved administrations in Wales and Scotland.<sup>21</sup>

3.18 In reality the formulae used to allocate resources across Great Britain are varied and complex. However, our regression analysis has found that the simple need proxies in Table 3.1 are extremely effective at modelling real funding allocations: the proxies are able to explain over 95 per cent of the variation in funding across sub-regions of Wales, England and Scotland. This inspires confidence that they are effective in modelling government and implicitly societal preferences and therefore provide a reasonable basis for determining the funding needs of the devolved administrations.

3.19 The regression approach has enabled us to derive an equation to calculate the relative needs of the nations of the UK that requires us to make minimal independent judgments and is derived from actual spending allocations in the three countries. The formula we have developed is both simple (it contains only the need factors set out in Table 3.1) and also has a high degree of completeness (its strong explanatory power when applied to sub-regional funding allocations implies that it captures the relevant aspects of need).

## Implications of the formula for the funding of the devolved administrations

3.20 The needs formula introduced above combines the needs indicators set out in Table 3.1, weights each one in proportion to its importance in determining spending decisions in Wales, England and Scotland, and generates an overall relative need value for the countries of the UK. If applied to Wales, the formula produces an overall estimate of Welsh relative need of some 115 per capita, where the value for England is 100. This suggests, based on the relative needs of Wales and the importance attached to those needs by the UK Government and the devolved administrations, that Wales should receive £115 per person to spend on devolved activities for every £100 per person spent on comparable activities in England.

3.21 In our first report, we calculated the funding that Wales would receive from the UK Government were it treated as a region of England. We concluded that Wales would receive at least £114 per person for every £100 of comparable English spending. The fact that both of the approaches we have adopted have arrived at very similar estimates of Welsh relative need provides confidence in the robustness of our methods. In producing the estimate in our first report, we deliberately adopted methods that were “certain to produce a conservative overall estimate,

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<sup>21</sup> To the extent that governments in different countries disagree in their assessment of the relative importance of the various aspects of need when allocating resources, this is taken into account. In effect the weight given to each country's preferences is proportional to its population.

and likely to generate an underestimate of Welsh relative needs".<sup>22</sup> It is therefore unsurprising that the estimate of Welsh relative needs generated by our formula is a little higher than the estimate that was provided in our first report.

3.22 Scottish areas were included in the calculations to derive the needs formula and, if applied to Scotland, the formula generates an estimated need to spend of £105 in Scotland for every £100 spent per person in England for the same "basket" of devolved government functions. However, it should be noted that the functions devolved to Scotland are different from those devolved to Wales. Most importantly, law and order and justice are devolved in Scotland, but not in Wales, as are the proceeds from the non-domestic rating system. As a result, the programme areas covered by the allocations used to derive our needs formula are not as closely aligned with the block grant for Scotland as they are for Wales. The relative needs estimate for Scotland would therefore require adjustments, but as they stand are broadly indicative.<sup>23</sup>

3.23 Although expenditure data from Northern Ireland were not included in the process of estimating weights for each needs indicator, the indicators are available on a consistent basis and applying the same formula to Northern Ireland generates an estimated need to spend of £121 for every £100 spent per person in England on devolved activities. For similar reasons as those set out above in relation to Scotland, this result should be seen as only broadly indicative for Northern Ireland.<sup>24</sup>

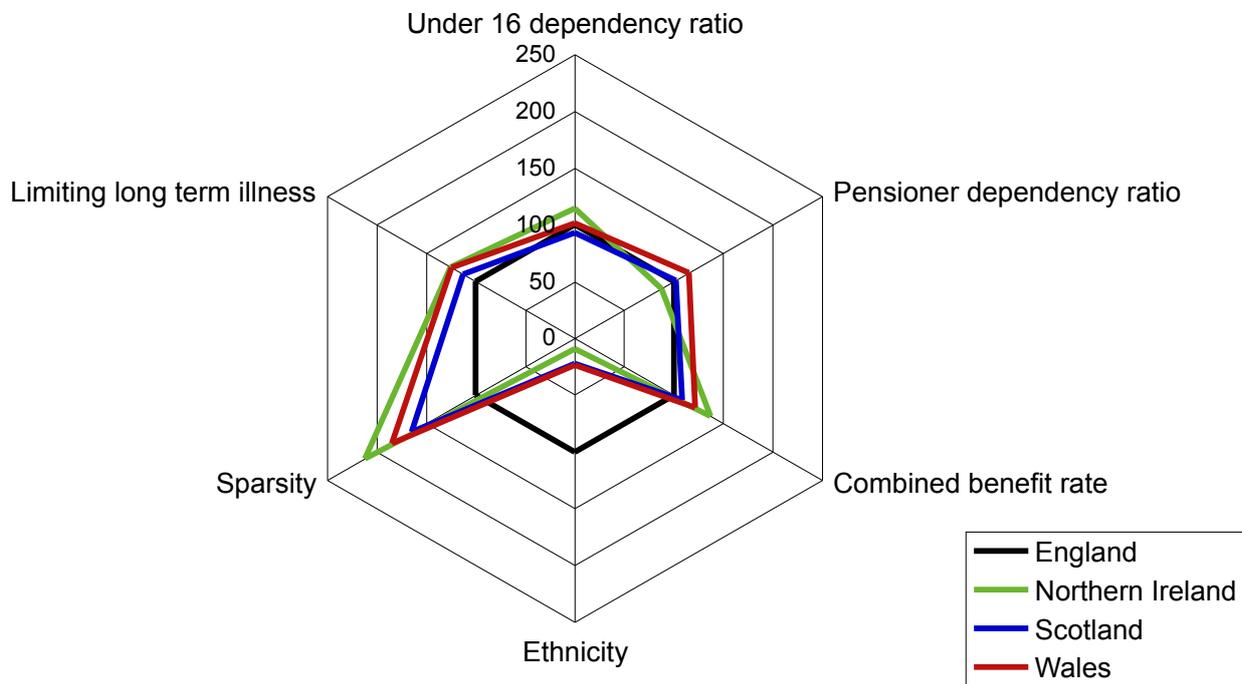
3.24 Chart 3.1 shows in graphical form that five of the six need factors contained in the needs assessment formula are higher in Wales than in either England or Scotland.<sup>25</sup> Ethnicity is the only need factor that is higher in England than in Wales. Four of the six need factors are higher in Northern Ireland than in the other three nations, the exceptions being the number of pensioners and ethnicity.

<sup>22</sup> Independent Commission on Funding and Finance for Wales, 2009 p.47.

<sup>23</sup> The Scottish household crime rate was 2,791 per 10,000 households in 2008-09, which is similar to the rate in England and Wales over the same period (2,831 per 10,000 households). The prison population in Scotland (1.44 per 1,000 population in 2007-08) was slightly lower than the comparable England and Wales figure (1.48 per 1,000 population). While not conclusive, this suggests that the costs associated with devolved policing and justice are unlikely to result in a major upward revision of the estimated relative needs of Scotland. Source: Scottish Crime and Justice Survey, British Crime Survey and ONS Regional Trends.

<sup>24</sup> Policing and justice were devolved to Northern Ireland in April 2010.

<sup>25</sup> Chart 3.1 replicates an approach to graphically illustrating a range of needs indicators that was presented in the House of Lords Select Committee on the Barnett Formula, 2009.

**Chart 3.1: Distribution of needs across Wales, England and Scotland (England = 100)**

Source: Commission calculations

## Possible modifications to the formula

3.25 We have attempted to minimise any introduction of our own judgment into the analysis but there are a couple of points where an alternative procedure would have been defensible and which would alter model allocations. In each country the local government funding regime is devolved and takes account of the ability of local authorities to raise their own resources via the council tax. However, this is not done on a consistent basis across countries, and the defined tax base in different areas bears no relation to the taxable capacity as indicated by house prices. We believe that a needs-based funding regime for the devolved administrations would have to take some account of variations in taxable capacity across countries, although a number of possible mechanisms for doing this can be envisaged, none of which is self evidently "correct". In order to preserve the simplicity of our approach we have therefore made no adjustment to local government funding allocations to account for differing taxable capacities, beyond that which is incorporated in the allocation formulae of each nation. In Annex 4 of our full report, we discuss one way of modifying our methodology to account for variations in taxable capacity, and show that adoption of this approach would generate a somewhat higher estimate of relative needs in Wales and the other devolved administrations than is obtained from the unadjusted data. The modification entails an adjustment to the local government formula allocations so that each local authority is assumed to make an equal tax effort relative to current property prices. This adjustment leads to an estimate of relative need per head in Wales of 116.

3.26 The Welsh Language Act 1993 requires public services in Wales to be provided in both Welsh and English “on a basis of equality”. This generates an additional need to spend on certain public services in Wales, notably education, which is analogous to the impact of ethnic diversity. A modification could be introduced to the formula to make some allowance for this need to spend - for example, an estimate of the number of people speaking Welsh as a first language could be added into the ethnic minority variable in the formula. An alternative approach could be to replace the ethnic minority variable with a language-needs indicator. A census-based indicator is available which identifies people who were born, or whose parents were born, outside the UK in non-English speaking countries. Again, this could be combined with an estimate of first-language Welsh speakers. Both of these modifications would increase the estimate of relative need per head in Wales to 116 (with England=100). Combining either of these with the local tax capacity adjustment described in paragraph 3.25 would produce a relative need estimate of 117 for Wales.

3.27 Adjusting the grant for parity of tax effort and to meet the requirements of bilingualism seems perfectly reasonable so it may well be that Wales should receive 117 per cent of average English expenditure per head. These are matters for political decision, however, on which we express no final view and in the remainder of the Chapter we continue to use 115 in illustrations of how the revised system would operate.

## Putting a new formula into practice

3.28 Our first report argued that an arm’s length body should be established to operate the new funding formula and to calculate annual budgets. This remains our view. It is highly desirable that the technical aspects of the funding regime should be, and be seen to be, managed independently of the parties that provide or receive funding.

3.29 The new funding formula should ensure that each devolved administration receives an allocation reflecting its needs relative to other areas. Then it has to fulfil two criteria, namely:

- i) it should ensure that changes in relative funding are aligned with relative needs; and
- ii) it should provide a mechanism to redress any over- or under- funding.

### i) Aligning funding changes with relative needs

3.30 At present, the devolved administrations receive an unhypothecated block grant that is carried over from one year to the next. As discussed in Chapter 1, changes to the grant (known as “consequentials”) are determined by the Barnett Formula, which is given in Equation 3.1 below:

$$\begin{aligned} \text{Change in block grant} &= \text{change in English spend} \\ &x \text{ Welsh population share} \\ &x \text{ comparability factor} \end{aligned} \tag{3.1}$$

3.31 We have sought to develop a mechanism that aligns relative funding with relative needs while also retaining the simplicity of Barnett. A subsidiary requirement may be to minimise changes to current procedures. With these objectives in mind, we propose that the current approach should be maintained for the calculation of increments, with the inclusion of a needs adjustment term in Equation 3.1 to ensure that funding consequentials are set at a level appropriate to the relative needs of each nation. The **needs adjustment term** would simply be equivalent to the relative needs of

each devolved administration as calculated by a relative need formula with variables like those set out in Table 3.1. In the case of Wales therefore the needs adjustment term would initially be set to 115 per cent.

3.32 Since our proposed approach for assessing relative needs is straightforward, it would in principle be possible to update the value of the needs adjustment term annually. However, in the interests of maintaining a regime that provides for stable and predictable budgets we propose that the needs adjustment terms for each country should be fixed for the duration of each spending review period (i.e. for three forward years).<sup>26</sup> Within each spending review period, the new formula for calculating changes to the block grant would be.

$$\begin{aligned}
 \text{Change in block grant} &= \text{change in English spend} \\
 &x \text{ Welsh population share} \\
 &x \text{ comparability factor} \\
 &x \text{ needs adjustment term}
 \end{aligned}
 \tag{3.2}$$

## ii) Closing the funding gap

3.33 As previously stated, our proposed needs formula estimates that Wales should receive £115 of funding per head for every £100 per head spent on devolved activities in England. If the overall level of funding for devolved functions in Wales happened to be at this level when the new funding regime was introduced (and assuming no change in relative populations), then Equation 3.2 would provide increments to Wales that were in line with Welsh relative needs and would maintain the overall funding position for Wales in its correct place. No further change to the funding formula would be required; Wales would receive its normal Barnett-style consequentials, multiplied by 115 per cent.

3.34 In practice, when the formula is introduced there will be a gap between the needs target derived from the needs assessment formula and actual level of funding received by each country. For example, in our first report we estimated that in 2010-11 Wales would receive around £112 for every £100 spent on devolved activities in England. On this basis the needs formula described above implies that Wales is under-funded by around £3 for every £100 spent in England.<sup>27</sup> This amounts to around £400 million of under funding in 2010-11. We would expect such a **funding gap** to be eliminated over a period of time rather than all at once and the overall formula would therefore include a transition mechanism to ensure that relative funding approached the needs target in a predictable way over a reasonable time period.

3.35 A simple approach to devising a transition mechanism would be to add a set proportion of the funding gap to the overall settlement each year, in addition to the budgetary changes that result from Equation 3.2. In the case of Wales, where current funding falls below relative need, this transition

<sup>26</sup> Census variables change only every ten years anyway; new income variables are available annually with a lag.

<sup>27</sup> This estimate was based on the outcome of the 2007 Spending Review and will be affected by more recent budget revisions and updated population estimates. More fundamentally, there are substantial uncertainties at the time of writing about the scale of in year budgetary changes, both in England and Wales, in 2010-11.

mechanism would result in an additional sum being added to the Welsh block grant each year until relative funding and relative needs were equivalent. If a country's relative funding were above its relative needs at the start of the new funding regime, the transition mechanism would subtract resources from the block grant until parity between needs and funding were achieved.

3.36 Our proposed funding formula, combining needs-based increments with a transition mechanism to close any funding gap, can therefore be expressed as follows:

$$\begin{aligned}
 \text{Change in block grant} &= (\text{change in English spend} \\
 &\quad \times \text{Welsh population share} \\
 &\quad \times \text{comparability factor} \\
 &\quad \times \text{needs adjustment term}) \\
 &+ \text{transition mechanism to account for any} \\
 &\quad \text{discrepancy between the needs-based} \\
 &\quad \text{assessment and the last block grant}
 \end{aligned}
 \tag{3.3}$$

3.37 The transition mechanism should ideally be the same for all the devolved administrations but should be sufficiently flexible in form to allow adjustment to occur at speeds appropriate to each. Since the funding gap for Wales is relatively modest in the context of total UK public expenditure, it should be feasible to align relative funding and relative needs over a fairly short period of time. The situation could be different in other devolved administrations - a country with a large funding gap might require a rule that prevented impractically large year on year reductions. In Annex 4 of our full report we consider the design of the transition mechanism along with a discussion of other technical issues.

3.38 While this system could operate effectively over several spending review periods, it would need to be subject to periodic review to ensure that the process of assessing relative needs continues to provide a fair reflection of needs across each devolved administration. We propose that once per decade the needs assessment formula set out in Table 3.1 should therefore be reviewed, with any amendments being subject to agreement of the UK Government and the devolved administrations. Since many of the variables in our needs assessment formula are derived from the census, it would make sense for the review to occur shortly after the publication of the latest census data.

## Recommendation - needs-based formula

The Assembly Government should pursue the introduction of a simple needs-based formula as the means of determining the Welsh block grant.

# Chapter 4: Tax devolution - evidence and constraints

## The feasibility of tax devolution

### International comparisons

4.1 Although the nature and extent of tax devolution varies widely across countries, most sub-national governments are funded to some degree by their own tax revenues. Sub-national tax revenues tend to be highest in federal states and in countries with highly decentralised systems of public services. The UK has a strikingly low proportion of tax revenue collected at the sub-national level, even by the standards of unitary states.

### Do sub-national taxes make people move or alter how much they work?

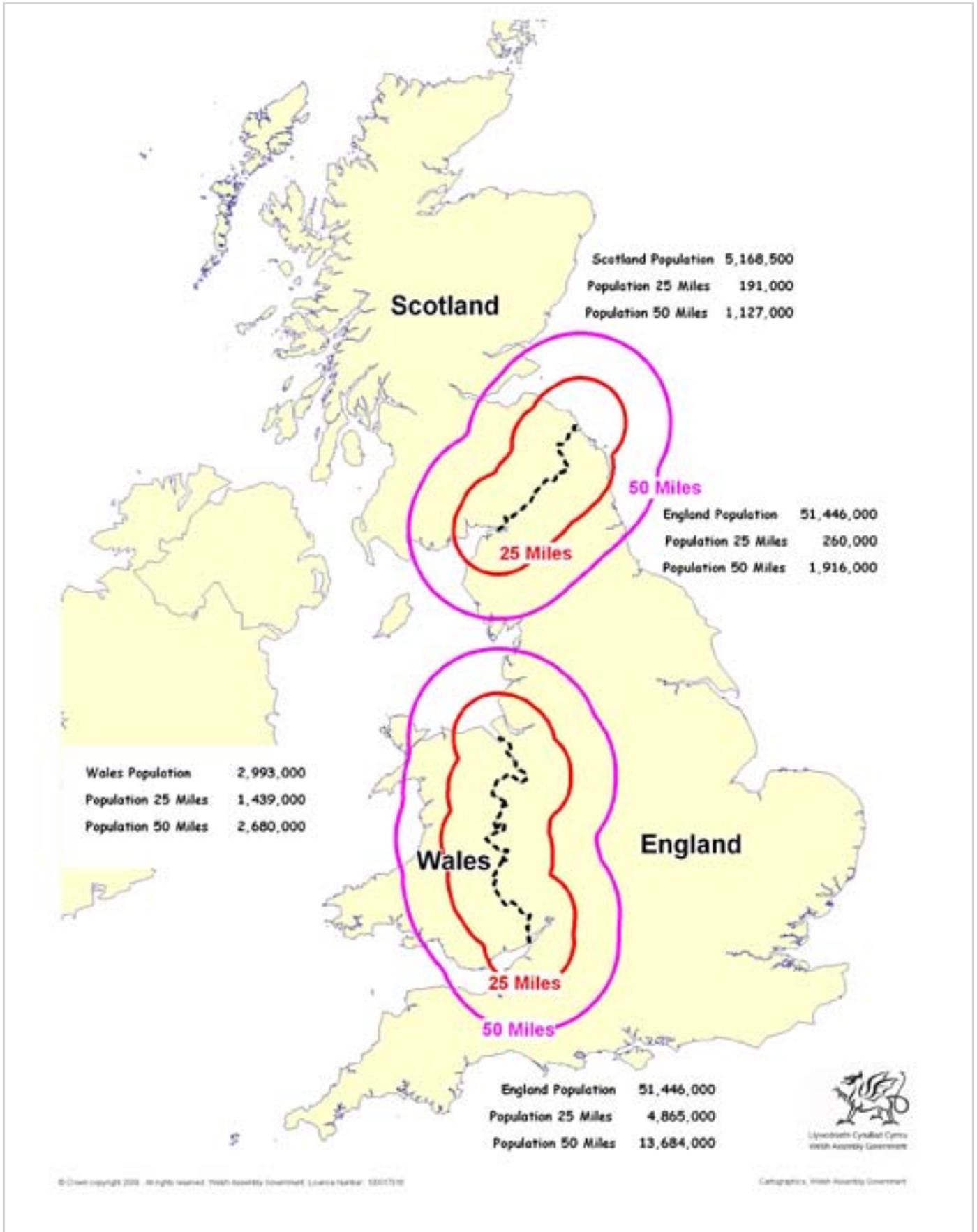
4.2 Overall, the empirical evidence does not provide conclusive guidance on whether Wales should have tax devolution or how much. However, it is possible for relatively small sub-national states or regions to operate different tax policies from their neighbours within an integrated economy. That said, such tax differences are likely to induce migration between regions, and some changes to work practices for those who do not move. The magnitudes are uncertain but both the migration and the work response are disproportionately likely among the affluent, while migration is also a more likely response among the young and highly skilled to different sub-national tax burdens.

## Tax devolution: socio-economic constraints specific to Wales

4.3 The economy in Wales is very highly integrated with England. Chart 4.1 shows that over 1.4 million people in Wales (48 per cent of the total) live within 25 miles of the border with England, and 2.7 million people (90 per cent of the total) live within 50 miles of the border. The number of people living close to Wales on the English side of the border is even larger - almost 4.9 million and 13.7 million people in England live within 25 and 50 miles of the border with Wales respectively. In aggregate, 30 per cent of the population of Wales and England, or over 16 million people, live within 50 miles of the border between the two countries. In contrast, only five per cent of the combined population of Scotland and England, around three million people, lives within 50 miles of the border between those countries.

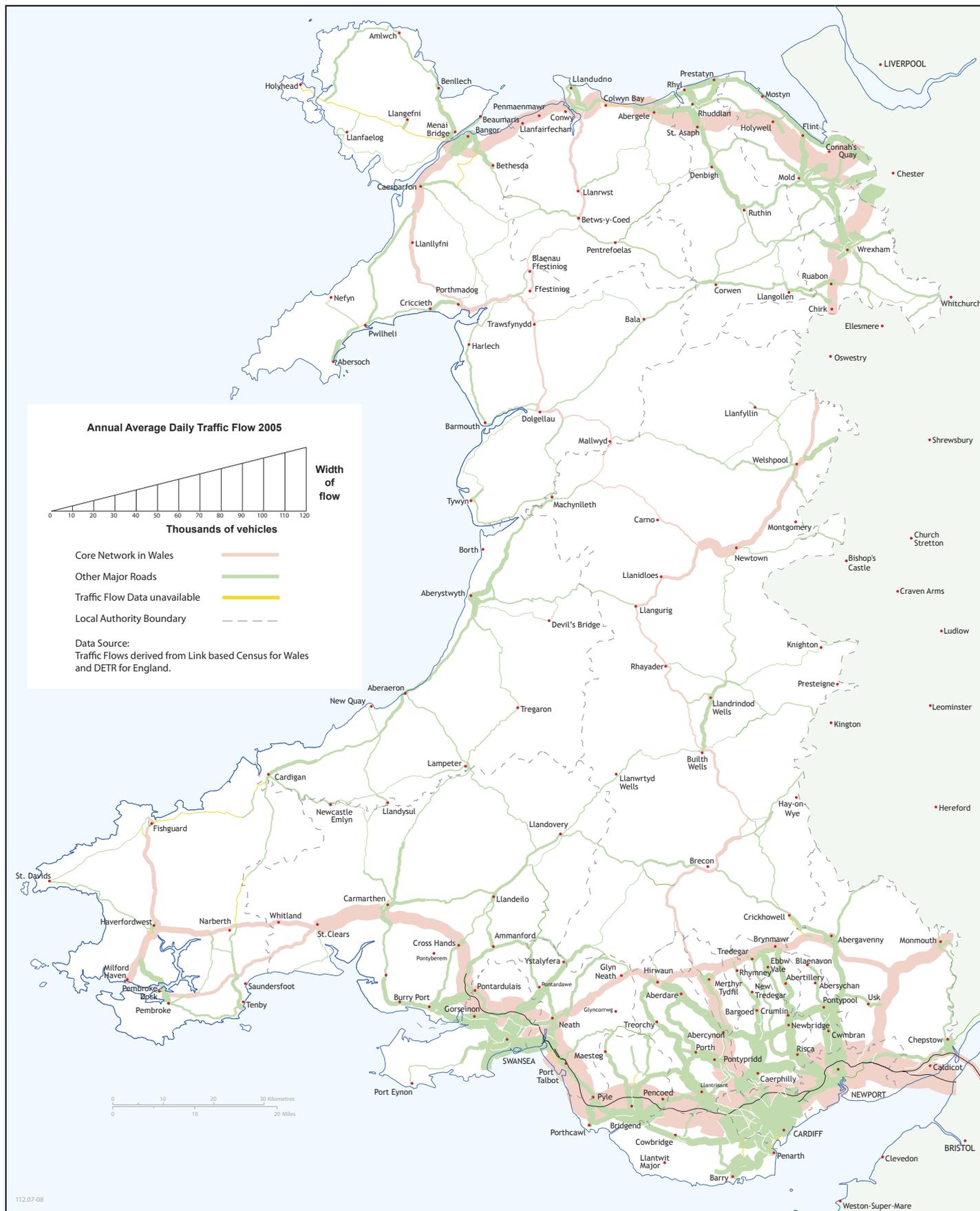
4.4 Traffic flows across the Wales-England border are very substantial; every day around 100,000 people travel between Wales and England for work. North East Wales is highly integrated into the economy of Merseyside and North West England, while in South Wales the bulk of traffic movement is focused along the M4 corridor. Chart 4.2 shows that journeys in Wales are largely East-West, with relatively little North-South movement. Any tax devolution must take account of such economic integration.

Chart 4.1: Populations close to the Wales - England and Scotland - England borders, 2008



Source: ONS LSOA and SNS Data Zone

Chart 4.2: Traffic flows in Wales, 2005



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Base map derived from digital data supplied by Lovell Johns Ltd., Oxford

Cartographics, Welsh Assembly Government

Source: Welsh Assembly Government

## Revenue raised by UK-wide taxes in Wales

4.5 Table 4.1 provides an estimate of the revenues raised in Wales by each of the taxes that are collected for the UK exchequer (see Annex 5 of our full report for further information on how those values were estimated). In aggregate, around £17 billion was raised in Wales in 2007-08, the most recent year for which robust data are available. This sum amounts in total to more than the entire Welsh block grant in the same year (around £13 billion). In addition, council tax and non-domestic rates (NDR) are paid by Welsh citizens and businesses to fund part of the services that are provided by local authorities. In 2007-08, council tax raised £0.9 billion in Wales (net of council tax benefit), while NDR raised £0.8 billion. In aggregate, the total amount of taxes raised in Wales in 2007-08 was therefore a little under £19 billion.

4.6 The Welsh block grant accounts for only slightly more than half of total identifiable spending on public services in Wales. Most of the rest is accounted for by social security, tax credit and public sector pension payments. In aggregate, total identifiable expenditure in Wales in 2007-08 was £25 billion, around £6 billion more than tax receipts. This is commonplace given Wales's relatively high needs. Out of the devolved countries and the nine English regions, only London and the East and South East of England have fiscal surpluses.<sup>28</sup>

**Table 4.1: Revenues raised in Wales by UK-wide taxes, 2007-08**

Tax	Approx value (£ billion)
Income tax	5.2
National insurance contributions	3.7
Value added tax	3.6
Corporation tax	1.5
Fuel duty	1.2
Alcohol and tobacco excise duties	0.8
Vehicle excise duty	0.3
Stamp duty	Land tax: 0.2 Other: 0.1
Capital gains tax	0.1
Betting and gaming duties	0.1
Inheritance tax	0.1
Insurance premium tax	0.1
Landfill tax	0.04
Climate change levy	0.04
Aggregates levy	0.03
Air passenger duty	0.01
<b>Total</b>	<b>17.1</b>

Source: HMRC, Driver and Vehicle Licensing Agency and Commission calculations

## Which taxes are the best candidates for devolution?

4.7 In this section, we review the taxes that are collected across the UK and consider their suitability for devolution to Wales. We have assessed each tax against the following criteria.

- i) **Accountability.** The case for devolution of tax-varying powers to Wales is based on the need to enhance the accountability of the Assembly Government to citizens in Wales. Tax devolution should enable Welsh Ministers, at the margin, to increase or reduce the overall size of the Assembly Government's budget, and to do so in a manner that is apparent to Welsh citizens. An ideal tax that enhanced accountability would therefore be one that:
  - a) is paid by a high proportion of Welsh residents;
  - b) raises substantial revenue;
  - c) is "visible" to most citizens; and
  - d) is well understood by the general population.
- ii) **Economic efficiency.** It is important that tax devolution should not provide individuals or firms with strong incentives to alter their behaviour solely in order to reduce their tax burden.
- iii) **Administrative efficiency.** The devolution of a particular tax should not impose substantial additional administrative burdens on citizens or firms, and should not increase the cost of collection unreasonably.
- iv) **Policy relevance.** Certain taxes may be useful as policy levers, providing a tool that helps Welsh Ministers achieve their policy goals.
- v) **Legal constraints.** Devolution of a tax has to be consistent with European law.
- vi) **Impact on the UK tax base.** In handing control over a specific tax to the Welsh authorities, it is important to limit the risks to the UK tax base.

4.8 Of course, no tax wholly meets all of those criteria. We therefore have to judge the extent to which each tax possesses some of the characteristics that make it a candidate for devolution, and to weigh those factors against the extent to which it also has features that make it less suitable for devolution. Assessed in that way, we see no case for devolving the following taxes to Wales:

- income tax on savings and dividend income;
- national insurance contributions;
- value added tax;
- fuel duty;
- alcohol and tobacco excise duties;
- vehicle excise duty;
- stamp duty on shares;

- capital gains tax (other than capital gains tax on property and land, which is discussed in Chapter 7); and
- betting and gaming duties;
- inheritance tax;
- insurance premium tax; and
- climate change levy.

4.9 Devolving those taxes would either create unacceptable distortions or the cost of devolving and monitoring them would be excessive. Our thinking in ruling out those taxes is explained in more detail in our full report. That leaves the following taxes for more detailed consideration:

- income tax (excluding income tax on savings and dividend income);
- corporation tax;
- taxes on property and land;
- minor taxes with a relatively immobile base and which may be of value as policy levers (landfill tax, aggregates levy and air passenger duty); and
- new taxes, which could be levied by the Assembly Government on goods or activities that are currently untaxed at the UK level.

4.10 Income tax is by far the strongest candidate on this shortlist that could, if devolved, have a major impact on the accountability of the Assembly Government to Welsh citizens. It is highly visible, raises substantial sums and is paid by almost everyone at some point in their lives. If income tax could be partially or wholly devolved to Wales, the accountability deficit in the current funding settlement would be largely resolved.

4.11 In theory, property taxes could also have a significant impact on accountability. However, property taxation in the form of council tax already provides accountability for local government. Devolution of the remaining taxes on our shortlist would have only a limited impact on accountability. They raise much less revenue than income tax, and they are paid either by firms (corporation tax, aggregates levy, landfill tax) or intermittently by sub-groups of the population (air passenger duty, stamp duty land tax).

4.12 It is also possible to conceive of a number of new taxes that could be introduced in Wales in areas such as tourism, natural resource depletion or alcohol consumption.

4.13 In the next Chapter, we discuss how any tax devolution should affect the block grant and consider the main risks to the Welsh budget that would arise. In Chapter 6, we consider in detail the case for income tax devolution to Wales as a means of tackling the accountability deficit. We then discuss in Chapter 7 whether devolution of the remaining taxes on our shortlist would be advisable, and we consider how a mechanism enabling the introduction of new taxes might be developed.

# Chapter 5: Tax devolution and the block grant

## Risks to the Welsh budget

5.1 Devolution of tax-varying powers, in replacing a portion of the block grant with a stream of devolved tax receipts, has the potential to expose the Welsh budget to a number of risks that are, at present, managed at the UK level. There are three main risks associated with devolved tax receipts.<sup>29</sup>

- i) **Macro fiscal or cyclical risk.** Some tax receipts are highly cyclical with significant year on-year volatility.
- ii) **Differential tax base growth.** This is the risk that the tax base in the devolved administration grows differently from the equivalent tax base across the UK as a whole and therefore over time generates differing levels of resources for the devolved administration than it would have received from a grant-based regime that is ultimately sourced from the UK tax base.
- iii) **Policy risk.** If powers over the overall structure of a devolved tax (such as the size of the bands and allowances in the case of income tax) are retained at the UK level, there is a risk that a policy change by the UK Government could have a large impact on the revenue raised by the devolved tax. We refer to this as UK policy risk. Similarly, Welsh policy risk arises if decisions by Welsh Ministers impact on the Welsh tax base and affect the revenue raised by a devolved tax.

5.2 Risks consequent on the actions of the Assembly Government should be borne by its budget and risks consequent on the action of the UK Government should be borne by UK budgets. Risks outside government control and arising from elsewhere should be pooled across the union. It follows that in principle the Welsh budget should be sheltered from cyclical and UK policy risk, as those are not under the control of Welsh Ministers. Differential tax base growth may stem from outside forces or be the result of Welsh policies. It is highly unlikely that those different effects could be disentangled in practice, making it impossible to develop a funding system that allocates risks across the governments of the UK in an ideal way. That must be taken into account when “pricing” a devolved tax.

## Pricing devolved tax revenues

5.3 When a tax is devolved, Welsh Ministers exchange a stream of block grant revenue, funded from UK tax revenues, for taxes that are levied in Wales. The “price” paid by Welsh Ministers for those devolved tax receipts is a combination of:

- i) the reduction in the block grant that takes place at the time of devolution; and
- ii) the way in which that deduction is calculated in subsequent years.

<sup>29</sup> We are grateful to Professor David Heald for a submission that provided useful advice on the different types of risk introduced to devolved budgets as a consequence of tax devolution.

5.4 When deciding on a fair price, a range of economic and non-economic factors must be taken into account. From an economic perspective, the fair price depends on the following features of the tax:

- i) the tax yield;
- ii) the expected growth rate of the tax (faster growth makes the devolved tax more attractive);
- iii) the volatility of the tax (relatively volatile revenues are less attractive because they introduce unpredictability into the devolved budget); and
- iv) the extent to which the tax revenue is correlated with other devolved receipts (a tax that is highly correlated with other devolved revenues is less attractive as it amplifies swings in the budget).

5.5 Those factors will vary from one tax to another. A high-yielding, stable tax, whose receipts are expected to grow rapidly should not be priced in the same way as a tax with low, volatile yields that are in long-term decline.

5.6 There are several non-economic reasons why tax devolution might be desirable, which may alter the price that Ministers are willing to pay. For instance, a tax may provide a valuable instrument that makes it easier to achieve policy objectives in an area of devolved responsibility. There may also be a value in devolution for its own sake, i.e. as a demonstration of the autonomy of the devolved administration. The attitudes of the devolved administration and the UK Government towards risk are also relevant factors in determining a fair price for devolving a tax. While we are unable to put a value on non-economic reasons for tax devolution, by making certain assumptions about attitudes to risk it is possible to very roughly indicate the sort of deal that might be appropriate for any candidate tax. This is discussed further in the full report (Chapter 5 and Annex 7).

## Chapter 6: Addressing the accountability deficit - income tax devolution

### Income tax revenue raised in Wales

6.1 Table 6.1 provides estimates of the revenue raised from income tax in Wales in 2009-10 (excluding savings). It shows that income tax was paid by almost 1.4 million people in Wales in that year, and generated around £4.2 billion in receipts.<sup>30</sup> It is clear therefore that devolution of control over some or all of income tax in Wales to the Assembly Government would much increase its accountability to Welsh citizens.

**Table 6.1: Estimated number of income tax payers and revenue raised in Wales, excluding savings and distributions, 2009-10**

Marginal rate of taxpayer	Taxpayers (000s)	Revenue (£ million)
Basic	1,280	2,850
Higher	90	1,300
<b>Total</b>	<b>1,370</b>	<b>4,150</b>

Source: HMRC and Commission calculations

### Analysing the economic effects of devolving income tax to Wales

6.2 Direct evidence of the effect of different sub-national income taxes in the UK is lacking and we must rely on inferences from foreign studies and from looking at the costs and benefits of moving. Substantial uncertainties remain but the following findings are reasonably robust:

- i) small differences in basic rates of income tax (up to around three pence) between Wales and England could be sustained over a period of time without being likely to induce significant migration or changes to labour supply;
- ii) a small increase in the Welsh basic income tax rate relative to the UK has the potential to generate substantial additional revenue for the Assembly Government (although the exact revenue impact will depend on what share of income tax is devolved to Wales);
- iii) high earning individuals would be most likely to move or alter their behaviour in response to a change in Welsh income tax rates. The loss of a small number of high earning individuals could have an appreciable impact on the Welsh income tax base;
- iv) increasing the higher rate, it appears, would at best raise little additional revenue and would be quite likely to substantially reduce the income tax paid by Welsh residents;

<sup>30</sup> A discussion of the methodology used to derive the estimates in Table 6.1 and subsequent analysis in this Chapter is provided in Chapter 6 and Annex 5 of the full report.

- v) decreasing the higher rate could potentially raise significant sums (though we cannot reliably quantify this effect), as high earning individuals in England would have an incentive to have a Welsh residence for tax purposes; and
- vi) variations in the higher rate would have to be limited if a serious degree of tax avoidance is to be prevented.

6.3 We conclude that devolution of some aspects of income tax is feasible and would enhance the accountability of the Assembly Government to its electorate. This would apply to tax on earned incomes. Income tax on savings would be too prone to avoidance if devolved and should remain at the UK level.

## What rate-setting powers should be devolved?

6.4 At present, the Scottish Government is able to vary the basic rate of income tax by up to three pence above or below the basic rate that is applied across the UK. The Calman Commission proposed that this power should be replaced by a new Scottish rate of income tax, which would be applicable to all tax bands. UK income tax rates in Scotland would be reduced by ten pence, with a corresponding once and for all proportionate reduction in the Scottish block grant. The Scottish rate could be set at the “default” rate across all bands (currently ten pence) that would restore the total rate of income tax in Scotland to the UK level. Alternatively, if the Scottish rate were set above / below the level necessary to restore total income tax rates in Scotland to the UK level, then the overall resources available to Scotland would increase / decrease.

6.5 If implemented, the Calman Commission’s recommendation would mean that a change in the Scottish rate of income tax would affect the marginal rate of all income tax bands by the same amount. Whatever the merits of that proposal in the Scottish context, our analysis suggests that it would be problematic for Wales. Our estimates show that increasing the marginal income tax rate faced by higher rate payers in Wales would be unlikely to raise substantial revenue even assuming no migration or behavioural response. Once an allowance is made for those factors, the net budgetary effect could well be negative. An insistence that any increase in taxes must apply across all income tax bands could reduce its revenue yield and perhaps reduce the likelihood of such powers ever being used. While Welsh Ministers might choose to increase tax rates on high income individuals to satisfy their principles of fairness, it seems unreasonable to require them to do so, given that such an increase could well have a negative overall impact on the budget. Our objective is not to second-guess what Welsh Ministers will wish to do but to propose a system that maximises their freedom of action without biasing the choices they face.

6.6 That points to an alternative of giving Welsh Ministers powers to vary basic and higher income tax rates separately. In such circumstances, they might raise taxes but another response might be to cut the higher rate in order to attract high earning individuals into Wales. While it is not possible to estimate the impact of such a policy precisely, the financial incentive for those with very high incomes to acquire a Welsh residence could be substantial. A policy of reducing the higher rate of tax could therefore generate additional revenues for the Assembly Government by attracting high earners.

6.7 While small differences between the top rate in Wales and the rest of the UK may be acceptable to the UK Government especially if, as a result of such a policy, Wales might require a smaller needs-based block grant, there would be very understandable reluctance to give Welsh Ministers the power to set tax policy in a way that caused significant harm to the UK tax base. We believe that an acceptable compromise would be to enable Welsh Ministers to set the basic and higher rates separately, but that the extent to which rates could vary from the UK rate should be constrained. We propose that income tax rates in Wales should be allowed to vary by no more than three pence relative to the UK. If that proposal is not accepted, a second best fallback would be to devolve powers to vary the basic rate only. We believe that any proposal which constrains the devolved administration to move rates in a way that impacts at the margin on both basic and higher rate taxpayers is not appropriate for Wales.

## **How should income tax revenue interact with the block grant?**

6.8 We recommend that in the first year of operation, the block grant would be reduced by an amount equivalent to the additional resources allocated to Wales from Welsh income tax revenue. In subsequent years, the offset would be recalculated based on the growth of the corresponding income tax bases across the UK.

## **How much of each income tax band should be devolved?**

6.9 The greater the share of the block grant that is replaced by devolved income taxes, the larger is the Welsh budget's exposure to the risk of differential tax base growth. There is no way of identifying precisely the optimal amount of that risk that should be borne by the Welsh budget, but we have a preference for devolving a constant proportion of each band so the most straightforward approach would be to devolve half of income tax rates across all income bands. That implies that ten pence of the basic rate, 20 pence of the higher rate and 25 pence of the new top rate of 50 pence should be devolved to Wales.

## **Allowances and thresholds**

6.10 We believe that income tax thresholds and allowances should remain under UK Government control. Tax liability in the UK is calculated by applying rates after all other calculations have been made. Applying different rates to taxpayers with a different residence tax code is a manageable business, but the complexity and cost of administering the system would rise sharply if the rules governing the tax base varied across the UK.

## **Making a tax decision**

6.11 To make clear its accountability to its citizens, the National Assembly should take an annual vote on Welsh rates of income tax.

## Recommendation - income tax

The Assembly Government should acquire limited powers to vary income tax rates in Wales.

- i) The basic and higher rates of income tax in Wales should be reduced by ten pence, 20 pence and 25 pence. The block grant should be reduced by an equivalent amount in the first year of the new system. In subsequent years, the size of the block grant deduction should be calculated to reflect the growth of the relevant income tax bases across the UK as a whole.
- ii) The National Assembly should vote annually to set Welsh income tax rates, which would be additional to the reduced UK rates that would apply in Wales.
- iii) Welsh Ministers should ideally be able to vary separately all rates of Welsh income tax. Income tax rates in Wales should be allowed to vary by no more than three pence relative to the prevailing rate in the UK. If this recommendation is not accepted, a second best alternative would be to devolve powers to vary only the basic rate.
- iv) The UK Government should retain responsibility for income tax on savings and distributions, and for designating income tax bands, allowances and thresholds.

# Chapter 7: Devolution of other tax-varying powers to Wales

## Candidates for devolution: corporate taxes

### Corporation tax

7.1 Several submissions to the Commission have suggested that corporation tax should be devolved to Wales. Indeed it has been argued forcefully to us that some transformational change is required to improve Wales's relative economic performance within the UK and no other single change would be likely to be as effective as giving Welsh Ministers the scope to reduce corporation tax.

7.2 There are no published statistics on corporation tax receipts in Wales but estimates range from £600 million to £1.2 billion, depending on the method used. Corporation tax receipts at a UK level, excluding North Sea oil have been volatile since the late 1990s, falling from £30 billion in 2000-01 to £25 billion in 2003-04, before rising to £40 billion in 2007-08 and then declining sharply to £32 billion the following year. The finance sector is responsible for much of the volatility but Welsh receipts would also be volatile.

7.3 The former UK Government considered and rejected the case for devolution of corporation tax to Northern Ireland following the Varney Review.<sup>31</sup> However, we note that the Government formed following the May 2010 general election is committed to "producing a government paper examining potential mechanisms for changing the corporation tax rate in Northern Ireland".<sup>32</sup>

7.4 It is evident that varying corporation tax in different parts of the UK raises issues at both the UK national and the European level and these may be in conflict. The UK Government would presumably wish to ensure that any variation was implemented in a way that was regionally equitable and not costly to HM Treasury. Yet devolution would also have to be consistent with European law, which precludes tax systems that could be interpreted as State aid to some businesses at the expense of others.

7.5 Our starting point is that the need for economic development is not identical with the need for expenditure on public services. The latter need is best measured by the kind of factors we discussed in Chapter 3, but a development need is indicated better by relative levels of GVA per head. One theoretical approach could be to make changes to the rate of corporation tax that were proportional to the difference between GVA per head in a given region and the UK average.

7.6 Companies wishing to claim the discount would have to demonstrate economic activity in the region concerned. This should not be a "brass plate" exercise; the location of head office would not be relevant. Corporation tax liability would depend on the location of economic activity. Evidently that could be defined in various ways but many countries, including the USA, have well tried formulae for allocating corporation tax bases across regions.<sup>33</sup> The simplest approach would be to allocate liability by proportion of payroll with the stipulation that payroll administration has to follow the physical

<sup>31</sup> Varney, 2007.

<sup>32</sup> HM Government, 2010 p.28.

<sup>33</sup> See Donald and Douglas, 1996, for a summary.

location of the employees. Once activity is assigned to different regions it becomes possible for the tax rate to vary by region. It would be for the company to establish the location of its activities.

7.7 In principle, the most straightforward way of varying corporation tax across the UK would be for this to be done by the UK Government; corporation tax would remain a UK tax, with no implications for devolved administration budgets. The tax would be collected by HMRC and receipts would accrue to the UK Government as at present. However, a scheme of this nature is highly likely to be challenged under European law and may very well be ruled out by the State aid argument.

7.8 The extent to which corporation tax can be permitted to vary within a decentralised EU member state in order to promote economic development has been the subject of recent legal dispute. A decision by the Portuguese Government to enable the government in the Azores to set a lower corporation tax rate in order to promote economic development was challenged by the European Commission (EC). In response, the European Court of Justice ruled against the Portuguese Government on the grounds that the government in the Azores was “insufficiently autonomous” from the central government. This was because the reduction in tax revenue which might result from reductions in taxes in the Azores was offset by a financing mechanism which involved a budgetary transfer from the Portuguese central government.

7.9 The most secure way of enabling corporation tax to vary in Wales relative to the UK therefore is to devolve the tax and to structure the powers devolved to Wales and their budgetary consequences in a way that falls within the Azores criteria. To comply with Azores the decision on whether to reduce the corporation tax rate would have to reside exclusively with the Assembly Government as would the extent of any reduction, up to the GVA-determined limit. It could be argued that the mere existence of an agreed limit to any cut compromises the “autonomy” of the devolved administration. Ultimately we must leave such questions to the lawyers but a European judgment subsequent to Azores offers hope that autonomy is not necessarily vitiated by an agreement between the central government and devolved administration where it set out pre-established limits on the competence of the devolved administration.<sup>34</sup>

7.10 Full devolution of corporation tax in a way that allowed Welsh Ministers to set rates within constraints that were determined by reference to relative GVA is an option worthy of consideration, although it would carry acute budgetary risks. Those risks would have to be weighed against the potential of the tax as a development tool. In the first place, when the tax was devolved its current receipts would be deducted from the block grant, as with any other devolved tax. If disparities in relative GVA were sufficiently large to permit the devolved administration to lower the tax, it would bear the full cost of the reduction on its own revenues - which is necessary to conform to the Azores judgment. Devolution would also introduce substantial unwelcome volatility into the Welsh budget.

7.11 Evidently a great deal of preparatory work would have to be undertaken before any such schemes could be evaluated and introduced. In particular, the compatibility of any proposals with European law would need careful study. Nonetheless, we consider those issues to be worthy of further consideration though we do not assume the Assembly Government will necessarily wish to proceed. We recommend that the Assembly Government confer with the UK Government and the other devolved administrations to investigate the feasibility of devolving corporation tax.

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<sup>34</sup> See Annex 5 of our full report on the “Rioja cases” (Paragraphs A5.38-A5.54).

7.12 Meanwhile, an alternative way for Ministers to lower the burden of taxes on businesses in Wales (should they wish to do so) would be by exercising the existing devolved powers to lower NDR. Below we discuss those powers and consider the case for greater devolution.

## Recommendation - corporation tax

The Assembly Government should seek discussions with the UK Government and the other devolved administrations about the feasibility of devolving corporation tax

### Non-Domestic Rates (NDR)

7.13 NDR, or business rates, are levied on the occupiers of non-domestic properties and are the means by which businesses and other occupiers of non-domestic property contribute towards the costs of local authority services. NDR raised £0.9 billion in Wales in 2008-09.

7.14 Powers over NDR are partly devolved to Wales but the budgetary impact of varying NDR is complicated. NDR is collected by local authorities, but the revenue raised is pooled at the all-Wales level and redistributed to councils along with the Revenue Support Grant (RSG) that the Assembly Government provides to fund council services. Changes to the Assembly Government's overall resources depend on consequential effects from the distribution of NDR receipts in England, which affect the Welsh Departmental Expenditure Limit (DEL) via the Barnett Formula.

7.15 The Assembly Government has powers to lower NDR by offering rate relief. Increases in the tax rate do not raise the overall level of resources available to the Assembly Government. Any additional tax effort by Wales relative to England would simply result in fewer resources being provided by the UK Government. If NDR were fully devolved (as it is in Scotland), it would generate additional volatility in the Welsh budget, as shortfalls or windfalls in actual NDR receipts compared to planned receipts would no longer be offset in-year by the UK Government.

7.16 Given that Wales already has significant powers to lower NDR and is unlikely to want to increase the tax relative to England, we see little case for further devolution since that would result in additional budgetary volatility for little real enhancement of tax-varying power.

### Candidates for devolution: property taxes

7.17 In principle, property taxation is an appealing source of revenue for a devolved administration because the tax base is immobile. In addition, the value of residential property in Wales is approximately £200 billion so the base is a very large one. However, property is already taxed in Wales through the council tax, which is administered by local authorities with the resources being allocated specifically to fund council activities. It therefore plays a central role in underpinning the accountability of local government, which we have no wish to change. Council tax has an important role in helping to finance the Welsh public sector seen as a whole, and in that context we can ask whether it is as well designed and exploited as it might be. Of course we recognise a political constraint: that property taxes, while admired by economists, tend to be more unpopular with the general public than other taxes because they typically take the form of large lump sum demands that are not automatically withheld with transactions or cash flows.

7.18 In addition to council tax, property is subject to certain taxes when it is traded. Properties and land are liable for stamp duty land tax at the point of purchase, and capital gains tax is also levied on the sale of land and properties (other than primary residences).

### Council tax

7.19 Council tax in Wales is levied on residential properties by local authorities and is partly a tax on property and partly a charge for locally-provided services. All homes are allocated to one of nine bands (labelled A-I) based on their market value as at 1<sup>st</sup> April 2003. The council tax rate for each band is a fixed fraction or multiple of the rate for a Band D property. Homes occupied by students or by a single person qualify for a discount on the council tax, while those on low incomes have the tax paid in full in the form of council tax benefit. In 2008-09, council tax raised £1.2 billion in Wales (including council tax benefit).

7.20 Local authorities retain their council tax receipts, which on average finance around 17 per cent of their revenue expenditure. The rest of their budget comes from the Assembly Government in the form of the RSG, NDR and specific grants. The RSG is allocated via a detailed formula that seeks to allocate resources to local authorities on the basis of relative need, and which takes account of the ability of each area to raise council tax. The funding formula is operated by the Assembly Government but is agreed with local authorities. Council tax therefore forms one element of an intricate local authority funding regime.

7.21 There is understandable wariness about reforming local taxation after the experience of introducing the community charge in 1989-90. A comprehensive review of local government finance that was commissioned by the UK Government and was published in 2007 concluded that the council tax remained fit for purpose, while suggesting gradual reform.<sup>35</sup> Nonetheless council tax has a number of disadvantages and it is therefore worth considering whether Wales could adopt reforms to the general advantage.

7.22 Council tax is regressive with respect to property values and income, as the tax rate for higher value properties increases more slowly than the value of the property band to which it relates and it accounts for a lower proportion of income for those on higher incomes. However, personal discount components and council tax benefit mitigate its regressive aspects with respect to income.

7.23 Wales is ahead of England in improving the way in which council tax is implemented. Whereas the English council tax regime continues to be based on 1993 property values, Wales held a revaluation exercise in 2005, and has a statutory commitment to a further revaluation by 2015. An extra band (for properties over £424,000) was also introduced in Wales at the time of the 2005 revaluation.

7.24 There is a good case for taking those reforms further by creating additional bands at the upper end of the distribution and by shortening the ten year revaluation cycle that is currently in place. It may be that a substantial reform of the current system would be desirable, involving the introduction of many more bands, with rates linked directly to current property prices through summary annual revaluations using some form of indexation but further work is necessary to determine exactly how far reforms should be taken.<sup>36</sup>

<sup>35</sup> Lyons, 2007.

<sup>36</sup> While Welsh Ministers have the ability to alter the number of council tax bands, their legal power to increase the number of bands so greatly that the system approximates one of point valuation is uncertain. Such a reform might therefore be beyond the scope of current devolved powers.

7.25 It is ultimately a matter of political judgment to determine the appropriate relationship between property values and council tax. The calculation is complicated by the hybrid nature of the council tax; indeed, there could be an advantage to making the user charge element explicit as a way of making the tax more transparent and hence more acceptable.

7.26 Property provides a large and immobile tax base, capable of raising substantial sums. In terms simply of revenue raised, the current council tax regime is equivalent to a property tax rate of around 0.65 per cent on average. If this were increased to, say, 0.8 per cent, an extra £300 million would be raised in Wales. It is therefore clear that the property tax regime should be kept in good order so as to increase the acceptability of the tax and to ensure that this source of revenue can make its full contribution to financing Welsh public services.

### **Council tax on second homes**

7.27 Second homes are eligible for a council tax discount of up to 50 per cent, at the discretion of the local authority but there is no scope for local authorities to charge second home owners more than the standard council tax. While second home owners are likely on average to place fewer demands on public services, a case could also be made that high rates of second home ownership in an area can have negative externalities by, for example, putting upward pressure on property prices and making it difficult for local people to buy homes in their communities.

7.28 Local authorities should be empowered to determine whether council tax on second homes should be set at a discount or a premium to the standard charge. If second home ownership is welcomed, a discount might be appropriate, but in areas where it is felt that the negative consequences of second home ownership outweigh the benefits, it should be open to local authorities to reflect those harmful impacts in the council tax levied on second home owners.<sup>37</sup>

### **Capital gains tax on property and land sales in Wales**

7.29 Capital gains tax is levied on profits or gains made following the sale or disposal of a range of assets, including certain land and property transactions. For many assets, such as shares and other financial instruments, devolution of capital gains tax is not practical or desirable as there would be substantial scope for tax avoidance and economic distortion. However, capital gains tax on land and property in Wales is a candidate for devolution since for those assets the potential for avoidance is greatly reduced. The tax is applied to:

- i) properties bought for investment purposes, for example under a buy to let arrangement;
- ii) second homes, for example holiday homes in the UK or overseas;
- iii) business premises, such as a shop or a factory; and
- iv) land, such as agricultural land.

7.30 Assuming that Wales's share of the tax is proportional to its contribution to UK GVA, we estimate that capital gains tax receipts from commercial and residential property and land sales

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<sup>37</sup> A recent housing Legislative Competence Order (LCO) included a proposal to allow local authorities greater discretion in respect of council tax on second homes. The LCO was laid before the UK Parliament but did not proceed through all necessary Parliamentary stages before Parliament's dissolution for the May 2010 general election.

in Wales was approximately £50 million in 2006-07, of which around £30 million was collected from residential property and land sales.

7.31 We believe that devolution of capital gains tax on property and land may be worth pursuing. Although it only raises modest sums, the ability to vary capital gains tax on second homes could be used as a policy instrument to alleviate the alleged negative externalities associated with high concentrations of second home ownership. Given the volatility of the tax, however, it would import some cyclical risk into the Welsh budget.

7.32 The administrative costs associated with devolution of this tax could be significant, given that there may be a need to amend the self-assessment forms by which UK citizens make declarations of their tax liabilities. These costs would have to be robustly estimated before a firm recommendation on the advisability of devolution could be made.

### **Stamp duty land tax**

7.33 Stamp duty land tax raised £240 million in Wales in 2006-07, equivalent to around 1.9 per cent of the block grant in that year. However, the revenues are highly volatile, raising only £115 million in 2008-09.

7.34 Welsh Ministers already have significant powers over housing, therefore devolution of this tax would be aligned with existing devolved responsibilities. We see a good case for devolving powers over stamp duty because it raises appreciable revenue and could be altered without distortion. The volatility of the tax receipts is, however, a complicating factor and should be taken into account when the deduction from the block grant is calculated that “pays” for devolving the tax.

7.35 Since the tax liability is calculated by the conveyancer, it ought to be feasible for the tax to operate differently in Wales from the rest of the UK. For example, removing the step-wise banded approach and making it a set percentage of the value of the property would reduce distortions and improve the operation of the property market.

7.36 We recommend that any discussions taking place at a UK level about the technical issues that need to be overcome before this tax could be devolved to Scotland should be broadened to include Assembly Government officials. This would ensure that issues of relevance to Wales are taken into account.

## Recommendation - property taxation

- a. Stamp duty land tax should be devolved to Wales, provided a fair offset to the block grant can be negotiated.
- b. The administrative costs of devolving capital gains tax on property and land should be explored with HMRC. If administrative costs are not prohibitive, then it should be devolved to Wales, provided a fair offset to the block grant can be negotiated.
- c. The Assembly Government should consider the reform of council tax by investigating (i) the introduction of additional bands covering high value properties and (ii) the scope to undertake more frequent revaluations of the housing stock.
- d. Local authorities should be given discretion to levy a higher council tax on second homes.

## Minor taxes: landfill tax, aggregates levy, air passenger duty

7.37 In Chapter 4, we identified three small taxes with immobile tax bases that are linked to the policy responsibilities of the Assembly Government, namely landfill tax, aggregates levy and air passenger duty.

7.38 Landfill tax is the most significant of the three taxes in terms of its revenue generating capacity, raising an estimated £40 million in Wales in 2006-07. UK figures show that receipts from landfill tax have been on a steady upward trend in recent years, peaking at £950 million in 2008-09. The increase in receipts has come from higher tax rates, particularly on active waste. The volume of waste in 2008-09 was 35 per cent lower than in 2001-02.

7.39 Aggregates levy raised an estimated £20 million in Wales in 2006-07. UK level receipts from the tax have been fairly static over the last decade, with increased tax rates in the last two years being offset by falling volumes.

7.40 It is estimated that air passenger duty generated around £10 million of revenue in Wales in 2006-07. At the UK level there was a sharp increase in receipts in 2007-08 reflecting a doubling of duty rates in February 2007.

7.41 Taken as a package, landfill tax, aggregates levy and air passenger duty raised £70 million in Wales in 2006-07, or around 0.6 per cent of the block grant in that year. While they do little for accountability (since they are not paid regularly by a large proportion of the population) and raise relatively limited resources, they are easily tied to a specific location (making it easy to determine whether the tax falls within the remit of a devolved administration) and they are levied on relatively immobile activities (which reduces the risk that cross-border variations in tax rates will lead to economic distortions).

7.42 The new UK Government has stated its intention to reform air passenger duty so that it is levied on a per plane rather than a per passenger basis. The implications for the devolution of this tax are not clear at the time of writing.

7.43 The case for devolution of these taxes ultimately depends on their usefulness as policy levers and the block grant sacrifice required to obtain them. We therefore recommend that the Assembly Government should undertake an assessment of the usefulness of those taxes as policy instruments, in the light of Ministerial objectives in those areas. If it is concluded that the taxes would provide Ministers with useful policy levers, then they should be devolved to Wales, assuming a reasonable deduction from the block grant can be agreed.

### **Recommendation - minor taxes**

The Assembly Government should undertake an assessment of the usefulness of landfill tax, air passenger duty and aggregates levy as policy instruments, in the light of Ministerial objectives in those matters. If it is concluded that the taxes would provide Ministers with useful policy levers then they should be devolved to Wales, assuming a reasonable deduction from the block grant can be agreed.

### **New taxes**

7.44 The Calman Commission proposed that a new mechanism should be developed that would allow Scottish Ministers to introduce new Scottish taxes for policy reasons, provided the UK Parliament gave its consent. We believe a similar mechanism would be worthwhile in Wales. A piecemeal approach to the devolution of powers to levy new taxes has parallels with the current law-making powers of the National Assembly, whereby legislative powers can be drawn down from the UK level in the form of Legislative Competence Orders (LCOs). The proposal would therefore create something approaching a system of Financial Competence Orders. We recognise that the LCO process has been criticised as being unnecessarily slow and restrictive, but we view those drawbacks as being a price worth paying for establishing a mechanism that would enable Welsh Ministers to develop new taxes in areas of devolved responsibility with the consent of the UK Parliament.

7.45 In the course of our work we have received a number of suggestions for new taxes that could be adopted in Wales. We do not make firm recommendations about specific new taxes, but in our full report we briefly consider the pros and cons of the following candidates:

- i) a tax on tourism to pay for public amenities necessitated by the tourist industry;
- ii) "corrective taxes" to discourage certain activities that are harmful to health and generate negative externalities; and
- iii) natural resource taxes, to provide a return to Welsh citizens from activities that make use of Welsh resources.

## **Recommendation - new taxes**

A procedure should be confirmed to enable the UK Parliament to confer power on the National Assembly to introduce new taxes in Wales, where the Assembly requests that power.

# Chapter 8: Devolution of borrowing powers to Wales

## UK Government borrowing

8.1 The UK Government borrows from capital markets in order to fund public expenditure, when tax receipts are insufficient to cover planned spending. Between 1997 and 2008 borrowing was subject to two fiscal rules:

- i) over the course of the economic cycle, the government would borrow only to finance capital expenditure (the “golden rule”); and
- ii) the UK’s net public sector debt would not rise above a threshold of 40 per cent of Gross Domestic Product (the sustainable investment rule).

8.2 Following the onset of recession in 2008, UK Government borrowing has increased very substantially and a new control framework has yet to be promulgated at the time of writing.

8.3 UK Government borrowing is undertaken by the Debt Management Office (DMO), which is an executive agency of HM Treasury. This means that the DMO is legally and constitutionally part of HM Treasury, but operates at arm’s length from Ministers. Debt issued by the UK Government is highly rated, which means it incurs low rates of interest.

## Borrowing powers of devolved administrations and local authorities

8.4 The Assembly Government does not have the power to borrow in order to fund public services in a manner comparable to the UK Government.<sup>38</sup> All services have to be resourced from within the Assembly Government’s annual budget, which is funded via the block grant. There are, however, limited conditions under which the Assembly Government can borrow additional funds. Welsh Ministers may borrow from the Secretary of State for Wales to meet a temporary excess in expenditure over income or to provide a working balance. This borrowing must not at any time exceed £500 million.<sup>39</sup>

8.5 At present, similar rules apply in Scotland, although the Calman Commission recommended providing Scottish Ministers with the ability to borrow to fund capital expenditure. Under the Calman Commission’s proposals, Scottish borrowing would be undertaken via the DMO. The former UK Government accepted the case for Scotland to be given limited borrowing powers along with enhanced ability to vary taxes, with the proviso that any borrowing would have to be self-financed by setting Scottish taxes above those of the UK.

<sup>38</sup> See Annex 3.

<sup>39</sup> This limit can be increased by the Secretary of State for Wales by order with the consent of HM Treasury - see s. 122(3) Government of Wales Act 2006. The draft order must be approved by the House of Commons.

8.6 The Northern Ireland Executive carries out functions that are undertaken by local authorities elsewhere in the UK, and it already has limited borrowing powers, which were acquired under the 2002 Reinvestment and Reform Initiative. Through this arrangement, the Executive gained access to additional capital expenditure funded by borrowing from the DMO.

8.7 Local authorities are able to borrow to fund capital expenditure. In principle, they are able to borrow from commercial banks and could also issue their own debt. In practice few do so, since they are able to borrow via the Public Works Loan Board (PWLB). This is a statutory body which operates within the DMO, and which will lend to local authorities at close to gilt rates, over any period of maturity. Since borrowing from commercial institutions or issuing debt under their own name would incur a higher interest rate charge, local authorities generally find that the most attractive option is to borrow via the PWLB. The PWLB's funds are drawn from the National Loans Fund, which is the account that brings together all the UK Government's lending and borrowing.

## **Ensuring access to End Year Flexibility (EYF): strengthening the current arrangements**

8.8 Any borrowing facility should be accompanied by an ability to save, safe in the knowledge that unspent resources will be available when required. One way of providing this assurance to Welsh Ministers would be to include an explicit statement to this effect in the Statement of Funding Policy (or ideally in a new jointly-approved Ministerial Concordat, as we proposed in our first report). The best institutional mechanism that would reinforce the statement would be to provide the Welsh Consolidated Fund with the same arrangement as the National Insurance Fund or National Lottery Distribution Fund. The balances from both of those funds are invested in government securities by the Commissioners for the Reduction of the National Debt (CRND). The interest accruing from those investments is credited to the relevant fund.

8.9 The establishment of a facility of this nature for the Assembly Government to save unspent parts of its block grant would provide greater assurance that such savings were available to draw down in future budgetary periods and would strengthen the ability of the Assembly Government to plan and manage its resources over a number of years. This arrangement would also put the finances of the Assembly Government on a different footing from Whitehall departments, and one more appropriate to a distinct tier of government.

### **Recommendation - ensuring access to EYF**

The Assembly Government should seek agreement with the UK Government for an arrangement to invest EYF funds in government securities under the auspices of the Commissioners for the Reduction of the National Debt.

## The case for borrowing powers in Wales

### The need for borrowing powers to offset budgetary volatility arising from tax devolution

8.10 The current overdraft facility of £500 million available to the Assembly Government, combined with a rollover facility enabling deficits to persist beyond the financial year end, would be sufficient to deal with the additional volatility arising from our preferred approach to income tax devolution. The maximum allowable overdraft would need to be kept under review and might have to be adjusted over time to take account of inflation and economic growth.

### Borrowing to fund capital spending

8.11 The Assembly Government currently has a 20 year programme for capital spending on school improvement (known as the 21<sup>st</sup> century schools programme). Similarly, capital expenditure programmes in the health service are developed with a ten year planning period. In transport, the forward capital expenditure programme covers five years. There is also a forward expenditure forecast up to 2020 for trunk road improvements. A typical transport project takes many years to develop and implement.

8.12 The capital programme is being developed therefore over much longer periods than the Assembly Government's actual capital budget horizon of three years at most. The lack of forward visibility combined with the occasional need to contemplate projects that are large relative to the annual budget can complicate investment planning. The main argument for borrowing powers, however, is that there are projects of a large enough scale as to make them an insupportable burden on the Welsh capital budget unless their finance can be stretched out over a longer time period. A single road programme under recent consideration, for example, would have absorbed some 20 per cent of the total capital budget for several years.

8.13 Our first report recommended the Assembly Government should have the ability to draw forward future capital budgets, for up to three years, in effect a limited form of borrowing within a highly constrained framework. If the Assembly Government remains wholly block grant funded, it could be argued that borrowing should be limited to the "draw forward" mechanism proposed in our first report but not beyond that period, as there are no budgets against which to borrow. That argument is not persuasive, since the Assembly Government can be sure that it will receive a budget of many billions of pounds beyond the three year budget planning horizon adopted by the UK Government in recent years, although of course the exact magnitude is uncertain. There is enough certainty to allow a constrained borrowing power for capital expenditure that fits within a UK framework provided it was small enough that its servicing was not a significant burden on the block grant. Some limited borrowing could therefore be undertaken in the absence of tax devolution.

8.14 That said, the case for borrowing powers is stronger once tax-varying powers are devolved. In such circumstances, the Assembly Government would have a distinct source of revenue under its own control that would provide additional reassurance about its ability to repay borrowed funds.

8.15 In either event, we believe the present restrictions on the Welsh capital budget are unjustifiable. Devolution of limited borrowing powers for capital purposes would enable planning horizons to be extended, and would enable larger projects to be entertained than current constraints easily permit. It would therefore make it easier to align capital expenditures with Welsh priorities.

8.16 We recommend that the Assembly Government should acquire limited borrowing powers to finance capital spending. A borrowing framework should be agreed between the Assembly Government and HM Treasury, and a ceiling should be placed on the total amount of debt that the Assembly Government should be able to carry. In the absence of a set of fiscal rules at the UK level at the present time, it is difficult to be specific about how borrowing at the Welsh level should operate, but it is clear that borrowing rules applied to Wales would have to be consistent with the fiscal framework of the UK Government. Borrowing in foreign currencies should be prohibited, and the Assembly Government should adhere to the Prudential Borrowing Framework.<sup>40</sup>

8.17 We consider the constraint that the former UK Government proposed to impose on Scotland, with borrowing having to be funded out of higher Scottish taxes, to be unjustifiable. No UK interest is served by insisting that borrowing by a devolved administration should have to be financed by increased taxes rather than restraint of public expenditure. If the Assembly Government prefers, it should be able to repay borrowed funds from future revenues and accept the lower future public spending that would result.

## Sources of funds

8.18 If Wales were to issue its own bonds or to borrow from commercial organisations, there would be a need for additional expertise in the Assembly Government. Those costs could be avoided by making use of the existing expertise in the DMO. The interest rate on Assembly Government-issued debt that would be demanded by lenders would also generally be higher than that which would be incurred by borrowing via the DMO.

8.19 If borrowing were undertaken via the DMO, Welsh Ministers would be able to borrow over any maturity they considered appropriate at very close to gilt rates. Borrowing could have a number of different structures - fixed or floating rate, standard bond or annuity-type, for example. It is therefore unlikely, on purely financial grounds, that the Assembly Government would ever want to borrow from anywhere other than the National Loans Fund or PWLB. In the event that Welsh Ministers decided to exercise their borrowing powers, they would generally be unable to get better terms from another source without incurring risk. Moreover, ensuring that Assembly Government borrowing is undertaken by an agency of HM Treasury also helps maintain clear UK Government oversight. We conclude that borrowing by the Assembly Government should take place via the National Loans Fund or PWLB.

### Recommendation - borrowing powers

Limited powers to borrow in order to finance capital expenditure should be devolved to the Assembly Government.

<sup>40</sup> See Annex 3.

## Chapter 9: The way ahead

### Relative funding and relative needs: the outlook for Wales

9.1 Estimating relative need to spend has an unavoidable element of imprecision - it cannot be calculated with certainty to the nearest pound, or even the nearest million pounds. In our first report we generated what we said was certain to be a conservative estimate and probably an under-estimate of Welsh relative needs. We concluded that if devolved activities in Wales were funded on the same basis as the UK Government applies to fund those activities in England, the Assembly Government would receive at least £114 for every £100 spent in England on functions that are devolved to Wales. The first report also demonstrated that relative funding for Wales in 2010-11 was likely to be below this level and, if the Barnett Formula remained in place, Welsh relative funding was very likely to decline further over the medium term.

9.2 As a result of the analysis in this report and in our first report, we now have a range of estimates of Welsh relative need. Table 9.1 summarises the estimates of relative need that were derived from the regression analysis in Chapter 3, while Annex 4 of our full report demonstrates the impact of relaxing some of the first report's conservative assumptions. In each case the estimates of Welsh relative need are closely aligned and fall within a range of 114-117. The fact that different approaches all generate such similar estimates provides further evidence that establishing a needs-based funding system does not have to be arbitrary or subjective. While it is not possible to arrive at a definitive point estimate of Welsh relative need, we can be confident that funding for devolved activities in Wales should fall within this range. For Wales therefore, a needs-based funding regime should deliver funding at somewhere between £114 and £117 for every £100 that is spent on devolved activities in England.

9.3 Since the first report was published, the outlook for public expenditure has become exceptionally uncertain. There is a likelihood of large changes in public spending plans, the possibility of fundamental reform to the public spending architecture and uncertainty over macroeconomic prospects and the inflation outlook. It is therefore impossible at the time of writing to forecast the Welsh budget over the next few years with any degree of confidence.

**Table 9.1: Summary of estimates of relative needs derived from regression analysis, based on varying assumptions<sup>41</sup>**

Tax capacity	Welsh language	Census language needs indicator, including Welsh language	Wales relative need (England = 100)
			115
√			116
√	√		117
		√	116
√		√	117

Source: Commission calculations

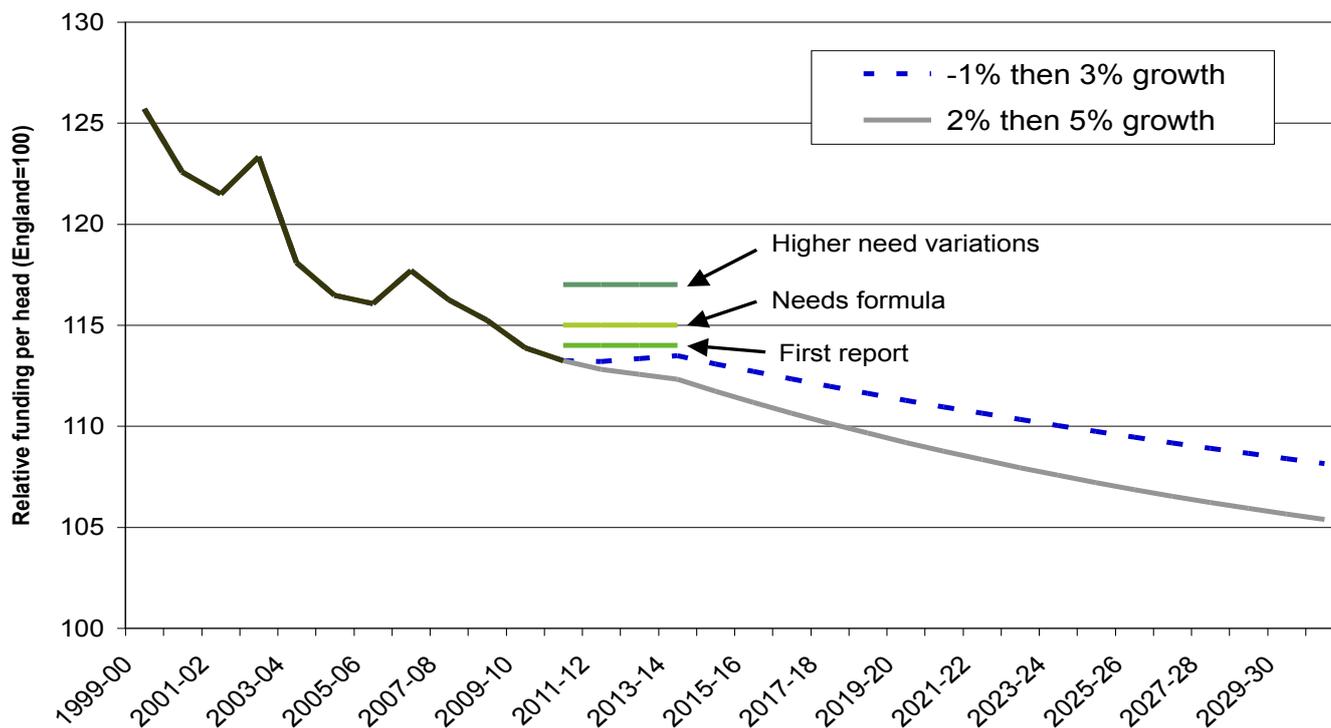
9.4 Under the Barnett regime, smaller budgetary increases lead to reduced convergence, and convergence goes into reverse if budgets are cut in cash terms. A further complicating factor is that EYF draw-downs and re-profiling of expenditure in Wales or England cloud the pattern of convergence in the short term.<sup>42</sup> The future rate of convergence in expenditure per head will depend on the nominal rate of increase in comparable spending programmes in England, whether driven by inflation or real changes in spending. Chart 9.1 provides projections of Welsh relative funding, based on two possible paths of change in comparable English spending. If it is assumed that this spending grows at two per cent per year over the three years starting in 2011-12 and then grows at a nominal five per cent per year in future, Welsh relative funding will fall continuously from its current position, moving ever closer to the English average. A more conservative assumption of one per cent annual cash cuts to comparable English expenditure for three years, followed by annual increases of three per cent leads to small increases in relative funding during the period of cash cuts and a resumption of convergence in subsequent years. In both scenarios, in every year, Welsh relative funding remains below the lowest point of our range of estimated relative needs, and far below the upper end of the range. Even if budget cuts are more severe than one per cent per annum in cash terms, it is unlikely that Welsh relative funding would move above the level of 115, which our unadjusted needs formula suggests would be equitable. There is therefore virtually no risk of Wales becoming over-funded, but every likelihood of persistent under-funding.

9.5 Once spending increases in cash terms, even if budgets are falling in real terms, convergence is likely to resume. We do not know what will happen to Welsh relative needs, but we do know that the Barnett squeeze will reassert itself and Wales can be expected to further converge on average English levels of funding.

<sup>41</sup> The top row shows the base case relative need in Wales. The other rows show relative need using alternative assumptions or indicators, as shown by a tick in the relevant column. The tax capacity alternative assumes local authority support is calculated based on equal local tax effort with respect to property values. The Welsh language alternative includes an estimate of first language Welsh speakers in the ethnic minority variable. The census language needs indicator alternative includes this variable instead of the ethnicity variable.

<sup>42</sup> Independent Commission on Funding and Finance for Wales, 2009 Chart 2.7.

**Chart 9.1: Welsh relative funding projections - two scenarios of nominal spending growth<sup>43</sup>**



Source: Commission calculations

9.6 In our first report, we recommended that, pending the introduction of a needs-based formula, a floor should be introduced to the Barnett Formula that would align funding increments with relative need. Under our proposal, the current funding regime would remain in place with the sole change that positive increments to the Welsh block grant would be multiplied by 114 per cent. This still remains an appropriate minimal solution, pending more comprehensive reform, as it would do no more than prevent Wales falling further below the lowest of all the estimates of relative needs.

9.7 It has been said that the current straitened fiscal circumstances make now a particularly bad time to move from Barnett to a needs-based formula. We disagree, since such a reform would be unlikely to increase, and could well reduce, the total resources provided to the devolved administrations relative to English expenditures. If that is politically too difficult, introduction of a floor would be almost costless in cash terms when budgets are growing slowly. If budgets were growing rapidly then the cash increases required to maintain a floor would be greater, though tiny in the context of UK budgets. From the UK Government’s perspective there is now an ideal opportunity, if it remains resistant to the full needs-based approach, to put in place a simple adjustment to the existing funding formula that would retain the advantages of Barnett but would also fix the huge flaw in the current system at very low cost and in a way that should be acceptable to all parts of the UK.

### Tax devolution in the absence of a needs-based grant

9.8 Even if our proposals for tax devolution were implemented in full, the block grant would still account for around 85 per cent of the total resources available to the Assembly Government. Ensuring that Barnett is replaced by a system that sets the block grant by reference to Welsh relative needs therefore should be a priority for Wales.

<sup>43</sup> Both of the scenarios illustrated assume no change in the population of Wales relative to England.

9.9 Under the existing Barnett regime, the resources allocated to Wales are essentially arbitrary. Such circumstances impede the appropriate operation of a devolved tax system. Without an evidently fair and transparent system for allocating block grants a reduction in tax (particularly income tax) by a devolved administration could well be taken by the public as a signal of over-funding that would invite a UK Government response. In a recent paper, David Heald and Alasdair McLeod state that the fear of a challenge from HM Treasury to both levels of Scottish spending and the unconditional nature of the grant has played a role in discouraging Scottish Ministers from cutting the Scottish Variable Rate.<sup>44</sup> They conclude that “The political viability of income tax variation therefore depends on some measure of consensus that the funding system is “fair” and on Devolved Administrations having confidence that their use of taxation powers will not be nullified by actions of the UK Government”.<sup>45</sup> The only way to achieve a consensus of fairness is to transparently align relative funding with relative needs. It is therefore strongly desirable for a needs-based funding regime to be in place in advance of significant tax devolution.

## Implications of our recommendations for the Assembly Government and the National Assembly

9.10 At present the Assembly Government finance function is primarily focused on accounting and audit functions, such as ensuring that the block grant is spent appropriately and that accounts are accurate and timely. Devolution of any fiscal powers would represent a significant change in the tasks required of the Assembly Government.

9.11 Responsibility for collection of all devolved taxes in Wales should remain with HMRC. Even if our recommendations are implemented in full, we see no need to establish a separate Welsh exchequer. This view is consistent with the recommendations of the Calman Commission, which also concluded that HMRC should retain its role in collecting devolved taxes in Scotland.

9.12 Limited borrowing powers to finance capital spending were devolved to Northern Ireland in 2002 (see Chapter 8). We understand that the additional capacity requirements this placed on the Northern Ireland Executive were minimal, once the initial procedures had been developed. Our proposals on borrowing are not different in kind from those that are now exercised by the Northern Ireland Executive. We are therefore confident that the Assembly Government would be able to take on the limited borrowing powers we propose without the need for substantial additional staff resource.

9.13 Should tax-varying powers be devolved, Welsh Ministers are likely to require some specialist support to help determine tax policy. Perhaps counter-intuitively, the need for expert advice might be greater for some of the smaller taxes which primarily have a policy rationale than for income tax, which has a revenue-raising objective. To some extent, the need for additional capacity within the Assembly Government would be reduced by developing good working relations with HMRC well in advance of any devolution of tax-varying powers. Provided that officials in the Assembly Government are able to draw on the expertise of HMRC specialists, the extra staff requirements in the devolved administration will probably be modest. That said, we envisage that some enhancement to the Assembly Government’s Finance Department would be necessary, though this is likely to comprise a fairly small unit of specialists, including economics and statistical expertise.

<sup>44</sup> Heald and McLeod, 2010 p.16.

<sup>45</sup> Heald and McLeod, 2010 p.32.

9.14 Equally, devolution of fiscal powers would have implications for the National Assembly. At present its financial scrutiny is undertaken by the Finance Committee, which analyses the draft budget in detail every autumn. The issues facing the Committee would become more complex in the event of fiscal devolution. Some enhancement to the official support available to the Finance Committee would be one obvious way of ensuring that the Committee was able to exercise its scrutiny role effectively in those circumstances. One option might be to establish a small unit of officials with public finance expertise that could support the work of the Committee on a full time basis once fiscal powers are devolved. A further possibility could be to enable paid experts to be co-opted onto the Committee for limited periods of time.

### Transition arrangements

9.15 Both the UK Government and the Calman Commission have made it clear that a great deal of preparatory work needs to be undertaken before greater tax devolution could be implemented in Scotland. The need for thorough preparation is equally important in Wales.

9.16 It will take time - in all likelihood, several years - to prepare the ground for devolution of tax-varying powers to Wales. It would make sense for any significant new fiscal powers to be conferred on the National Assembly at a time that coincided with a National Assembly election. In any event the earliest practical option for devolution of significant tax-varying powers would probably be not much before May 2015. It may be possible for more limited powers, for example over borrowing or certain minor taxes, to be transferred sooner. In the meantime, Wales should have a seat at the table in any discussions about fiscal devolution that are taking place at the UK level.

### Recommendation - transition arrangements

The preparatory work that is under way to implement tax devolution for Scotland should proceed on the assumption that similar tax powers could be devolved to Wales. The Assembly Government should have a seat at the table in any discussions about fiscal devolution that are taking place at the UK level.

### Reflecting devolved expenditure in UK statistics

9.17 The national accounts represent the main system for organising and articulating economic information for the UK. They include estimates of the UK domestic and national product, income and expenditure. Separate accounts are compiled for the different sectors of the economy: non-financial and financial corporations, general government, households, and the rest of the world. The general government sector is further split into central and local government. The National Assembly and the other devolved administrations are currently included in the central government sector.

9.18 The European System of Accounts, which provides the framework for the national accounts, includes provision for a third tier of "provincial" government between central and local government. Following devolution, there are now three tiers of government in Wales, Scotland, and Northern Ireland. The circumstances of these institutions meet the requirements laid down in the European System of Accounts, and also in the OECD Standardised National Accounts system to be counted as a state or provincial tier. The situation should be properly reflected in the UK national accounts by taking the devolved administrations out of the central government sector and including them

in a new “provincial” government sector. This development would allow the transactions involving the devolved administrations to be separately identified, including the transactions between those administrations and the UK Government.

## Recommendation - improved statistics

The Assembly Government should seek modification of the UK’s national accounts to include a “provincial” tier of government spending.

## Need for a referendum

9.19 It is for Ministers to decide whether the proposals in this report would require a referendum to be won before they could be implemented, or whether public endorsement of a manifesto pledge in an election would be sufficient. We can only offer some reflections on the likely impact of our recommendations on the Welsh budget and on the relationship between the Assembly Government and the citizens it serves. A referendum could be held on the principle of tax-varying powers or on a specific set of proposed tax powers. Welsh practice has tended to be to hold referenda on a specific set of limited proposals rather than on broad principle as in the Scottish case. We express no view on that other than to note that the Welsh approach tends to mean you have to have more referenda to get to the same place.

9.20 There is no suggestion that a referendum would be required to endorse devolution of borrowing powers. The purpose of enabling Welsh Ministers to borrow is to enhance their ability to manage financial resources over time. Borrowing powers have little impact on the accountability of the devolved institutions to the citizens of Wales. Moreover, constitutional precedents confirm that a referendum is unnecessary. Borrowing powers were given to the Northern Ireland Assembly without a referendum, and the former UK Government proposed to pass borrowing powers to Scotland without seeking endorsement of its plans through a referendum. An additional consideration is the fact that the Assembly Government already has limited borrowing powers (see Annex 3).

9.21 Powers to alter the structure of council tax in Wales are already devolved, so if Welsh Ministers were minded to add extra property bands or to revise the frequency of revaluations no referendum would be necessary. More fundamental reform to the council tax regime may be beyond Ministers’ current powers and therefore could require primary legislation. However, previous large changes to local government taxation at the UK level have not required endorsement in a referendum.

9.22 If a referendum on broad principle is excluded, it seems unlikely that a referendum would be required for the specific devolution of stamp duty, capital gains tax on land and property, landfill tax or aggregates levy to Wales. Transferring those powers from the UK to the Welsh level of government would not fundamentally alter the relationship between the citizen and the devolved administration. The amount of money raised by those taxes is small (approximately 2.5 per cent of the current Welsh budget), so the block grant would continue to account for the vast majority of the Assembly Government’s resources even if all of them were devolved. Moreover, each tax relates to an issue where responsibility already lies primarily with the Assembly Government. Devolution of those limited tax varying powers would result in a deepening rather than a broadening of the Assembly Government’s remit.

9.23 Precedent implies that the proposed mechanism for introducing new taxes would also not appear to require a referendum. This incremental approach to acquiring tax-varying powers is very similar to the existing system of LCOs by which limited legislative powers are devolved to Wales at the request of the National Assembly and with the consent of the UK Parliament. The LCO system was introduced as part of the Government of Wales Act 2006 without requiring a referendum.

9.24 Devolution of powers over income tax would represent a major shift in the relationship between the citizen and the devolved administration, and would also have very substantial budgetary impact. If our recommendations were implemented, around 15 per cent of the Welsh budget would be obtained from Welsh income tax revenues. Although it is not ultimately a matter for us, it appears likely that devolution of powers over income tax would take place only after a referendum. Wales has never had, as Scotland did in 1997, a referendum on the principle of tax-varying powers and, without that, devolving income tax may be too big a change to make without public endorsement.<sup>46</sup> If Ministers come to that conclusion, future UK legislation for income tax devolution to Scotland could contain clauses that would allow for devolution of income tax powers to Wales in line with our recommendations, but which would only be activated in the event of a positive referendum vote.

## Conclusions: fairness and accountability

9.25 Two themes have come to dominate this report: fairness and accountability. The existing system of devolved finance has its virtues but we consider that it has two great failings. First, it does not ensure horizontal equity among the nations of the UK and the regions of England; in a word it is unfair. Second, it has created public bodies with massive vertical imbalances in their finance; they have to spend billions of pounds of public money but they are not responsible for raising one penny of it. Experience and theory together argue that is not a situation in which public money is best spent.

9.26 It is easy enough to diagnose the failings of the current regime and we do not think reasonable people would waste much time attempting to deny them. Reform can only be opposed on the grounds that nothing better is available that would not raise worse problems. To hold such a view, we assert, it is necessary to be a monumental pessimist. One is reminded of the remark attributed to the Duke of Wellington among others: "Reform, reform? Aren't things quite bad enough already?" Much of this report has been devoted to demonstrating that change that removes the failings is possible in Wales, if the people want it.

9.27 It is important to emphasise that our proposals for fair funding are not simply a ruse by which we hope to secure additional resources for Wales. We have tried hard, both in this report and in our previous publications, to avoid any suspicion of special pleading. We maintain that a strong link between the relative needs of the devolved administrations and the block grants they receive from the UK Government is essential for any devolved system of finance to retain public and political support. That support is the only basis for further development or for ensuring that public services are funded equitably in all parts of the UK.

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<sup>46</sup> A recent report by the House of Lords Select Committee on the Constitution concluded that referendums should only be used to address "fundamental constitutional issues". The Select Committee did not attempt to provide a precise definition of a "fundamental constitutional issue" but listed the following examples: "To abolish the Monarchy; To leave the EU; For any of the nations of the UK to secede from the Union; To abolish either House of Parliament; To change the electoral system for the House of Commons; To adopt a written constitution; and To change the UK's system of currency" (House of Lords Select Committee on the Constitution, 2010 p.27). While these appear significantly more far reaching than any of the changes proposed in this report, it may be that, in a Welsh context, devolution of income tax could meet the criterion of being a "fundamental constitutional issue".

9.28 It is also worth re-stating that our recommendations for devolution of limited new fiscal powers to Wales are designed to go with the grain of the existing constitutional settlement. While we make no claim to constitutional expertise, we believe that almost all of our recommendations could be introduced without fundamentally altering the constitutional status of the Assembly Government and the National Assembly. We have not, for example, considered options that would move Wales substantially towards (or further away from) independence than it is at present. We therefore hope that our proposals for fiscal devolution will be judged by the extent to which they enhance accountability in a practical way, and not by whether they move Wales towards some hoped-for or feared constitutional destination.

9.29 We do not suppose that the changes we recommend can all be rapid. On the fairness issue, we believe we have demonstrated that a simple, serviceable needs-based formula can be derived from existing practice to replace Barnett. Yet we acknowledge that the political obstacles are considerable and negotiation on detail could be time-consuming. That is why we proposed an interim solution of a “floor” and even that has not been immune to fear of political repercussions, although it implies relatively tiny changes to the status quo.

9.30 On the accountability issue, there are legitimate reasons for the lead time for change to be even longer. Proper accountability, we argue, requires a measure of tax devolution; there we concur with the Calman Commission in Scotland. Establishing the practicalities of tax accounting and collection will require detailed work. It seems likely that preparing legislation on Calman consequently will take some time and implementation may not follow immediately on the passage of a Parliamentary Bill.

9.31 Wales, therefore, has opportunity for reflection. It must decide, broadly, what possibilities it wishes to have open by the time that Calman legislation is before the House of Commons. That would permit appropriate enabling clauses for Wales to be included in the legislation. A further period of preparation and publicity would then be necessary to air the issues and frame any question(s) to be put to the Welsh people in a referendum. The fruits of this report, if it bears any, are unlikely to be harvested before the Assembly session that begins in 2015. We hope nonetheless that the harvest will come and will be judged a good one.

# Recommendations from the Commission's final report

## Needs-based formula (Chapter 3)

A1.1 The Assembly Government should pursue the introduction of a simple needs-based formula as the means of determining the Welsh block grant.

## Income tax (Chapter 6)

A1.2 The Assembly Government should acquire limited powers to vary income tax rates in Wales.

## Corporation tax (Chapter 7)

A1.3 The Assembly Government should seek discussions with the UK Government and the other devolved administrations about the feasibility of devolving corporation tax.

## Property taxation (Chapter 7)

A1.4 Stamp duty land tax should be devolved to Wales, provided a fair offset to the block grant can be negotiated.

A1.5 The administrative costs of devolving capital gains tax on property and land should be explored with HMRC. If administrative costs are not prohibitive, then it should be devolved to Wales, provided a fair offset to the block grant can be negotiated.

A1.6 The Assembly Government should consider the reform of council tax by investigating (i) the introduction of additional bands covering high value properties and (ii) the scope to undertake more frequent revaluations of the housing stock.

A1.7 Local authorities should be given discretion to levy a higher council tax on second homes.

## Minor taxes (Chapter 7)

A1.8 The Assembly Government should undertake an assessment of the usefulness of landfill tax, air passenger duty and aggregates levy as policy instruments, in the light of Ministerial objectives in those matters. If it is concluded that the taxes would provide Ministers with useful policy levers then they should be devolved to Wales, assuming a reasonable deduction from the block grant can be agreed.

## New taxes (Chapter 7)

A1.9 A procedure should be confirmed to enable the UK Parliament to confer power on the National Assembly to introduce new taxes in Wales, where the Assembly requests that power.

## **Ensuring access to EYF (Chapter 8)**

A1.10 The Assembly Government should seek agreement with the UK Government for an arrangement to invest EYF funds in government securities under the auspices of the Commissioners for the Reduction of the National Debt.

## **Borrowing powers (Chapter 8)**

A1.11 Limited powers to borrow in order to finance capital expenditure should be devolved to the Assembly Government.

## **Transition arrangements (Chapter 9)**

A1.12 The preparatory work that is under way to implement tax devolution for Scotland should proceed on the assumption that similar tax powers could be devolved to Wales. The Assembly Government should have a seat at the table in any discussions about fiscal devolution that are taking place at the UK level.

## **Improved statistics (Chapter 9)**

A1.13 The Assembly Government should seek modification of the UK's national accounts to include a "provincial" tier of government spending.

# Recommendations from the Commission's first report

## Ensuring that funding is aligned with needs (Chapters 3 and 6)

A2.1 In the medium term the funding arrangements for Wales should be based on relative needs.

A2.2 No further decline in relative funding per head should occur in Wales until a new funding system is in place. This could be achieved in a straightforward way by simply multiplying any positive increments allocated to Wales by 114 per cent.

## Enhancing the funding flexibility available to the Welsh Assembly Government (Chapter 5)

A2.3 The Assembly Government should be able to draw forward its capital budget across the period of a spending review.

A2.4 The Assembly Government should have a free hand in accessing the EYF funds that it has accumulated in prior years, without the requirement for discussion with, and agreement from, HM Treasury.

A2.5 The Assembly Government should be able to switch funds from capital to resource budgets, provided that such transfers would not cause a breach of the UK Government's overarching fiscal rules.

## Reducing the likelihood of future disputes (Chapter 5)

A2.6 Technical aspects of the operation of the Barnett Formula should be administered by an independent advisory body that is at arm's length from both HM Treasury and the Assembly Government.

A2.7 The UK Government and the Assembly Government should jointly agree a new Ministerial concordat on the detailed funding arrangements for Wales.

## Improving transparency (Chapter 5)

A2.8 In order to enhance the transparency of the process by which the Assembly Government is funded, the UK Government should produce an annual publication that would enable direct comparisons between Assembly Government expenditure covered by the Barnett Formula and similar expenditure in England.

A2.9 A Treasury Minister should be invited to meet the National Assembly for Wales's Finance Committee at least once in every spending review period to discuss the funds made available to Wales.

# Current borrowing powers in Wales

## The current borrowing powers of the Assembly Government<sup>47</sup>

A3.1 The Assembly Government does not have the power to borrow in order to fund public services in a manner comparable to the UK Government. All services have to be resourced from within the Assembly Government's annual budget, funded via the block grant.

A3.2 There are, however, limited conditions under which the Assembly Government can borrow additional funds. Under Section 121 of the Government of Wales Act 2006, Welsh Ministers may borrow from the Secretary of State sums that are deemed required to meet a temporary excess in expenditure over income or to provide a working balance. HM Treasury may then issue funds to the Secretary of State out of the National Loans Fund. In total, borrowing as set out under Section 121 must not at any time exceed £500 million.

A3.3 Amounts borrowed under Section 121 must be repaid to the Secretary of State under conditions outlined by HM Treasury. Borrowing under Section 121 counts towards the Public Sector Net Cash Requirement and hence is included within the Assembly Government's total budget. Any increases in borrowing must be offset by reductions in other spending. The effect is to reduce the level of grant from the UK Government and hence to restore the UK borrowing position. Therefore, if Welsh Ministers borrowed under Section 121, the effects of such borrowing would be offset by a reduction in the grant received from HM Treasury if the sums were not re-paid using existing funds.

A3.4 The Government of Wales Act 2006 also makes provision for the Assembly Commission and the Auditor General for Wales to borrow on similar terms in order to meet temporary budget shortfalls.

A3.5 In summary, although the Assembly Government does have some borrowing powers, they are limited and are not equivalent to borrowing to fund current or future public services in a manner comparable to the UK Government or local authorities.<sup>48</sup>

## Borrowing powers of other public sector organisations

A3.6 While the Assembly Government has only limited powers to borrow, other public sector bodies have greater flexibility to borrow to fund public services.

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<sup>47</sup> Under the Government of Wales Act 2006.

<sup>48</sup> Following the merger of the Welsh Development Agency (WDA) with the National Assembly for Wales (as outlined in The Welsh Development Agency (Transfer of Functions to the National Assembly for Wales and Abolition) Order 2005), the Assembly inherited limited borrowing powers for the purpose of exercising functions under the Welsh Development Agency Act 1975. In the event that these powers were exercised, HM Treasury could mandate that any income raised from borrowing be treated as a receipt and would therefore pass directly to the UK Consolidated Fund, resulting in no additional net resources for the Assembly.

A3.7 Local authorities in Wales have much greater freedom to borrow funds under the prudential borrowing system.<sup>49</sup> This system, detailed in the Local Government Act 2003, enables local authorities to determine their own levels of affordable capital investment and required borrowing providing they can demonstrate that borrowing can be supported within their existing resources. Specific Assembly Government consent for borrowing is no longer required under the prudential system.<sup>50</sup>

A3.8 The Prudential Borrowing Framework places great weight on the importance of sustainability, prudence and in particular affordability as the ultimate constraint on whether borrowing should take place and the amount that a local authority can spend or borrow. Affordability is determined by a judgment about acceptable council tax levels and in the case of borrowing to provide housing, acceptable rent levels. However, this decision is underpinned by a range of judgments such as likely levels of capital receipts, additional revenues raised from fees and charges in “invest to save” schemes and treasury management considerations.

A3.9 NHS Trusts in Wales also have some limited power to borrow funds. While there are no restrictions on the source of borrowing, the aggregate of all sums borrowed must not exceed £300 million, or £600 million if the borrowing is guaranteed by Welsh Ministers. Trusts fall within HM Treasury budgetary controls and therefore such borrowing scores against the Assembly Government budget.

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<sup>49</sup> The current legislative framework replaces the previous scheme of credit approvals where a local authority in Wales would have to seek approval from the Assembly Government on a case by case basis. “Credit approval” borrowing is also termed supported borrowing, as all local government borrowing covered under the previous scheme was funded by the RSG.

<sup>50</sup> Although there are no UK-wide limits imposed on prudential borrowing, beyond the local authorities’ assessment of affordability, overall local authority borrowing levels are monitored by HM Treasury to ensure that public sector borrowing does not exceed central government borrowing rules. If deemed appropriate by HM Treasury, borrowing limits may be introduced.

## Annex 4

# Independent Commission on Funding and Finance for Wales

## Origins of the Commission

A4.1 The Commission was established by the Assembly Government in line with a commitment in “One Wales: a progressive agenda for the government of Wales”.

## Terms of reference

A4.2 The Commission’s terms of reference are to:

- look at the pros and cons of the present formula-based approach to the distribution of public expenditure resources to the Welsh Assembly Government; and
- identify possible alternative funding mechanisms including the scope for the Welsh Assembly Government to have tax varying powers as well as greater powers to borrow.

## Relationship of the Commission to the Assembly Government

A4.3 The Commission is separate from the Assembly Government for the purposes of communicating and consulting with the public, collecting, considering and analysing information, and producing reports.

## Reporting arrangements

A4.4 The Commission reports jointly to the First Minister, the Deputy First Minister and the Minister for Business and Budget.

A4.5 The Commission was charged with producing a first report by the summer of 2009 and a final report by summer 2010.

## Members of the Commission

A4.6 **Gerald Holtham** is Managing Partner of Cadwyn Capital LLP and former Chief Investment Officer of Morley Fund Management, the investment arm of Aviva PLC. The Aberdare-born economist has wide experience of conducting and applying economic research on a range of public policy issues as director of IPPR and at the OECD and the Brookings Institution. He is actively involved in Welsh public life, and is currently a Director of the Institute of Welsh Affairs, a visiting Professor at Cardiff University Business School and a member of the Assembly Government’s Economic Research Advisory Panel.

A4.7 **David Miles** is a member of the Bank of England’s Monetary Policy Committee, a visiting Professor of Financial Economics at Imperial College, University of London, and was until August 2009 a non executive Director of the Financial Services Authority. The Swansea-born specialist in research

on financial markets has published widely on many aspects of finance and macroeconomics. In 2003, he undertook an independent review for the Chancellor of the Exchequer of the UK housing market, focusing on the absence of much longer-term fixed rate lending. He joined the Bank of England's Monetary Policy Committee in June 2009.

A4.8 **Paul Bernd Spahn** is Professor Emeritus of Goethe University, Frankfurt am Main, Germany. After retirement from the university in 2005, he served as Macro Fiscal Advisor to the Minister of Finance and Treasury of Bosnia and Herzegovina, and became the founding Executive Director of the House of Finance in Frankfurt. A former Vice-President of the University of Frankfurt, Professor Spahn has held several visiting professorships across the world, has published widely in scholarly and policy-oriented journals and has provided expert advice to more than fifty governments worldwide.



From left to right:

David Miles, Gerald Holtham,  
Paul Bernd Spahn

## Abbreviations used in the report

AME	Annually Managed Expenditure
CRND	Commissioners for the Reduction of the National Debt
DEL	Departmental Expenditure Limit
DMO	Debt Management Office
DWP	Department for Work and Pensions
EYF	End Year Flexibility
GVA	Gross Value Added
HMRC	HM Revenue and Customs
LCO	Legislative Competence Order
NDR	Non-Domestic Rates
NHS	National Health Service
ONS	Office for National Statistics
PWLB	Public Works Loan Board
RSG	Revenue Support Grant

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Independent Commission on Funding and Finance for Wales  
Room 2-017  
Crown Buildings  
Cathays Park  
Cardiff CF10 3NQ  
Email: [Holtham.Commission@wales.gsi.gov.uk](mailto:Holtham.Commission@wales.gsi.gov.uk)  
Website: [www.walesfundingreview.org](http://www.walesfundingreview.org)