Llywodraeth Cymru
Welsh Government

Reforming UK funding and fiscal arrangements after Brexit

Securing Wales' Future

Contents

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Preface

As the UK Government prepares to leave the European Union (EU), we face a period of considerable uncertainty. Brexit will have an impact on every nation and region of the United Kingdom (UK) and we must consider how the Union will function outside the EU. This includes establishing how the UK's funding and fiscal arrangements will evolve to meet the new circumstances and challenges, to provide clarity for businesses and communities and, above all, to build confidence for the future.

Brexit provides an opportunity to design a new funding mechanism which will guarantee fair and continuing investment where it is needed - in Wales and in the rest of the UK. This should also help clarify important aspects of the UK's future relationship with EU networks, including continued access to the finance and expertise available from the European Investment Bank (EIB).

Since the moment the referendum result was announced, we have worked tirelessly to put forward detailed proposals for a sensible Brexit. Through our White Paper – 'Securing Wales' Future' – and subsequent policy documents on trade, migration, regional investment and devolution, we have published evidence, analysis and detailed proposals for a Brexit that would protect jobs and the Welsh economy. Each policy document has been designed to make a constructive contribution to the debate about the UK's future outside the EU.

This document is the latest in that series. It sets out the case for a Brexit which would secure the interests of Wales, and argues for a pragmatic and balanced approach which would deliver a robust funding solution to serve the UK for many decades to come.

Carwyn Jones
First Minister of Wales

Foreword

We have achieved a great deal in Wales since devolution, against a background of greater devolution throughout the UK – in Scotland, Northern Ireland and increasingly in England. However this has been accomplished within the security of an EU framework for funding and fiscal equalisation which we now stand to lose.

In place of this, the UK needs to establish a new rules-based way of working, involving a fair and principled methodology. This must protect our immediate requirements – ensuring that Wales continues to benefit from the funding for which we have qualified and we retain our access to important European partnerships and networks. But it must also deliver for the future – reforming the current ad hoc approach to fiscal arrangements which undermines our strategic ambitions through its fragmented and incremental approach.

Alongside the programme we have put forward for the future governance of the UK, the UK's inter-governmental finance machinery must also be reformed. We must move to a position where we operate on the basis of parity of participation, collaboration and agreement – unafraid of independent oversight. In place of the Barnett formula, we should progress to a new, rules-based funding system which is embedded in a Fiscal Agreement which is developed in parallel with the other post-EU UK frameworks.

The challenges and opportunities highlighted in this document apply to all parts of the UK – and not just Wales. The UK Government must now work with the nations, regions and cities of the UK to develop a principled, fair and robust funding mechanism which will ensure a better future for all.

Mark Drakeford

Mark Drakeford
Cabinet Secretary for Finance

1 Summary of the Welsh Government's proposals

At the start of 2017 the Welsh Government, together with Plaid Cymru, published a White Paper, 'Securing Wales' Future', setting out how we think the UK should approach withdrawal from the EU. This new document sets out further details of the Welsh Government's proposals for how the UK's funding and fiscal arrangements need to adapt in the future to ensure that they meet the aims and needs of a UK outside the EU.

Wales is a net beneficiary of our membership of the EU. It is essential that withdrawal from the EU does not take money away from our communities and does not limit our ability to continue to invest in our economy and the people of Wales. As we continue to work with other governments in the UK during the transition period, we are seeking agreement on the following key priorities:

(i) **Wales must not lose out.** Funding that Wales would have otherwise reasonably expected from EU sources must be replaced by the UK Government without any top slicing or conditions attached;

(ii) **Wales must have continued access to important European partnerships and networks** that bring sources of finance but also much wider benefits from participation. We need to build on the legacy of programmes such as the European Cooperation Programmes; Horizon 2020; ERASMUS+; the Creative Europe Programme; the Inter-territorial cooperation programmes; and the Connecting Europe Facility. We also need continued access to the finance and expertise available from the European Investment Bank;

(iii) We have operated our fiscal powers within an EU framework which provides a set of objectives and rules for fiscal equalisation. As the UK leaves the EU and work on UK frameworks intensifies, there is now a compelling case to develop a new Fiscal Agreement for the UK, its devolved countries and regions:

a. We repeat our calls for r**eplacing the Barnett formula with a new, rules-based system** which ensures the allocation of resources within the UK is based on relative need;

b. We call for the development of a **principles-based approach to UK funding and fiscal arrangements** which promotes fairness across the UK, encourages balanced economic growth across all parts of the UK and upholds and enhances devolution. This new Fiscal Agreement must be clear about objectives and approach, and based on consent;

c. We propose **reforms to the inter-governmental machinery** overseeing funding and fiscal arrangements to ensure they are based on the principles of partnership, agreement and consent. This includes evolving the existing Finance Ministers Quadrilateral into a four-way decision-making body, and an explicit role for bodies independent of government to oversee the operation of the new arrangements, including dispute resolution.

Wales makes an important contribution as part of the UK, and we will continue to do so after the UK's withdrawal from the EU. However, we fundamentally and urgently need to review, clarify, and in some cases reform, our existing funding and fiscal machinery to ensure that the UK approach is sustainable and benefits all parts of the UK outside the EU. This can only be achieved through working collaboratively and with a shared set of objectives and ways of working over the longer term.

2 Protecting our communities

Funding that Wales would have otherwise reasonably expected from EU sources must be replaced by the UK Government without any top slicing or conditions attached.

The Welsh Government welcomes the provisional agreement on a transition period for the UK after the formal departure from the EU. We made the case for such a period very shortly after the referendum in order to avoid a "cliff edge" and to enable the detailed level of negotiation needed to ensure the UK's withdrawal and our future relationship with the EU represent the best outcome for the whole of the UK. The Welsh Government has also concluded with the UK Government an Intergovernmental Agreement on the European Union (Withdrawal) Bill and the Establishment of Common Frameworks. The agreement and the amendments made to the European Union (Withdrawal) Bill alongside the agreement ensure that devolution is protected and establishes an agreed process for dealing with policy areas which will benefit from agreed UK-wide application.

We now want to bring the same certainly to our future financial arrangements in the context of EU exit. We will look to provide the maximum possible certainty and stability for businesses and people in Wales as the UK leaves the EU. Specifically we wish to protect and support those who need it most and enable them to continue to progress as they have done within the EU.

Building on our legacy

As outlined in our White Paper ('Securing Wales' Future', January 2017) the financial implications of the UK leaving the EU are more stark for Wales than other parts of the UK as we are a net beneficiary of EU membership: over the last five years Wales' share of the UK contribution to the EU is estimated to be smaller than the level of EU programme spending in Wales.

In total Wales receives around £680m in EU funding annually. The bulk of this funding comprises receipts under the Common Agricultural Policy (CAP) and Structural Funds with the balance made up from Horizon 2020 and other smaller, but economically significant, pots of funding such as Erasmus+, Creative Europe and the Inter-territorial cooperation programmes.

Our rural and coastal communities benefit from significant investment through the CAP and the European Agricultural Fund for Rural Development. Welsh farmers and landowners currently benefit from around £274m each year in direct subsidies under the CAP, and the Common Fisheries Policy supports vital investment in Welsh coastal areas. The Welsh share of the funding the UK receives from the EU for rural and coastal communities – at almost 10% – is much higher than our population share (5.6%). This reflects the fact that a high proportion of Welsh land is classified as 'less favoured'.

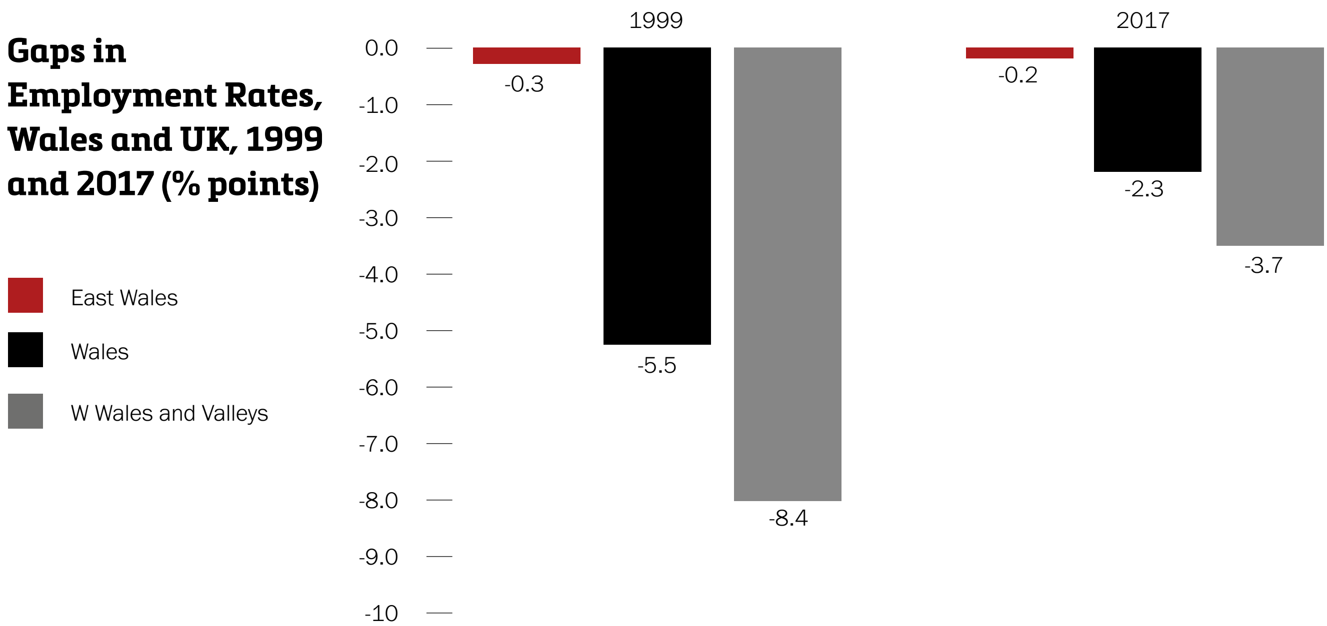
Our land managers and coastal communities make an important contribution to the economy, deliver environmental value to Wales and support some of the most important parts of our society. Over 90% of Welsh land is in the hands of our farmers, foresters or other stewards of the landscape. As we set out in 'Brexit and Our Land' (July 2018) we have the opportunity to redesign support systems to enhance the wider benefits land brings to Wales and support the delivery of our unique legislative framework.

One of the key building blocks in the UK's plans for a successful post-Brexit Britain involves significant investment in science and research where the explicit aim is to grow greater economic growth, inclusiveness and social prosperity. The 2016 Elsevier 'International Comparative Performance of the Welsh Research Base' showed that Welsh research continues to perform above its research income and UK average and accounts for a disproportionately high share of the world's published academic articles and global citations, despite its relatively small research base. This impressive growth in Wales' research performance has resulted in part from the significant investment by the Welsh Government in support of research and innovation over the past 18 years, enabled by the European Structural and Investment Funds (ESIF). We want to be able to continue to support this growth in performance in the future.

More generally, EU funding brings a wider value to the Welsh economy. It enables the Welsh Government to leverage additional resources from both the public and private sector. Together with match funding, the current ESIF will drive a total investment of almost £3bn across Wales during the lifetime of the current programme. Again, proportionately Wales receives significantly more investment from ESIF – around 20% of the UK total – than our population share. This reflects the relatively high levels of need in West Wales and the South Wales Valleys. ESIF funding supports investment which generates growth, supports people into work and delivers major infrastructure projects, such as the South Wales Metro and the A55 connectivity investment.

Through this, we have invested in research and development, business competitiveness, increasing renewable energy and energy efficiency and improving connectivity and urban development. Our investment in some of Wales' most deprived communities has yielded significant benefits, despite the adverse economic and social impact of the UK Government's failed policy of austerity. Over the most recent two years for which data are available, Wales has seen faster economic growth per head than the UK as a whole. The West Wales and the Valleys – where EU funded investment is concentrated – has grown faster than Wales as a whole on the same basis and over the same period. Taking the whole period since devolution, the proportion of people in employment across both Wales and, particularly, West Wales and the Valleys, has increased at a faster rate than across the UK as a whole (see chart). Economic inactivity across both Wales and West Wales and the Valleys has fallen at a faster rate than across the UK as a whole over the same period.

Gaps in Employment Rates, Wales and UK, 1999 and 2017 (% points)



Note: 2017 data is for year end December 2017

Source: Welsh Government

These are among the positive outcomes we have achieved. The Welsh Government will build on this legacy, working in partnership to marshal the experience built up in communities over many years to maintain investment across Wales at a time when the impact of austerity means that our people need it the most. Our paper 'Regional Investment after Brexit' (December 2018) sets out the evidence of ongoing need for regional investment in Wales and the positive impact that EU funds have had. It also sets out proposals for how post-EU funding could operate in Wales.

The Welsh Government continues to seek agreement with the UK Government on the future funding arrangements as the UK leaves the EU. While we have welcomed the guarantees from the UK Government regarding funding for the current round of EU programmes, we now need clarity about the long-term arrangements.

Wales must not lose out

Our original White Paper was clear: the UK Government must honour the assurances the people of Wales received during the referendum campaign that leaving the EU will not result in Wales being worse off than if we had remained part of the EU. EU funding that is currently spent in Wales must be repatriated to the Welsh Government without any claw back or top slicing by the UK Government.

The baseline of the Welsh Government's block grant from the UK Government must be readjusted from the point of EU exit to reflect the real loss of European funding. A "Barnettised" share of UK funding can not be acceptable; nor would a 'bidding' system, in which Wales is at the behest of UK Ministers. Wales must receive at least the funding we would have received if the UK had remained part of the EU.

Alignment of funding to devolved responsibility

Where powers are devolved to the National Assembly for Wales and Welsh Government, including powers in devolved areas currently being exercised at EU level, which are due to revert, funding must follow. This includes any areas where the Welsh Government has agreed that policy should be taken forward on the basis of UK-wide frameworks. This should also include any areas where new activity is required in Wales because we no longer have access to EU-wide functions in the future.

We explicitly and vigorously reject any notion of a UK centralisation of regional economic development policy. A UK Government "shared prosperity fund" approach would be a direct attack on devolution and would risk depriving some of our most disadvantaged communities of the funds they need to develop economically. This would be contrary to the UK commitment that leaving the EU would not leave Wales worse off.

We do, however, accept that there are some important areas of inter-dependence between devolved and non-devolved matters. In these areas, we are very ready to work together with the UK Government and other devolved administrations in a spirit of open co-operation for shared beneficial outcomes.

We are keen, to work productively with the UK Government on the UK Industrial Strategy to develop jointly the industry, technology and skills in Wales that will power future growth. We need a UK partner that can bring its weight to the table, while respecting the devolution settlement and providing the fair share of funding we need.

In higher education, institutions in Wales are operating in an international market for students, research and innovation. There are interdependencies in terms of UK policy on migration that must recognise the needs of the Welsh economy, including the important contribution made by international students. We need institutions across the UK to work together to maximise the opportunities for joint research and innovation and joint promotion of Wales and the UK as a great place to study and research. Higher education in Wales also needs to continue to access wider EU sources of funding and opportunities provided by current EU schemes as discussed in the following section.

3 Continuing access to the benefits of EU partnerships

Wales participates in a range of partnerships and networks that enable us to share best practice and undertake collaborative work. The benefits of participation are much more than simply the funding Wales receives. Where membership is extended to European countries outside the EU, and where it is in our power to do so, we will maintain our participation and co-operation. However, to maximise our access to these programmes, we need a pro-active and positive approach from the UK Government which should continue to fund UK-wide participation in key programmes on behalf of the whole of the UK.

EU programmes

Wales has a particularly close co-operative relationship with the Irish Republic and through the European Territorial Cooperation Programmes we have strengthened that relationship and built prosperity in our maritime links at Holyhead, Pembroke Dock and Fishguard. In addition, Wales has benefited from wider transnational cooperation through our involvement in INTEREGG Atlantic Area and the North West Europe Programme. Outside the EU, we want to maintain access to this joint working and this will clearly also contribute to the UK's wider relationship with Ireland. We look to the UK Government to include this element of funding in its forward relationship with the EU and to support our call for the EU to continue to apply the programmes across maritime borders, not just land borders.

We need continued access to cross-border collaboration projects funded through Horizon 2020 and its successor, Horizon Europe. This has provided opportunities for Welsh businesses and the education sector to collaborate towards common goals, often for wider societal benefit.

ERASMUS+ provides valuable life-skills and international experience to help participants develop personally, professionally and academically. During 2014 alone more than 2,000 participants were involved in Welsh international exchanges and in 2014 and 2015 combined, Welsh organisations secured around £10m of funds across 86 projects.

We believe Wales, and indeed the whole of the UK, should continue to participate in international exchanges such as ERASMUS+ and its successor after the UK leaves the EU. As the funding for ERASMUS+ is expected to double in the next Multi-annual Financial Framework, we should match that growth by stepping up our activity and sharing a wider ambition for enhanced learning and knowledge sharing.

The Creative Europe programme supports co-operation in the cultural and creative sector which has benefitted a number of Welsh language projects and broadcasters in Wales. We want to continue in the programme to further strengthen Wales' cultural and creative identity in Europe.

We are committed to ensuring that Wales remains an outward-looking nation after the UK's withdrawal from the EU and we will continue to engage proactively with international partners and networks. Continued access to cross-border projects and funding will help make sure Wales remains connected to Europe and maximises the benefits that close cooperation and joint working can bring.

European Investment Bank

The European Investment Bank (EIB) brings direct benefits to the Welsh and UK economies. Over the decades of EU membership almost €2.5bn of EIB loans have been made available to enterprises in Wales. This includes flagship investment such as the Second Severn Crossing and the new Swansea Bay University Campus. As we are facing unprecedented challenges in terms of public finances it is vitally important that we unlock all opportunities to boost investment in Welsh infrastructure.

The EIB brings long-term, low-cost capital for much-needed investment in public and private infrastructure. It generates a significant additional benefit for project promoters in the form of commercial expertise, enabling Wales to benchmark and learn from international best practice. The South Wales Metro project, for example, has benefitted from the bank's commercial expertise to inform the procurement process, while previous investments in Wales have, similarly, benefited from expertise and best practice offered by the EIB.

With no equivalent body in the UK and major barriers to creating a new UK institution with the scale and expertise of the EIB, we have strongly advocated that the UK remain a subscribing partner in the EIB and that Wales continue to gain from our direct relationship with the bank. While this remains the Welsh Government's preference, we have noted that the joint report from the negotiators of the EU and the UK on progress during phase one of the Brexit negotiations describes modalities for the UK's eventual withdrawal from the Bank. The joint report states that after the date of withdrawal, UK projects will not be eligible for new operations from the EIB. However, with regard to the future relationship between the bank and the UK, the report states that "there could be mutual benefit from a continuing arrangement between the UK and the EIB." It adds that, "The UK wishes to explore these possible arrangements in the second phase of the negotiations".

As a minimum, we have called for the UK Government to negotiate a specific mandate for continued bank lending in the UK as part of any future arrangements with the EU. This could be achieved by adding the UK to the list of potentially eligible countries in line with Decision No 466/2014/EU of the European Parliament and of the Council of 16 April 2014. Alternatively a UK loan facility, equivalent to the arrangements between the EIB and the EFTA states under the EFTA Loan Facility could be established. Either way, Wales must retain access to this vitally important source of finance and expertise and the Welsh Government, given its close and enduring relationship with the bank, should play a constructive part in that negotiation.

4 A principles-based approach to developing a new Fiscal Agreement for the UK, its devolved countries and regions

Previous sections have highlighted the immediate requirements for Wales as the UK leaves the EU. We recognise the EU has also, until now, provided the overarching framework for fiscal equalisation across its member states. Dilemmas have existed in treading a path to fiscal devolution, but we have progressed so far as part of a shared EU framework in relation to funding. Now, as the UK leaves the EU, there is an immediate need to review our fiscal relationships to ensure they deliver for the devolved countries and regions as part of the UK as well as for the UK as a whole.

The UK entered the Common Market as a highly-centralised state and until recently the UK was one of the most fiscally-centralised states of the OECD. Wales was unique in international comparisons, having a democratic institution with legislative powers without any devolved fiscal competence.

The funding arrangements for Wales were established in the context of the UK Government's plans to introduce devolution to Scotland and Wales in the 1970s. In practice, devolution in Wales was established in response to the Welsh referendum of September 1997. The Government of Wales Act 1998 paved the way for a new Welsh democratic institution. The finance provisions in the Act did not extend to the funding arrangements from the UK Government.

Financing arrangements remained largely unchanged for the best part of a decade but became increasingly contentious. Dissatisfaction was expressed in various parts of the UK for diverse reasons. In Wales, as part of the *One Wales* coalition agreement, the Independent Commission on Funding and Finance for Wales (the Holtham Commission) was established. It recommended a range of reforms to the funding arrangements for the Welsh Government, including replacing the Barnett formula with one that is based on the relative need to fund public services and a range of new responsibilities including the devolution of tax and borrowing powers.

In 2010, the UK coalition government established the Commission on Devolution in Wales (the Silk Commission) with a remit to review the financial and constitutional arrangements in Wales. As a result of the commission's recommendations, the Wales Act 2014 conferred additional responsibilities on Welsh Ministers including the devolution of tax and borrowing powers.

The devolution of taxation powers represented a fundamental change in the way devolved public services are funded in Wales. For the first time Welsh Ministers are able to vary the amount of resource available to fund devolved services in Wales by varying devolved taxes. In addition, Welsh Ministers are now able to borrow for capital investment.

Rules-based funding arrangements

For the most part Wales has been happy to operate within the EU governance model for policy and funding. This model has been based on the principles of: legitimacy; co-production; and respect for the responsibilities of the EU and the Welsh Government. Within this model the Welsh Government has been able to operate with a high degree of autonomy with the certainty that a rules-based multi-annual funding framework established.

The UK funding framework does not share all the principles of the EU framework that we value. While the Welsh Government has a high degree of autonomy within the UK funding framework, the UK Government operates the framework in a centralised model with little genuine co-production. In addition, the UK model can be open to wider political influence as demonstrated by the UK Government's financial package for Northern Ireland following the confidence and supply agreement the Conservative party reached with the Democratic Unionist Party following the General Election in 2017.

Funding based on multi-annual financial frameworks has brought important clarity to our delivery partners and beneficiaries with seven-year funding plans, compared to the typical three-year plans set by the UK Government in its spending reviews. Importantly the funding arrangements are based on clear rules for eligibility based on objective measures of need.

Within the UK, the UK Government's *Statement of Funding Policy* outlines the process by which the Welsh Government (and the other devolved administrations) is funded. This allocation is based on the Barnett formula which has been in place since devolution and allocates changes in funding for the devolved governments based on the relative population of each nation.

The principles and operation of the Barnett formula have been a topic of much political and academic debate with few commentators concluding its operation provides a sound basis for funding the devolved governments.[1] There is also growing discontent within England.[2] The Welsh Government has long called for the replacement of the Barnett formula with a new formula based on needs.

The fiscal framework, which sets out the wider fiscal arrangements to accompany the devolution of tax powers to Wales, secured important reform to the Barnett formula as applied to Wales. The addition of a specific needs based factor means for the first time relative funding in Wales is aligned to Wales' relative need to fund devolved public services. This important reform implements the funding floor proposed by the Holtham Commission.

However the Holtham Commission's funding floor was always proposed as an interim measure while more fundamental reform to funding arrangements was undertaken. The Holtham Commission proposed a simple needs-based formula to allocate changes in funding within the UK.

As a matter of principle, the Welsh Government believes the allocation of resources across the UK should be based on relative need set within a new funding framework agreed between all four UK nations. We believe the fiscal arrangements of the UK should enable all parts of the union to provide an equivalent level of services taking account of relative needs of the population and assuming equivalent tax effort. We recognise the wide range of different approaches to fiscal relations in different countries (Annex 1 includes some key examples) and no reasonable option should be off the table as we continue to discuss this.

A needs-based system for all parts of the UK would align funding to need and strengthen the social union, ensuring all parts of the country are able to provide a standard level of public services taking account the relative needs of the population.

Replacement for State Aid arrangements

In addition to new rules-based funding arrangements for allocating resources fairly within the UK, we need replacement rules for providing state assistance which recognise the value of regional development.

Those rules have traditionally been set through the State Aid framework, which has provided clarity across Europe. Of course, our preferred model for the UK's withdrawal from the EU would maintain full and unfettered access to the single market and would thus be likely to entail continued alignment with EU State Aid rules and requirements. However, with the UK Government

1 House of Lords Select committee on the Barnett Formula provides a good overview of the debate within the UK https://publications.parliament.uk/pa/ld200809/ldselect/ldbarnett/139/139.pdf
2 The Dog that finally barked England as an emerging political community. IPPR: https://www.ippr.org/files/images/media/files/publication/2012/02/dog-that-finally-barked_englishness_Jan2012_8542.pdf

pursuing alternative trade relationships, we need a clear set of rules to ensure a level playing field while also recognising the importance of regional investment to support a more equal and prosperous UK.

A replacement set of rules to support regional investment is also crucial in the context of fiscal decentralisation within the UK. The existing State Aid rules govern the appropriate use of taxation to support economic and social objectives. These rules are important to limit authorities in tax competition and the potential race to the bottom – both in respect of taxation and the provision of grants and subsidies – which only undermines the state's ability to support public services.

Given the importance of new rules covering State Aid issues, the Welsh Government needs to be part of those discussions. Any new arrangements should be drawn up in line with our principles of agreement and consent, working collaboratively with the UK Government and the other devolved nations. Any new bodies set up to regulate State Aid, or existing bodies repurposed, should be established with a governance model reflecting the realities of devolution and the nature of a post-EU United Kingdom.

Agreeing a principles-based approach to a new UK Fiscal Agreement

We believe the extent of fiscal devolution should be sufficient to enable genuine choices about levels of tax and spend and to provide meaningful levers to support growth and other policy objectives. Consistent with the importance we place on the functioning of the UK, we do not believe fiscal devolution should undermine the scope for redistribution across the UK or enable the creation of undue distortions, which undermine the functioning of the UK single market.

There are new budgetary risks from fiscal devolution through the potential interaction between devolved and non-devolved fiscal powers – UK Government tax policy changes will have an impact on devolved tax revenues and, in certain cases, also on the block grant adjustment. We recognise the important role the Welsh Government's fiscal framework plays in the management of fiscal devolution. It provides tools to manage the additional risks and uncertainties through the new Wales cash reserve and resource borrowing powers. It also includes additional scope for capital borrowing, giving the Welsh Government greater flexibility to plan and manage large infrastructure projects. Furthermore it addresses problems with the Barnett formula, with additional resources in the short to medium term and a long-term guarantee to limit convergence in the future. However, the framework was not designed to operate in a post-EU UK. Both the details of the framework and the broader fiscal arrangements will need to be reviewed.

There are a range of approaches to fiscal decentralisation in OECD countries. The UK already has a different set of approaches to fiscal devolution in Scotland, Wales and Northern Ireland, which are distinctly and separately underpinned by democratic support within each nation. There have also been significant developments in fiscal decentralisation within England in recent years. These developments have been unsystematic and highly asymmetric, with some English regions – like London and Manchester – having a much greater degree of control over funding and fiscal matters than others, contributing to a very complex picture overall. Reform of fiscal arrangements within the UK must also take account of England.

The OECD[3] suggests there is a general case in principle for the devolution of fiscal powers from central governments in terms of promoting efficiency, democratic accountability of public spending and enhanced incentives for developing the economic and revenue base. The international evidence also supports the case for sub-national governments to be able to borrow for capital investment on grounds of efficiency and inter-generational equality. In addition, the

3 OECD, Fiscal Federalism 2014: making decentralisation work.

OECD has highlighted that fiscal decentralisation supports growth if appropriately managed.[4]

Asymmetric fiscal devolution, as across the UK, requires active management to manage the risk of fragmentation and incrementalism.[5] The current arrangements for funding and fiscal devolution in the UK are unstable and unsustainable, and more so as the UK leaves the EU. It needs to be addressed as a matter of urgency. At a minimum, the UK and devolved governments urgently need to agree a clear set of aims and principles for fiscal devolution, which articulate the benefits, both for devolved nations and the UK. This will enable a more strategic approach to fiscal devolution, while allowing for the possibility of different arrangements in different parts of the UK to suit differing circumstances. Delivery of agreed aims and principles will fundamentally rest on the ability of the national and devolved governments to work collaboratively and share responsibility for outcomes in a measured and even way. Alongside the intensifying work on other UK frameworks, one of our conclusions is the compelling case for a parallel Fiscal Agreement to be developed.

Strengthened intergovernmental machinery

The current arrangements in the Statement of Funding Policy are imposed by the UK Government with little meaningful consultation with the devolved governments and are not jointly agreed. As a result, those processes have been brought into dispute. In 2008, a disagreement was raised in relation to UK Government funding for regeneration linked to the London Olympics. In 2017, the Welsh and Scottish Governments jointly raised a disagreement following the UK Government's decision to allocate an additional £1bn to Northern Ireland as part of the confidence and supply agreement between the Conservative Party and the Democratic Unionist Party following the 2017 General Election.

To support the devolution of taxation powers, a fiscal framework was agreed between the Welsh and UK Governments with a similar agreement reached between the Scottish and UK Governments. This marked a significant step forward in reaching agreement on the funding arrangements for the devolved governments while at the same time preserving the UK Government's reserve competence over fiscal and macro economic policy.

We support the development of jointly-agreed funding arrangements based on consent and cooperative working. This needs to operate with the UK Government and all of the devolved administrations, ending bilateral deals and agreements to bring consistency and clarity to the fiscal arrangements within the UK. The current system does not support the operation of effective government and as demonstrated by recent disputes results in governments arguing over the application of the rules. This diverts resources away from running public services that many in society depend on.

As we set out in '*Brexit and Devolution*' (June 2017), withdrawal from the EU will radically increase the areas of inter-connected competence as a result of devolved matters where UK wide approaches will need to be negotiated and agreed and non-devolved matters which will have a major impact on devolved services and budgets.

Cooperation and a partnership approach to discussion between the devolved administrations and the UK Government is clearly the best approach for the longer term as we shape a new future for the UK. As policy areas are being developed within new joint frameworks based on cooperation and collaboration, funding arrangements need to be developed applying those same principles.

Equally, the UK's withdrawal from the EU may also offer new opportunities for tax devolution, since EU regulations currently constrain the ability to vary taxes such as VAT, alcohol duties and air passenger duty within the UK. As the debate around fiscal decentralisation continues within

4 OECD, Fiscal Federalism and Inclusive Growth, 2018
5 https://www.instituteforgovernment.org.uk/blog/tax-devolution-system-increasingly-lacks-coherence

the UK we need effective collaborative work between governments to consider and develop joint proposals for future fiscal arrangements – in approach, mechanism, and process –that build on the principles of partnership, agreement and consent.

As we set out in '*Securing Wales' Future*', we believe the current inter-governmental arrangements will no longer be fit for purpose and new ways of working need to be established. Moving to a new rules-based model based on agreement with collaborative and cooperative joint working will require reform to the existing intergovernmental machinery.

Specifically for finance and taxation matters, we believe it is time to strengthen the machinery around the finance quadrilaterals to provide the necessary assurance and oversight to the new UK funding framework. These discussions should have a decision-making remit for intergovernmental finance and taxation issues within the UK. The new UK funding framework we propose here, including aims and principles of fiscal devolution, should be agreed through the finance quadrilaterals with UK finance ministers having joint responsibility and ownership of these new arrangements.

Independent oversight

We also recognise that even with a model jointly agreed by governments there may be occasions where the application of those rules may be open to interpretation. It is unlikely that a funding framework based on agreement and consent will necessarily eliminate all grievances and disputes.

Recognising this, the fiscal frameworks for Wales and Scotland include a role for bodies independent of government to input into any dispute that could arise and cannot be settled through intergovernmental discussions. This model of independent oversight is commonplace in countries with intergovernmental funding arrangements. A new UK funding framework needs to include an explicit role of bodies independent of government to oversee its operation.

Conclusion

Since devolution, there have been significant steps made to reform our fiscal settlement to provide a fairer approach to funding, and devolution of tax-raising powers. The UK leaving the EU puts a different lens on this progress, highlighting the future funding needs and the insufficiency of the current fiscal devolution arrangements to deal with the strategic challenges which we now face.

The Welsh Government believes there are five key areas where progress will need to be made:

a. Wales must not lose out financially from the UK leaving the EU;

b. Wales must have continued access to important European partnerships and networks;

c. The Barnett formula must be replaced with a new, rules-based funding system;

d. A new principles-based approach to UK funding and fiscal networks must be developed, enshrined within a new Fiscal Agreement which is developed in parallel with other post-EU UK frameworks;

e. The UK finance inter-governmental machinery must be reformed to embed collaboration and agreement, including a clear role for independent oversight of these arrangements.

These issues are not unique to Wales – the approach to English devolution has an impact in Wales. A comprehensive and robust response to the above issues will result in fairer and more inclusive societies, more balanced economic development across all parts of the UK and uphold and enhance devolution.

Annex 1: Fiscal decentralisation – selected case studies

Basque Country

The Basque Government has an annual budget of approximately €11bn and has sole responsibility for revenue generation to fund public services. Via the Economic Settlement (agreed in 1981) and associate "Cupo"/Quota (negotiated every five years), the Basque Government effectively reimburses the Spanish Government for the delivery of reserved services (defence, foreign affairs, etc). The Cupo rate currently stands at 6.24%. This represents the Basque Government's "share" of the total Spanish Government spend on reserved matters.

With the exception of the collection of customs duties, the Basque Government is responsible for managing all taxes within the Basque Country/Euskadi, including VAT and corporation taxes. Executive and legal competence for tax and wider fiscal policy is devolved to the three Basque provinces – Biscay, Alava and Gipuzkoa. Beyond this, local authorities and town and city councils have a degree of autonomy in relation to local tax rates.

The Basque Government's annual budget decisions are informed by strategic and departmental plans. Improvement of living standards across the region is a high priority for the Basque Government, with priority spend on social welfare (€500m) and health (more than €3bn). To support economic growth, the Basque Government aims to sustain a 5% year-on-year increase on spending on technology and innovation.

We understand nominal revenue annual growth is projected to be 4% to 4.5% (GDP growth current stands at 2.9%), which affords some flexibility within budget to meet short-term demands while investing in delivering longer-term objectives. While the Basque Government has adopted a progressive approach to tax rates, taxation is very much geared towards revenue generation as opposed to taxation as a tool to deliver policy outcomes.

Our assessment is that this is largely driven by the demands of managing a comprehensive range of taxes while having complete responsibility for revenue generation and fiscal policy. That aside, the Basque Government has in place a variety of tax reliefs to support priority economic sectors and people in need, which is in line with its liberal socialist approach to fiscal policy.

The Basque Government has established an arm's length coordination body to help ensure alignment of fiscal policy and tax rate variation between provinces (and between local authorities). This body also ensures compliance with agreed reporting arrangements and with national and international obligations.

Belgium

Belgium is a federal state with most tax revenues being managed by the federal government. The Belgian regions have limited tax autonomy and depend on federal grants and revenue transfers for the bulk of their funding. There is, however, a growing trend towards fiscal decentralisation.

Belgium consists of three administrative regions – Flemish, Walloon and Brussels-Capital – three communities (the Flemish Community, the French Community and the German-speaking Community), 10 provinces and nearly 600 municipalities. Most major taxes are set and collected by the Belgium government. Income tax and VAT revenues are distributed to the Belgian regions (income tax) and communities (VAT).

The Belgian regions currently set rates for gambling and betting tax, estate, inheritance and gift taxes, vehicle road fund tax and vehicle registration fees, property transfer and mortgage registration fee, and radio and TV Licence fees. In the last 10 years, the regions have gained more fiscal autonomy, particularly for tax credits in relation to housing and energy efficiency.

Germany

There are three main tiers of government in Germany: federal (Bund), states (16 Länder) and local authorities (Gemeinden). The federal government has sole jurisdiction over tariffs, indirect taxes (including electricity tax, tobacco tax, alcohol taxes and tea and coffee tax) insurance taxes, capital transaction taxes, and surcharges on income tax. Revenues from income tax, corporation tax and VAT are shared between the federal government, the Länder, and – to a lesser extent – local authorities.

Revenues from wealth tax revenues (not levied since the mid-1990s), motor vehicle tax, inheritance and gifts tax, property purchase tax, betting tax, beer tax and fire protection tax flow to the Länder. There is no variation in rates for these taxes across the Länder (with the exception of property purchase tax) with rates being set jointly by the federal government and the Länder. Local business and property tax rates are set by local authorities.

Income tax and corporation tax revenues are shared with the Länder on the basis of taxpayer residence and the location of firms. VAT revenues are distributed to the Länder on a per capita basis.

Australia

The Australian Federation consists of two self-governing territories and six states, and more than 560 local authorities. The Australian Government maintains responsibility for major taxes, although the territories and states are responsible for nearly 50% of government spending.

The federal government is responsible for collecting income tax, corporation tax, excise duties and trade levies. The state and territorial governments set tax rates and receive revenues from land taxes, capital transaction taxes, taxes on insurance, gambling taxes, motor vehicle tax and mining royalties (except for offshore oil and gas). Overall, Australian territories and states generate just over half their spending from the tax revenues they collect, with the remaining funding being provided by the Australian Government.
Local authorities retain the revenues generated from local rates and user charges.