

Y Comisiwn Annibynnol ar  
Ariannu a Chyllid i Gymru

Independent Commission on  
Funding & Finance for Wales

First report

# Funding devolved government in Wales: Barnett & beyond

summary

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# Preface



On behalf of my fellow Commissioners, I am pleased to present our first report. The Commission has been set the following terms of reference:

- 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.

This report focuses primarily on the first part of the remit. It assesses the Barnett Formula as it has been applied to Wales and considers the case for change. Detailed consideration of tax-varying and borrowing powers, and the Commission's recommendations on the appropriate funding arrangements for Wales, will follow in a final report.

We look forward to receiving the response of the Assembly Government to this first report and to the planned Plenary debate by the National Assembly for Wales.

In the meantime, we have begun to plan how we should address the second part of our remit. In an annex, we set out our initial thoughts on the areas that will require further investigation and following the publication of this report we will announce a call for evidence for the second phase, inviting views on widening borrowing powers and the devolution of tax measures to the Assembly Government.

The Commission warmly thanks those people and organisations who have already given of their time to support its work by submitting written evidence and by attending the Commission's meetings to share their expertise. Fuller acknowledgment is made in Annex 5 of the full report. We should also express our gratitude to the secretariat to the Commission for their good work in helping us to discharge our mandate. That said, the conclusions and recommendations in this report are, of course, solely the responsibility of the Commission.

## **Gerald Holtham**

Chair

Independent Commission on Funding and Finance for Wales



# Chapter 1: Scope of the report and principles for reform

## Background

1.1 Following a referendum in September 1997, the Government of Wales Act (1998) led to the creation of the National Assembly for Wales (“the Assembly”), which met in Plenary session for the first time in May 1999. The Assembly initially inherited the executive powers of the Secretary of State for Wales, though its powers have since grown incrementally. As a result of the Government of Wales Act (2006), those executive powers are now exercised by the Welsh Ministers, and the executive as a whole is known as the Welsh Assembly Government (“the Assembly Government”).

1.2 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 these 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 these funds are referred to as “the Welsh block grant”.<sup>3</sup> The Assembly then adopts a budget motion that provides resources to the Assembly Government. Welsh Ministers are free to allocate this grant in line with their priorities, subject to approval from the Assembly.<sup>4</sup> The Assembly has no tax varying powers that could alter the overall size of the Welsh Consolidated Fund and Welsh Ministers have only very limited borrowing powers.<sup>5</sup>

## Context

1.3 The first decade of electoral devolution has benefited from relatively benign political and fiscal circumstances; the same party was in office (alone or in coalition) in London, Cardiff and Edinburgh throughout the period from 1999-2007, and budgets have generally increased substantially year on year. With a range of political parties now in power across the UK, and with increased fiscal stringency likely in the future, the financial arrangements that underpin devolution must function in more challenging circumstances.

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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. Chapter 2 explains how the Barnett Formula operates (paragraphs 2.4-2.5)

<sup>2</sup> The Welsh Consolidated Fund acts as a neutral pot where the money voted by Parliament for Wales is held. In addition to the budget provided to the Assembly Government, the separate expenditures 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 Assembly is responsible for approving 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.

<sup>3</sup> Chapter 2 provides further information on what is covered by the term “Welsh block grant” (paragraphs 2.2-2.3).

<sup>4</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>5</sup> Annex 2 provides a detailed description of the current fiscal powers of the Assembly Government, including its very limited ability to borrow over the short term from HM Treasury, and its role in determining council tax and business rates.

## Approach to the terms of reference

1.4 The Commission's terms of reference include two distinct elements, which are 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.

1.5 The Assembly Government asked the Commission to concentrate initially on the current formula-based block grant system, before considering tax varying and borrowing powers at a later stage. Accordingly, this report focuses primarily, though not exclusively, on the first part of the Commission's remit. It assesses the Barnett Formula as it has been applied to Wales and considers the case for change. Detailed consideration of tax-varying and borrowing powers, and the Commission's final recommendations on the appropriate funding arrangements for Wales, will follow in a final report.

1.6 Given that order of business, the recommendations in this report are designed to be applicable both to a reformed Barnett Formula and also to a more fundamentally altered system. In the latter case, our recommendations would apply to the block grant element of whatever mechanism was in place to transfer funds between the UK Government and Wales. The focus of this first report on Barnett therefore certainly does not rule out recommendations for more substantial reform in the Commission's final report.

1.7 The analysis and recommendations in this report are focused on Wales. It is not within the Commission's remit to make recommendations about funding arrangements for other parts of the UK. In a system of asymmetric devolution<sup>6</sup>, as currently exists in the UK, there is no reason to believe that each devolved administration should necessarily be funded in exactly the same way. However we believe that different outcomes in different parts of the UK should be the result of considering their different circumstances in the light of a common set of principles. The Commission has been mindful at all times to make recommendations based on principles that can be applied generally and to avoid any "special pleading" for Wales.

## Options for change: block grants and taxation

1.8 Possible funding systems for the Assembly Government range from a continuation of the current block grant-based arrangements (funded by the taxation and borrowing of the UK Government) through to a high degree of fiscal autonomy, where the Assembly Government's expenditure would largely be financed from taxes raised in Wales that were under the control of the Assembly.

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<sup>6</sup> The scope of devolved responsibilities is different in Wales, Scotland and Northern Ireland.

1.9 Along this spectrum of options there are, broadly defined, four possible models for financing devolved government in Wales:

- i) a continuation of the existing block grant regime, whereby Wales remains funded by a grant from the UK Government, whose size may be determined by Barnett or by some new mechanism;
- ii) a block grant supplemented by the assignment of some tax revenue to Wales, though without the devolution of powers to vary taxes. Under this option, the block grant would be reduced by an amount equivalent to the assigned tax revenue, resulting in no overall increase in funding for Wales. Fluctuations in the assigned tax revenue over time would impact on the budget of the Assembly Government and would not be offset by compensating changes to the block grant;
- iii) a block grant coupled with assigned tax revenue as above, plus devolution of tax varying powers over certain designated taxes (“partial fiscal autonomy”); and
- iv) devolution of responsibility for all taxes raised in Wales, as well as for devolved expenditures. In effect this is a federal system of finance, with a range of possible transactions between the Assembly Government and the UK. Under such a system, 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 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”).

1.10 A federal system of finance may represent a feasible destination for Wales over the longer term but it seems inconsistent with the current scope of devolution. Full fiscal autonomy in particular would be anomalous within the current constitutional arrangements. For a Commission such as ours, charged with making recommendations for the Assembly Government as it is, or may soon become, option iv) is therefore of less immediate relevance than the other options. We expect to focus mainly on options i), ii) and iii) in our final report.

## Options for change: borrowing

1.11 Other than an extremely limited facility for short term borrowing from HM Treasury (set out in Annex 2), in practice the Assembly Government has no borrowing powers. At present, the Assembly Government is almost entirely dependent on resources voted by the Assembly, and the Assembly is in turn reliant on the funds it receives from the UK Government, which are set for several years at the time of each spending review. The Assembly Government’s revenue is therefore insulated from short term fluctuations in the Welsh economy and Welsh public finances, which reduces its need to borrow.

1.12 Conventional analysis suggests that a limited ability to borrow would probably be useful to the Assembly Government even if it continued to be funded under the existing arrangements. Borrowing would enable revenue flows to be more closely matched with capital expenditure requirements. Such borrowing would need to be limited since its servicing would imply a prior call on future block grants and the parameters would have to be agreed with the Treasury so that the borrowing capacity against UK tax revenue was allocated appropriately.

1.13 If Wales were to move towards a model where its block grant was supplemented by tax revenue raised in Wales (with or without the power to vary these taxes), it would acquire its own revenue stream and therefore would have a greater capacity to borrow. Indeed, if part of the Assembly Government's budget were directly dependent on taxes raised in Wales, there would potentially be a strong need for limited borrowing powers in order to manage the Assembly Government's resources effectively over the course of the business cycle. A truly independent revenue source would also broach the option of direct access to capital markets.

1.14 The case for the devolution of additional borrowing powers to the Assembly Government depends on (i) whether it enhances flexibility in spending in a way likely to benefit Welsh citizens and (ii) whether it can be implemented in a way consistent with the UK Government's responsibility for preserving macroeconomic stability. Our conclusions on borrowing will depend on the overall fiscal settlement, to be considered in our final report.

## Principles for reform

1.15 The Independent Expert Group to the Commission on Scottish Devolution has set out a series of principles to guide that Commission's work when considering how to reform current arrangements.<sup>7</sup> This Commission believes that those principles are for the most part generally accepted and we are happy to embrace them. They state that an ideal financing system for sub-national governments should have the following characteristics:<sup>8</sup>

- **Equity:** for the purposes of the analysis that follows in subsequent chapters, a "fair" allocation of funds is assumed to be one in which resources are allocated in a way that makes it possible to provide a standard level of service in all parts of the UK. Equity is a contested concept that is discussed in Chapter 3;
- **Autonomy:** it allows the sub-national government choice on what and how much to spend;
- **Accountability:** 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;<sup>9</sup>
- **Stability/predictability:** so that public spending can be managed properly;
- **Simplicity/transparency:** so that it is readily implemented and the justification is evident; and
- **Efficiency:** to avoid creating economic distortions by incentivising movements of people and the factors of production simply to avoid taxes.

<sup>7</sup> Independent Expert Group to the Commission on Scottish Devolution, 2008 p.7.

<sup>8</sup> The terms "sub-national" and "regional" are used in this report to refer to the devolved administrations. This follows the terminology in use in the existing economic literature and is not a reflection of the national status of Wales, Scotland or Northern Ireland.

<sup>9</sup> A link between a region's tax take and the budget of the regional government is also theoretically desirable in order to strengthen incentives to promote growth. That said, economic growth is likely to enhance a government's chances of re-election and therefore in practice all governments have strong incentives to promote growth irrespective of whether the tax take in a region directly impacts on a government's budget constraint.

# Chapter 2: The impact of the Barnett Formula on Wales

## The origins of the Barnett Formula

2.1 In the 1970s, the UK Government planned to introduce devolution to Scotland and Wales. It was intended that the budgets of the devolved administrations would be set as part of the annual public expenditure review for the UK, through a combination of political judgement and an assessment of relative needs.<sup>10</sup> A population-based formula for determining changes to the Scottish budget was introduced by the Treasury as an interim measure in 1978, pending the creation of the new devolved bodies.<sup>11</sup> However, following the failure of the devolution referenda in 1979, this funding mechanism remained in place for Scotland, and was extended to cover Wales from 1980.<sup>12</sup> Named after Joel (now Lord) Barnett, who was Chief Secretary to the Treasury at the time of its introduction, the formula has been, with only minor modifications, the basis by which the budgets for Wales, Scotland and Northern Ireland have been determined ever since.

## The Welsh block grant

2.2 The size of the Welsh block grant is set in advance for periods of three years (known as spending review periods) as part of the UK Government's spending review process, which is designed to align spending with the UK Government's priorities.

2.3 Chapter 1 (paragraph 1.2) sets out the process by which Parliament provides funds to Wales, via the Welsh Consolidated Fund. A key distinction is made between Departmental Expenditure Limit (DEL) and Annually Managed Expenditure (AME). DEL is a fixed budget set by the UK Government, which is planned and controlled in spending reviews. Devolved Administrations and UK Government departments have to manage spending so as not to breach their DEL. Expenditure in AME is generally less predictable and controllable than expenditure in DEL (examples include social security benefits and debt interest payments) and therefore cannot reasonably be subject to firm, multi-year limits in the same way as DEL. AME expenditure is not determined by the Barnett Formula. In addition, the Assembly Government receives European Structural Funds, which are also unaffected by the operation of the Barnett Formula. Much the greater part of the resources available to the Assembly Government is contained within DEL. In this report, the term "Welsh block grant" is, strictly speaking, a reference to the DEL element of the Welsh Consolidated Fund, changes to which are determined by the Barnett Formula.

## Description of the Barnett Formula

2.4 The Welsh block grant is carried forward from one period to the next, with the Barnett Formula being used to make changes to the block. In determining these changes (which can be positive or negative and are often referred to as "consequentials"), the formula combines three factors, namely:

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<sup>10</sup> Discussed in the report of the interdepartmental study coordinated by H M Treasury on the relative public expenditure needs in England, Scotland, Wales and Northern Ireland (HM Treasury, 1979 p.3).

<sup>11</sup> House of Commons Library, 2007 p.8.

<sup>12</sup> House of Commons Library, 2007 p.9.

- 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.

2.5 Box 2.1 provides a hypothetical example of how the formula works.

### **Box 2.1: An example of the Barnett Formula in operation**

The Barnett Formula determines changes to the Welsh block grant (often referred to as the Barnett consequential) via the following calculation:

$$\text{Change to Welsh block grant} = \text{change to equivalent English programme} \times \text{comparability factor} \times \text{Welsh to English population ratio}$$

To see the impact of this formula, consider a hypothetical £100 million increase in spending for a UK Government department. The comparability factor is determined by the extent to which the UK department’s programmes are devolved to Wales. Assuming that the UK department’s programmes are 90 per cent devolved to Wales, a comparability factor of 90 per cent will be applied. The population share is derived from Office for National Statistics (ONS) estimates, which at present show the Welsh population to be 5.83 per cent of the English population. Combining these factors, the increase in the Welsh block will be:

$$£100 \text{ million} \times 90 \text{ per cent} \times 5.83 \text{ per cent} = £5.25 \text{ million}^{13}$$

## **Convergence in spending: the Barnett “squeeze”**

2.6 Public spending per head is higher in Wales and the other devolved administrations than it is in England. However, additional allocations to the budgets of the devolved administrations through the operation of the Barnett Formula are the same per head as those in England. For this reason, overall relative spending per head in the devolved administrations should converge over time towards the English level of spending per head on comparable programmes. This phenomenon is known as the Barnett “squeeze”. Other things being equal, larger increases in real public spending (as have occurred over the last decade) or higher inflation rates should amplify the rate of convergence, as they will increase the importance of increments relative to the total budget.

<sup>13</sup> For a detailed description of the operation of the Barnett Formula, see HM Treasury, 2007a

**Box 2.2: An example of the Barnett squeeze**

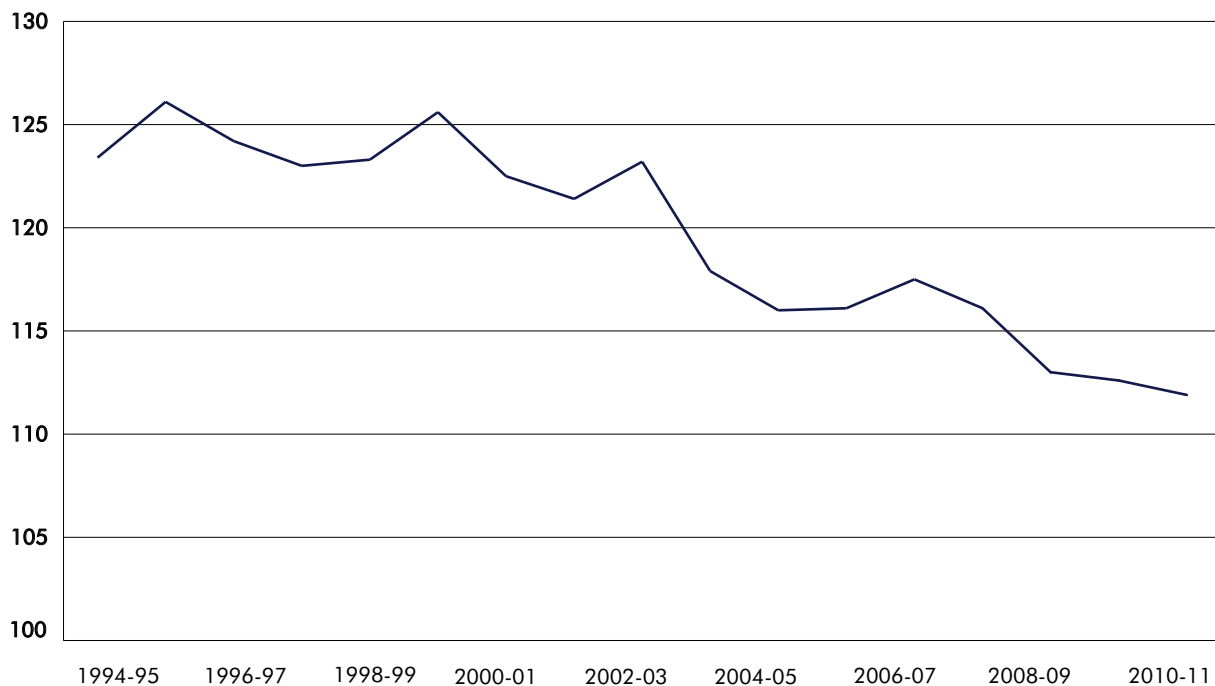
	<b>England</b>		<b>Wales</b>		
Population	50 million		3 million		
	£ billion	£ per head	£ billion	£ per head	£ per head (England = 100)
Baseline	100.0	2,000	7.2	2,400	120
Increase	30.0	600	1.8	600	
New budget	130.0	2,600	9.0	3,000	115

The table sets out, using round numbers, a hypothetical example of how the Barnett squeeze causes convergence in spending per head. Comparable expenditure in England, (that expenditure for which Wales receives Barnett consequentials), is assumed to have a baseline of £100 billion or £2,000 per head of the population. Baseline expenditure per head in Wales is £2,400, or 20 per cent higher than in England.

The table assumes that there is an increase in expenditure of £30 billion or £600 per head in England, so that the new level of spending per head in England would be £2,600. Through the Barnett Formula, Wales would receive the same increase per head of £600 and total spending per head would rise to £3,000. With England = 100, spending per head in Wales would fall from 120 to 115. Expressing this in another way: where England would see a 30 per cent increase in spending, Wales would only see a 25 per cent increase. Over time, continued application of the Barnett Formula would cause spending per head in Wales to move proportionately ever closer to average spending per head in England.

2.7 Chart 2.1 shows how, since the late 1990s, Barnett-related spending per head in Wales has been converging with comparable spending per head in England. In 1999-00, when the National Assembly began, spending per head in Wales on Barnett-funded programmes was 25 per cent higher than spending per head on comparable programmes in England, or 125 in index notation, where England is set at 100. At present (in 2009-10), Barnett funded expenditure per head in Wales is 113, and is expected to decline to 112 in 2010-11. In other words, the gap in spending per head between Wales and England will have roughly halved since the introduction of devolved elected government.

2.8 In contrast to the marked convergence seen in Wales, there has been no convergence in expenditure per head among English regions in recent years and no mechanism exists which would cause convergence independently of assessed relative needs.

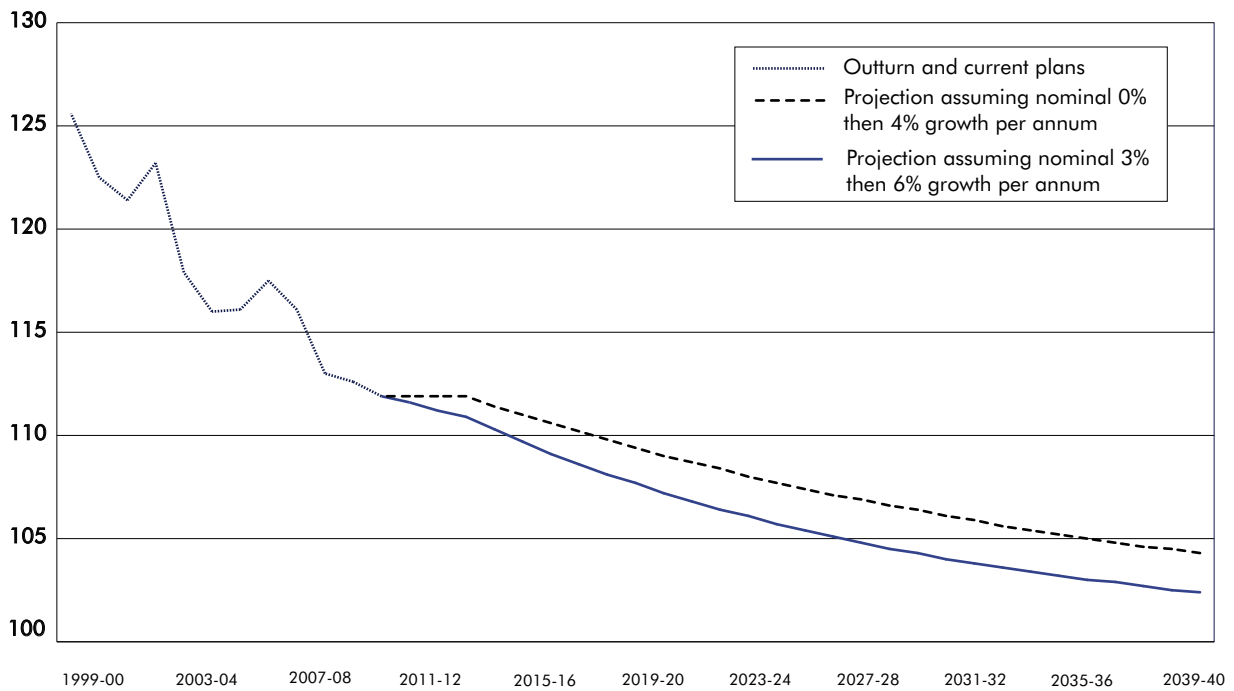
**Chart 2.1: Wales's relative expenditure per head on programmes covered by the Barnett Formula (England = 100), 1994-2011**

Source: Commission calculations

## Likely scale of the future squeeze: projections

2.9 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 by real changes in spending. Chart 2.2 illustrates two possible scenarios for future convergence. Both scenarios take account of the very limited scope for increases in expenditure over the next spending review period, as indicated by the public finance projections in the 2009 Budget. The faster growth scenario includes increases of 3 per cent a year in nominal terms between 2011-12 and 2013-14 followed by 6 per cent a year thereafter ("the historic average spending growth scenario"). This reflects a period of low growth followed by the same average nominal annual increase in comparable English spending as between the early 1990s and the current year. On this trajectory, Chart 2.2 shows that relative spend per head in Wales would fall from 112 at the end of the current spending review period to 107 over the following decade (with England equal to 100). In other words, the sustained squeeze in relative spending experienced in Wales over the previous decade would continue.

2.10 Chart 2.2 also shows the convergence that would occur with no growth in spending over the next review period followed by growth of 4 per cent nominal per year ("the low spending growth scenario"). Assuming relevant price inflation of 2½ - 3 per cent a year, this scenario would represent real reductions in expenditure followed by very slow real growth in public services by historical standards. In this scenario relative expenditure per head in Wales would still fall to 109 by 2020-21.

**Chart 2.2: Projected convergence in spending per head (England = 100), 1999-2040**

Source: Commission calculations

2.11 Barnett was originally introduced as a temporary measure but it has nonetheless lasted almost 30 years. If it lasts another 30 years, Chart 2.2 suggests that spending per head in Wales will converge to just 2 per cent above the England average, assuming historic growth rates in comparable spending. Assuming very low real growth over the whole period, spending per head in Wales will still converge to just 4 per cent above the English average over the next 30 years.



# Chapter 3: Assessment of the Barnett Formula against the principles for reform

## The Commission's assessment

3.1 Chapter 1 outlined six characteristics that are desirable in any system for financing sub-national governments. Barnett possesses some but not all of these characteristics. Judged against the principles for reform, Barnett performs relatively better on:

- **autonomy:** by providing an unhypothecated block grant, Barnett gives the Assembly Government a high degree of flexibility in determining its spending priorities. However, autonomy is limited since there is no scope to alter the size of the block grant;
- **efficiency:** the operation of Barnett itself results in few if any incentives for the relocation of people or businesses and hence causes few distortions to economic activity;
- **stability/predictability:** on the whole, Barnett provides a stable source of revenue. It is reasonably predictable, although there have been instances of revenue surprises in practice; and
- **simplicity/transparency:** Barnett is cheap to operate and, in principle, simple to understand. However, the detailed operation of the formula and its impact on spending outcomes can prove to be complicated.

3.2 Barnett performs poorly in terms of **accountability**; spending decisions made by the Assembly Government do not impact on the taxes paid by Welsh citizens. In addition, changes in the amount of tax raised in Wales have no impact on the size of the Welsh block grant.

3.3 The extent to which Barnett meets the **equity** principle (i.e. how well it provides resources to Wales that are in line with Welsh needs) is discussed below.

## Equity and needs

3.4 The size of the population of Wales is one indicator of the need to spend on public services in Wales, albeit a highly incomplete one if used in isolation. By linking changes in the Welsh block grant to the relative population of Wales, while avoiding any assessment of the appropriate size of the total grant, the Barnett Formula makes little effort to align budgetary allocations with the need for public services. In Chapter 2, we discussed how the Barnett Formula causes spending per head in Wales to converge over time on the average level of English spending per head, regardless of whether the need to spend on public services also converges. The failure to take real account of needs, coupled with the tendency of the formula to cause convergence in spending per head, means that allocations of resources generated by Barnett are almost bound to be detached from needs, and hence inconsistent with most notions of fairness in a union state. Any successor formula, if it is to be perceived as fair to all, will have to be needs-based.

3.5 While absolute needs are potentially infinite, governments only possess finite resources with which to meet these needs. Once the government has allocated the resources it thinks appropriate at the central level, any needs-based formula for geographical distribution must be concerned with determining *relative*, rather than *absolute* needs. In other words, the formula must be used

to allocate resources drawn from a fixed overall pot of funds, and would not be used to determine the size of the pot itself.

3.6 Needs and equity are of course contested concepts that are fundamentally political in nature. Perhaps the most common definition of a “fair” allocation of funds is one where resources are allocated in a way that makes it possible to provide a standard level of service in all parts of the UK. Such an allocation would enable governments in all parts of the UK to provide a broadly comparable level of public services to their citizens, should they choose to do so.

3.7 We believe that Barnett must ultimately be superseded by a needs-based formula. No doubt that will need to be accompanied by an adjustment mechanism since the formula may imply substantial changes to block grants and it would be both disruptive and politically difficult to introduce those rapidly. In order for a revised system to be durable, it would need to be seen to be equitable to all parties. Any new needs-based funding model should therefore be jointly agreed by Ministers from both the UK Government and all the devolved administrations concerned.

3.8 An ideal needs-based formula would be both simple (making it easy to implement, transparent and readily explicable to the non-specialist) and complete (i.e. it would capture all relevant aspects of need). In practice there is a trade-off between simplicity and completeness. When allocating an unhypothecated block grant there is a strong case for favouring a relatively simple formula since resources allocated on the basis of needs in one field may, in practice, be used in another.

3.9 At present, the Commission has not finalised its view on how best to incorporate an assessment of needs into future funding arrangements. We are under no illusions that moving to a needs-based funding system will be easy, but we are persuaded that the current system is not sustainable over the medium term. For Wales, the status quo would produce relentless convergence in relative spending towards the English average, irrespective of needs. Although the question of how to weigh competing claims of need is ultimately political and therefore beyond our remit, we believe that it will be possible to produce useful guidance on the issue of simplicity versus completeness and the choice of indicators. We intend to address those issues in our final report.

## Recommendation

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

# Chapter 4: Assessing the relative needs of Wales

## Applying English needs criteria to Wales: rationale

4.1 In the full report, we present a range of indicative statistics that make it clear that Welsh relative needs are greater than English relative needs. It is therefore unsurprising (and, in a world where relative spending is driven by relative needs, entirely justifiable) that public spending per head on services in Wales is greater than it is in England. The question to which we now turn is “*how much greater should it be?*”

4.2 Chapter 3 argued that decisions about the weight to be attached to different elements of need are unavoidably political in nature. Therefore, in attempting to determine the relative needs of Wales, it is important to emphasise that there is no single correct answer, and we do not (and cannot) attempt to provide such an answer independently of political guidance.

4.3 Instead, we intend to answer a different and more tractable question, namely “*how much would be spent on devolved public services in Wales if the Welsh block were calculated using English funding formulae?*” We do this by adopting as far as possible the UK Government’s current funding criteria for England and applying them to Wales. Under the existing constitutional settlement, the Assembly Government is almost entirely funded by the UK Government, which also acts as the *de facto* government for England. If it could be shown that Wales would receive more public funds for devolved activities than it receives at present were it funded as part of a single England and Wales block, this would provide a compelling case that Wales at present is underfunded, *using the UK Government’s own current criteria for assessing needs.*

## Applying English needs criteria to Wales: methodology and results

4.4 We attempt to assess the Welsh relative need to spend on each area of devolved competence using the current English criteria for allocating resources. The methods by which the UK Government allocates funds across England are highly varied, are in many cases complex and are changing over time. Therefore, absolute precision with regards to the exact methodology applied in each and every funding stream is not possible. We have focused on applying formulae in the major spending areas (where they exist), which in aggregate comprise the large bulk of the funding allocated to Wales. We are confident that our results are robust to the relatively minor methodological uncertainties that inevitably pertain to an exercise such as this. Box 4.1 sets out our approach.

4.5 Such an analysis inevitably involves a degree of judgement and approximation. Wherever we have been faced with more than one possible measure of relative needs in a particular area, we have taken the lower number. Our analysis is therefore certain to produce a conservative overall estimate, and is likely to generate an underestimate of Welsh relative needs.

4.6 Table 4.1 sets out the results of this exercise for all areas of devolved responsibility. The Assembly Government’s budget is dominated by a few expenditure categories. The most important of these is health, followed by children’s education and other support to local government. Together these three areas account for over 80 per cent of comparable programmes

in England. In the full report we provide information on how we have assessed Welsh relative need in each major spending area.

#### **Box 4.1 Assessing relative needs in Wales using the UK Government's own criteria: methodology**

In each area of devolved competence, the following stepwise approach has been taken to assess Welsh relative needs:

1. If spending in England is allocated on the basis of geographical units via a needs-based formula and if data limitations allow, the formula has been applied directly to Wales. In some cases, where the formula covers the bulk of a department's spending, the relative need derived from that formula has also been applied to the residual, non formula-driven programmes.
2. If data limitations make it impossible to directly apply the English formula to Wales, the formula has been applied indirectly by identifying factors that have strong explanatory power over actual English allocations and using these factors to predict an allocation for Wales.
3. If no regional needs-based formula is currently in use in England, we have modelled regional expenditures using objective measures of demand as a proxy for relative needs.
4. If no objective measure of demand is available, we have taken actual spending in the closest comparator English region to predict a Welsh allocation.
5. In the remaining spending areas, where it has not been possible to assign a relative needs score, we have applied the weighted average of need in those spending areas for which relative needs have been assessed.

By applying this approach, we have been able to cover some 80 per cent of the Welsh block grant in the top two categories, and 86 per cent in the top four categories.

4.7 It is possible to aggregate the relative needs assessment in each area of spending to produce a weighted average assessment of need for the whole of the Welsh block grant. This has been done by applying the relative size of each of the spending areas in England to the needs indices. Table 4.1 shows that this generates a result of 114. In other words, if Wales were funded as part of a single England and Wales block, we estimate it would receive at least £114 of public funding per head for its devolved public services for every £100 spent per head in England.

**Table 4.1: Applying English funding criteria to Wales: approach taken in main devolved spending areas and results**

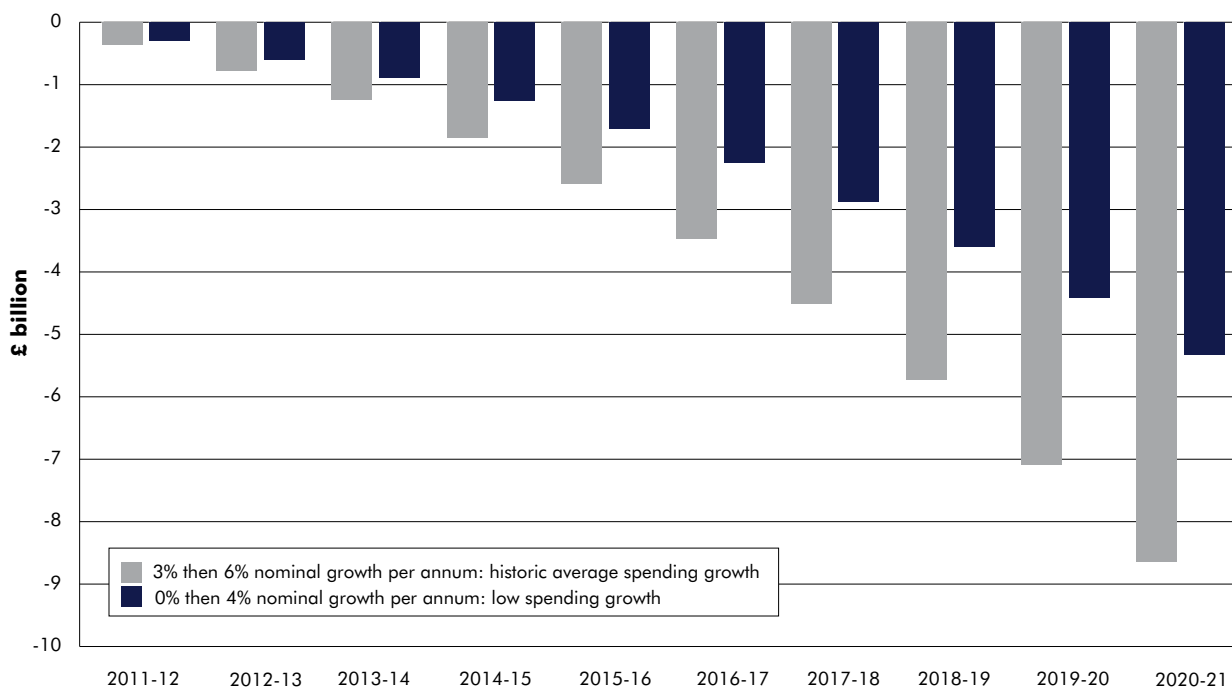
Spending area	Size of English budget 2010-11	Percentage share of total comparable English budget	Approach taken (see Box 4.1 for explanation of numbering)	Welsh relative need (England = 100)
Health	£108 billion	46	1. Needs based formula in existence, applied directly to Wales	114
Children, Schools and Families, of which:	£60 billion	25		103
<i>Schools and other DCSF programmes</i>	£51 billion	21	1. <i>Old schools element of local government formula applied to Wales</i>	102
<i>16-18 Further Education</i>	£7 billion	3	3. <i>Relative numbers of 16-18 year olds in state funded education used as best available proxy</i>	106
<i>Sure Start</i>	£2 billion	1	2. <i>Unpublished needs based formula, applied indirectly</i>	114
Local Government	£25 billion	10	1. Needs based formula in existence, applied directly to Wales	132
Higher Education	£8 billion	3	3. Relative student numbers per head used as best available proxy	117
Economic development (Regional Development Agencies)	£2 billion	1	4. No published formula in use in England, spending per head on RDA in the North East of England taken as best available proxy	223
Housing: Supporting People	£2 billion	1	1. Needs based formula in existence, applied directly to Wales	145
Other areas	£33 billion	14	5. Unable to assign relative need, assumed equivalent to weighted average of spending areas for which weights have been assigned	114
<b>Total</b>	<b>£237 billion</b>	<b>100</b>		<b>114</b>

Note: columns may not sum to the totals shown because of rounding.

4.8 Paragraphs 2.9-2.11 outlined two possible scenarios for spending growth over the next decade, which we termed the historic average spending growth scenario and the low spending growth scenario. Under the historic average spending growth scenario, the relative level of spending per head on devolved activities in Wales is projected to fall from 112 at the end of the current spending review period to 107 over the subsequent decade. Under the low spending growth scenario, the relative level of spending per head would decline to 109 over the same period. There will therefore be a growing gap between what Wales would get if it were funded by the formulae that are applied in England and what Wales will actually get from continued application of the Barnett Formula.

4.9 Chart 4.1 shows that the cumulative under-funding of Wales over the next decade will total £5.3 billion under the low spending growth scenario and £8.5 billion under the historic average spending growth scenario, even allowing for a period of particularly constrained budgets over the next 3 year spending review period. These figures are equivalent to £1,800 and £2,900 per resident of Wales respectively.<sup>14</sup>

**Chart 4.1: Projected cumulative underfunding in Wales arising from the Barnett Formula, £ billion, 2011-2021**



Source: Commission calculations

4.10 From these results we draw two conclusions:

- i) according to our analysis, Wales receives less than it would get were it funded by the UK Government using the funding formulae that it applies to England; and
- ii) if the current funding regime remains in place, the Barnett squeeze will cause Wales to become increasingly underfunded relative to its needs over the course of the next decade, using the UK Government’s own criteria for assessing needs. There is therefore an urgent requirement to reform the funding arrangements for Wales.

<sup>14</sup> The numbers quoted are not adjusted for inflation. Expressed in constant 2009 terms by assuming 3 per cent annual growth in relevant prices, then cumulative underfunding by 2020-21 would be £4.2 or £6.8 billion under the low and historic average growth scenarios respectively.

## Chapter 5: Operational issues

### Managing capital budgets

5.1 The Welsh block grant is separated into resource (which covers the recurrent costs of delivering services such as education, social care, and the health service) and capital (for investment in long term assets such as buildings and roads). Welsh Ministers have the ability to transfer funds from resource into capital, but not from capital to resource, unless permission is granted by the Treasury. The rationale for this restriction is to protect the fiscal rules that guide the UK Government's budget planning process.

5.2 The Barnett Formula is not well suited to the allocation of capital expenditures and the current system makes the management of capital budgets especially challenging. Capital budgets tend to be "lumpy", with spending varying from year to year as large scale investments are initiated or completed. Large shifts in English capital expenditure would generate similar shifts in the capital budget available to the Assembly Government, which would have no necessary connection with Wales's capital requirement at the time.

5.3 A practical improvement to current arrangements would be for the Assembly Government to be given permission to draw forward its capital budget over the course of a spending review period, helping to smooth capital budgets and to permit capital investment in excess of the arbitrarily-determined capital budget allocated to Wales via Barnett. If implemented, this reform would enhance the Assembly Government's ability to undertake capital investment in a way that is appropriate to Welsh circumstances.

#### Recommendation

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

### End Year Flexibility (EYF)

5.4 A significant issue for the ability of Welsh Ministers to manage their budget and smooth capital expenditures over the medium term stems from the rules that determine access to unspent resources. The policy of End Year Flexibility (EYF) is designed to enable the devolved administrations and UK Government spending departments to carry over unspent resources into future years. The objective of EYF is to improve the use of public resources, by removing the incentive for unnecessary expenditure at the end of each financial year.

5.5 Welsh Ministers are able to draw down EYF following discussion with and agreement from the Treasury, whose interest in seeking to regulate access to EYF is to control government expenditure and protect the fiscal rules. However, in the context of total Department Expenditure Limit spending of £362,000 million across the UK in 2008-09, it is highly unlikely that any draw down of EYF entitlements by the Assembly Government could upset the overall UK fiscal arithmetic.

5.6 A reformed system in which automatic access to accumulated EYF funds was available would particularly alleviate the difficulties of managing capital expenditures discussed above. There is no reason why the requirements for large public infrastructure investments should happen to be synchronised in England and Wales and therefore Wales should have the ability to “save” windfalls coming from large projects in England, unfettered by the need to discuss and agree with Treasury access to these savings.

### Recommendation

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

## Moving funds from capital to resource budgets

5.7 The Assembly Government is allowed to switch funding from resource into capital, but it is not able to move funding from its capital to its resource budget other than in exceptional circumstances that require the consent of the Treasury. The purpose of this restriction is to assist HM Treasury in meeting its fiscal rules; however the Commission considers that the case for it is weak. There is no particular reason to presume that the optimal allocation of funds between resource and capital in Wales mirrors that found in England. There may well be circumstances in which Welsh Ministers might wish to move funds from capital to resource budgets. Decisions about the allocation of funds to resource and capital expenditure in Wales ought in principle to be a matter for the Assembly Government rather than the Treasury, unless overarching UK interests are affected. Welsh Ministers should therefore be free to transfer funds from capital to resource budgets, except in the unlikely event that it would breach the UK Government’s fiscal rules.

5.8 In the event that the Assembly Government were granted this facility and was also given the power to draw forward future capital budgets (as recommended in paragraph 5.3), the ability to move funds from capital into resource would only apply in years when no capital was drawn forward. This would ensure that drawn forward capital was only used to fund additional capital spending, over and above that provided to Welsh Ministers via Barnett. In effect, the Assembly Government would be free each year either to draw forward capital to finance additional capital investment, or to move funds from capital into resource, but it could not do both.

### Recommendation

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.

## Dispute resolution: current arrangements

5.9 Serious disputes between the UK Government and the devolved administrations over the operation of the Barnett Formula appear to have been limited in the early days of political devolution, although more significant tensions arose over the settlement provided in the 2007 Comprehensive Spending Review (CSR). The existing formal dispute resolution procedures, which provide for an appeal firstly to Treasury Ministers, then to the Joint Ministerial Committee (JMC) of UK and devolved administration Ministers and finally to the UK Cabinet, have not been tested.

## Reducing the likelihood of future disputes

### Technical operation of the formula

5.10 To date, the existing dispute resolution arrangements have “worked” to the extent that disagreements have not prevented budgets from being allocated. However, they have not worked in the broader sense of providing a framework within which the devolved administrations feel that their case will be given a fair hearing and judged on its merits. In the first years of devolution, the political and fiscal climate reduced the likelihood of serious disagreements between the UK Government and the devolved administrations. From the perspective of the devolved administrations, the dispute resolution arrangements have not operated effectively even under these favourable conditions, and are therefore unlikely to prove robust in the more challenging circumstances that may lie ahead.

5.11 Dispute resolution is, however, what the engineers call an end-pipe solution, an attempt to remedy problems after they have arisen. The Commission believes that changes could be made that would make disputes much less likely to arise. The most effective way of reducing the likelihood of future disputes is for the technical operation of the formula to be administered by an advisory body that is at arm’s length from both the Treasury and the Assembly Government. This would ensure that the rules of the settlement were implemented in a manner that was seen to be fair to all parties.

### Concordat

5.12 When disagreements arise at present, the key reference document is the Statement of Funding Policy (SFP), which provides a detailed technical description of the current arrangements.<sup>15</sup> Welsh Ministers are consulted on the content of the SFP but are not signatories to the document.<sup>16</sup> The SFP is revised at the time of each spending review. In addition, a shorter separate document sets out in a concordat the broad principles governing the relationship between the Welsh and UK levels of government.<sup>17</sup>

5.13 In principle, the processes underpinning the operation of devolution should wherever possible be developed and implemented by the UK Government and the devolved administrations on a basis of mutual agreement. The fact that Welsh Ministers are not signatories to the SFP is inconsistent with this principle. Ideally, all of the topics covered in the SFP should be transferred to a new concordat that would be subject to the joint approval of the UK Government and the Assembly Government.

<sup>15</sup> HM Treasury, 2007a p.1.

<sup>16</sup> The Secretaries of State for each of the devolved nations are co-signatories to the SFP.

<sup>17</sup> HM Treasury and Welsh Assembly Government, 2005.

5.14 In practice much of the content of SFP is in any case relatively uncontentious. As the SFP itself states, the arrangements set out in the Statement “represent, in most cases, the continuation of long-standing conventions that have guided funding for Scotland, Wales and Northern Ireland prior to devolution and are consistent with the Devolution White Papers and the Devolution Acts”.<sup>18</sup> It should therefore be straightforward to transfer the bulk of the SFP into a new document that is jointly owned by Welsh and Treasury Ministers, without damaging the Treasury’s legitimate responsibility for maintaining overall fiscal control. However we recognise that mutual agreement, while desirable, may not be achievable in all instances. In the absence of consensus, it is appropriate under the current constitutional settlement for the UK Government to retain the right to have the final say, though it would be important to have clarity on which issues had been agreed by mutual consent and which were resolved by a unilateral Treasury decision. If necessary, a separate Treasury-owned SFP should therefore be issued covering those topics on which no agreement had been reached or the circumstances in which it would act outside of the concordat.

5.15 While the establishment of an arm’s length body coupled with a new Ministerial concordat would reduce the likelihood of disagreements, it would not of course necessarily eliminate them. We see little point in changing the institutions of dispute resolution under the UK’s present constitution. Disagreements over recommendations made by the arm’s length body and issues relating to the implementation of the SFP or the Ministerial concordat would therefore be referred to the JMC for appeal and discussion. In the absence of consensus, the UK Government would retain the right to impose a decision.

### Recommendation

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 the UK Government and the Assembly Government.

### Recommendation

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

## Improving transparency

5.16 A lack of detailed and robust statistics makes it difficult to analyse the impact of the Barnett Formula and undermines transparency. This could be remedied by publication of an annual statistical report on the funding of the devolved administrations.

5.17 In order to further improve transparency, there would be merit in a Treasury Minister being invited to meet the National Assembly for Wales’s Finance Committee at least once per spending review period.

<sup>18</sup> HM Treasury, 2007a p.1.

## Recommendation

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.

## Recommendation

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.



# Chapter 6: The way ahead

## A system overdue for reform

6.1 The UK Government makes an annual block grant to each of the devolved administrations in the British Isles. The relative sizes of those grants derive from what they were in the late 1970s. Presumably at that date the size of the grants had some basis in perceptions of fairness or need. We cannot be sure because little justification for the distribution of grants at that date has ever been made, though the needs assessment undertaken by the UK Government in the 1970s suggested that Wales was being underfunded relative to its needs at that time.<sup>19</sup> In any case those baselines are now 30 tumultuous years old. The baselines are linked to the present situation by the operation of the Barnett Formula. In principle, the operation of this formula would have slowly pushed the expenditure per head in the devolved administrations to the average expenditure per head for England as a whole. It was, in apparent intention, a convergence formula.

6.2 In practice, the Barnett Formula has not yet resulted in complete convergence. The reasons have to do with unforeseen population movements and with ad hoc “work-arounds” whereby territorial administrations received additional resources in response to a particular need or political situation. When Barnett was first introduced, expenditure per head was substantially higher in Scotland and Northern Ireland and somewhat higher in Wales than it was in England. Over the subsequent decades spending relativities have varied, though our analysis has demonstrated that in Wales at least there has been marked convergence towards the English average over the past decade, and that this convergence will continue in the absence of reform.

6.3 When an arrangement persists as long as the Barnett Formula has, it clearly serves some interest or fulfils some function. The function in this case was to avoid political quarrels and make the annual distribution of public expenditure to the devolved administrations as low-key, uncontroversial and automatic as possible. As HM Treasury’s Statement of Funding Policy puts it, the formula “largely removes the need to negotiate directly the allocation between Treasury Ministers, Secretaries of State and Ministers of the devolved administrations”.<sup>20</sup> The Barnett Formula and its operation minimised political debate without removing from governments of the day the ability to respond to occasional political imperatives. By contrast, any formula which subjected allocations to a set of objective criteria could well have entailed large changes in the status quo that were politically undesirable, or at least undesired.

6.4 The Barnett Formula therefore has no stated purpose other than getting a distribution done. In this it unquestionably succeeds. The purpose that can be inferred from its operation is to achieve the distribution with a minimum of public political conflict.

## Where next?

### The medium term solution

6.5 Any Commission asked as we have been to consider the current state of affairs cannot fail to conclude that there is scope for significant improvement on the status quo. We have proposed a number of specific changes that would recalibrate the fiscal relationship between the Welsh

<sup>19</sup> HM Treasury, 1979.

<sup>20</sup> HM Treasury, 2007a p.7.

and UK tiers of government, in a way that is appropriate to the post-devolution constitutional status of Wales. If implemented, our recommendations would improve the transparency and robustness of the current system, and would also enhance the ability of Welsh Ministers to allocate resources in line with Welsh priorities. At root, however, the fundamental flaw in the current system is that it makes no attempt to align the funding allocated to Wales with the country's relative needs. It appears unarguable that the level of public resources made available in Wales ought broadly to correspond to the relative need to spend on devolved activities. It logically follows that in the medium term the funding arrangements for Wales (and in principle the other devolved administrations) should be based on needs.

6.6 We are mindful that the introduction of a needs-based system would face formidable political and practical hurdles. It is likely that a conference of politicians and experts from across the UK would be required to settle those issues that are fundamentally political in nature. However, to argue that an attempt to establish a needs-based mechanism for the funding of the devolved administrations would fail because the political issues would be too difficult to resolve is a defeatist and indeed demeaning position. The UK manages to make allocations to local government on the basis of assessed needs. And a great many countries have devised formulae for the allocation of resources to different layers of government in provincial and federal systems. There is something rather shameful in suggesting that the UK political system is somehow uniquely incapable of doing the same. For any new settlement to be durable it would require broad political support. This makes it essential that both the assessment of relative needs, and the mechanism by which funding would be aligned with needs, should be developed through mutual agreement and not through unilateral imposition of a Treasury decision.

### **The immediate priority**

6.7 We are realistic about the scale of the political challenge and are aware that developing and implementing the new system may take some time. However, the arbitrary and obsolete nature of the formula requires some immediate changes that follow from already agreed principles and can be implemented without any radical innovations in practice.

6.8 Our analysis has shown that Wales currently receives less than it would were it to be funded by the UK Government using the formulae it applies to England. In the absence of reform, the gap between Welsh relative needs as assessed on the UK Government's criteria and the level of funding provided by that same Government, will increase. This situation cannot be left unresolved until political agreement is secured on more substantive reform.

6.9 As a matter of principle, Barnett-driven convergence should cease when a devolved administration's budget is no larger than it would be were it funded as an English region. In the case of Wales this point has already been reached; our analysis has demonstrated that Wales would receive £114 to spend on devolved activities for every £100 spent in England if its budget were determined by English funding formulae. At a minimum, no further convergence in relative funding per head should occur in Wales until a new funding system is in place. A straightforward remedy would be to simply multiply any positive increments allocated to Wales by 114 per cent. This small adjustment to current arrangements would place a floor under the funding provided to Wales, and would prevent any further convergence until such time as more comprehensive reform has been agreed. An example of how this would work in practice is set out in Box 6.1 below.<sup>21</sup>

<sup>21</sup> Since Wales is moving into a position where it is under-funded compared to what it would receive via English funding formulae, it would be inappropriate for any negative increments allocated to Wales to be multiplied by 114 per cent.

6.10 It is worth emphasising that we do not argue that the floor this would put under Barnett is correct in any objective sense - politicians (and voters) may well take the view that maintaining relative funding at current levels is inadequate given Wales's relative needs. However, setting the floor at this level does have the merit of at least preventing Wales from falling further below what it would receive from the UK Government were it to be funded by the formulae that the UK Government applies to England. It therefore represents a simple minimum adjustment to the current arrangements in order to prevent under-funding of public services in Wales, pending wider reform.

**Box 6.1: An example of how Barnett would apply to Wales with increments multiplied by 114 per cent**

Increases to the Welsh block grant generated by the Barnett formula should be multiplied by 114 per cent. This would ensure that increments in Wales reflect relative need and that there is no further convergence in relative spending per head between Wales and England. Consequentials for the Welsh block grant arising from reductions in English programmes should be calculated using the existing Barnett Formula. Funding for Wales is now below what it would receive from English funding formulae, so it should receive no more than its population share of reductions. For increases, there would be the following simple adaptation of the calculation shown in Box 2.1:

$$\text{Change to Welsh block grant} = \text{change to equivalent English programme} \times \text{comparability factor} \times \text{Welsh to English population ratio} \times 114\%$$

This can be illustrated using the same hypothetical example as in Box 2.1, with a £100 million increase in spending for a UK Government department. This department's programmes are 90 per cent devolved to Wales, so there is a comparability factor of 90 per cent. In addition, latest estimates show that the Welsh population is 5.83 per cent of the English population. Combining these elements with the needs-based factor of 114 per cent, the increase in the Welsh block would be:

$$£100 \text{ million} \times 90 \text{ per cent} \times 5.83 \text{ per cent} \times 114 \text{ per cent} = £5.98 \text{ million}$$

## Recommendation

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.



# The Commission's recommendations

## Ensuring that funding is aligned with needs

In the medium term the funding arrangements for Wales should be based on relative needs. (Chapter 3)

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. (Chapter 6)

## Enhancing the funding flexibility available to the Welsh Assembly Government

The Assembly Government should be able to draw forward its capital budget across the period of a spending review. (Chapter 5)

The Assembly Government should have a free hand in accessing the End Year Flexibility funds that it has accumulated in prior years, without the requirement for discussion with, and agreement from, HM Treasury. (Chapter 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. (Chapter 5)

## Reducing the likelihood of future disputes

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 the UK Government and the Assembly Government. (Chapter 5)

The UK Government and the Assembly Government should jointly agree a new Ministerial concordat on the detailed funding arrangements for Wales. (Chapter 5)

## Improving transparency

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. (Chapter 5)

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. (Chapter 5)

# The Assembly Government's current borrowing and tax powers

## Borrowing powers

A2.1 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.

A2.2 There are however, very 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. The 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.

A2.3 Amounts borrowed under Section 121 must be repaid to the Secretary of State under conditions outlined by the Treasury. Borrowing under Section 121 counts towards the Public Sector Net Cash Requirement (PSNCR) 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 the Treasury if the sums were not re-paid using existing funds.

A2.4 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.

A2.5 In summary, although the Assembly Government does have some borrowing powers, these are strictly 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>22</sup>

## Taxation

A2.6 Most taxation in the UK is administered centrally. The two main exceptions comprise taxation for the provision of local services, namely Non Domestic Rates (NDR) and council tax.

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<sup>22</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.

A2.7 NDR is a property tax levied on the occupiers of non domestic properties. It is the means by which businesses and other occupiers of non domestic property contribute towards the costs of local authority services.

A2.8 The Assembly Government has the power to adjust NDR in two ways. Firstly, adjustments can be made to the rate of relief that is applied. However, any such changes must be funded from within the Assembly Government's budget. Secondly, the Assembly Government can change the rate of increase in business rates each year, termed the poundage or multiplier. The UK Government sets the multiplier rate at the rate of inflation and if the Assembly Government were to set a multiplier below the rate of inflation then the block grant would be adjusted to reflect the reduction in NDR revenue that this would create.

A2.9 Each local authority in Wales is responsible for setting its council tax. Approximately 20 per cent of all Welsh local authority revenue is raised from council taxation. The overall amount of the tax raised is set by the local authority annually and charged according to house valuation bands. Welsh Ministers make known their expectations in terms of acceptable levels of council tax increases each year. If an authority's planned council tax increase exceeds these expectations it is open to Welsh Ministers to take steps to limit ("cap") the authority's budget requirement for the year and therefore restrict its council tax increase.

A2.10 The Statement of Funding Policy outlines the steps that may be taken if changes in council tax rates in Wales impact on the administration of related UK taxation and benefits. For example, if following changes to council tax the costs of the subsidy paid to local authorities changes at a disproportionate rate relative to changes in England, then balancing adjustments may be made to the Assembly Government's block grant.

# Independent Commission on Funding and Finance for Wales

## Origins of the Commission

A3.1 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

A3.2 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

A3.3 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

A3.4 The Commission reports jointly to the First Minister, the Deputy First Minister and the Minister for Finance and Public Service Delivery.

A3.5 The Commission was charged with producing a first report by the summer of 2009. Ministers have stated that the report will be debated by the National Assembly for Wales, prior to the Commission undertaking further work.

## Members of the Commission

A3.6 **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.

A3.7 **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 a non executive Director of the FSA. 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 of the UK housing market, focusing on the absence of much longer-term fixed rate lending, for the then Chancellor of the Exchequer, Gordon Brown. He joined the Bank of England’s Monetary Policy Committee in June 2009.

A3.8 **Paul Bernd Spahn** is Professor Emeritus of Goethe University, Frankfurt am Main, Germany. After retirement 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

## Commissioned Research

A3.9 Two research projects were commissioned under phase 1:

- “The Barnett Formula and its consequences for Wales: a literature review”
- “The use of needs based formulae in the allocation of public resources: literature review”

## Priorities for phase 2

A4.1 The Commission will review the plans for the second phase of its work in the light of the response from the Assembly Government, the outcome of the Plenary debate by the National Assembly for Wales and the submissions received during its second call for evidence. On the basis of the evidence submitted to date, the Commission proposes to address the following issues in phase 2.

### Block grant

- i) Final recommendations on the appropriate way of determining the block grant for Wales, including guidelines for a possible needs-based formula.
- ii) An assessment of the applicability to Wales of the recommendations made by the House of Lords Select Committee on the Barnett Formula.
- iii) A response to comments on the analysis and recommendations presented in the first report.

### Taxation

- iv) An assessment of the applicability to Wales of the recommendations made by the Commission on Scottish Devolution that address fiscal matters.
- v) A set of principles to guide future thinking on the devolution of powers over taxation.
- vi) A series of "if - then" statements on taxation powers, i.e. a guide to the pros and cons of various options.
- vii) A discussion of the "Azores judgement" and other elements of European law that have implications for fiscal autonomy in Wales.
- viii) Analysis of the fiscal balance of Wales.

### Borrowing

- ix) A set of principles to guide future thinking on the devolution of borrowing powers.
- x) A series of "if - then" statements on borrowing powers, i.e. a guide to pros and cons of various options.
- xi) A discussion of the scope for the Assembly Government to develop innovative borrowing mechanisms within the current legal framework.

## References used in the full report

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The Commission would welcome comments and submissions of further evidence on the issues considered in its first report.

The Commission would also be pleased to receive submissions of evidence on its programme of work for phase 2 (see Annex 4).

To ensure that the information can be acted upon, comments and evidence should be forwarded in electronic format (by email or on CD) to the Commission secretariat by the 31st October 2009.

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Please note that the Commission intends to publish, in part or in full, all relevant evidence that it receives.

Submissions of evidence and other substantive responses to the Commission's work will be held by the Commission Secretariat on behalf of the Welsh Assembly Government. There may be circumstances in which the Assembly Government will be required to communicate the information to third parties on request, in order to comply with its obligations under, for example, the Freedom of Information Act (2000).

For further copies of this report, please contact the Commission Secretariat at the above address.