

Submission to the Independent Commission on funding and finance for Wales

This submission will look at the formula based approach to public expenditure in Wales and the potential alternative funding mechanisms including the potential for tax varying and borrowing powers, including reference to recent ECJ rulings.

This paper will attempt to deal with these matters in the context of an over-arching framework including reference to corporation tax (which I assume to be a reference to the Azores case) and the applicability of European law within the limited space of the 3,000 words permitted. The key points of which will be as follows:

- It is not enough to look only at a replacement of the Barnett formula by another formula, however improved.
- The framework must be flexible enough to accommodate the potential of a change in the areas of competence which fall to the Welsh Government
- There needs to be an appropriate standing framework to discuss both the administrative and financial tensions that currently exist, and will undoubtedly continue to do so. This framework must be robust enough to deal with the likelihood that there will be administrations of a different political persuasion in London and Cardiff from time to time.
- The framework must be capable of dealing with the issue of addressing the regional imbalance between Wales and the rest of the UK, particularly the south-east of England.
- The need for borrowing and contingency borrowing powers.
- The potential for fiscal powers within the European framework
- The issue of regional aid from both a UK and European perspective

It is not intended to deal with the issue of whether the Barnett formula is satisfactory or not in any detail. It seems clear that it starts from an entirely misconceived premise (that expenditure allocation should be on a per capita basis) and bears all the hallmarks of an approach based on administrative convenience rather than on any principled logic. Its operation is particularly reprehensible in a country (the UK) that is the most regionally unequal in the whole of the European Union.¹

This submission will deal with these issues under two separate headings:

1. The funding of the Welsh government by the UK government
2. The expansion of the fiscal and financial powers of the Welsh government

¹ See Eurostat news release 12th February 2008

1. The funding of the Welsh Government

- a. Wales is one of the poorest parts of the UK, as borne out by the statistics in respect of GDP/GVA per capita as well many other indicators. The most recent Europe wide figures for comparative GDP per capita (2005) show that Wales has a GDP per capita of some 77% that of the UK, and that West Wales and the valleys some 66% of the UK². In the case of the latter this is 79% of the European Union average, and it may well be the case therefore that this area will cease to be eligible for any further convergence funding when the current programme expires.
- b. This relative poverty gives rise to two distinct problems. Firstly there is the need to deal with the issues that such poverty creates, such as higher mortality rates, high health costs, low educational achievement, higher unemployment and incapacity benefit rates etc. Secondly and separately there is the issue of what type and what amount of aid (such as grants or fiscal stimulus) should be available to diminish the GDP gap.
- c. These issues also need to be viewed through the lens of those areas of competence for which responsibility is devolved in whole or in part, those areas which are identifiable but not devolved, and those areas which are not devolved and not identifiable.
- d. This submission assumes that in a fair society funding should be made available on the basis of need. There are, of course, other need parameters apart from poverty/deprivation that may need to be taken into consideration, such as rurality and dispersal of population, linguistic provision etc., but in view of the current economic situation in Wales it is fair to say that economic considerations are vital. A per capita formula flies in the face of the principles underlying the health service, social security etc. In the case of the Barnett formula the argument has always been that it would be too complicated to create such an index of need and too difficult to administer it. It seems to me that this justification cannot be supported. It is clear that analysis of deprivation is required for a variety of government expenditure purposes, and the data undoubtedly exist. Within England itself there is substantial divergence of wealth. In respect of local government funding allocations have to be made in respect of a number of different criteria in order to arrive at the amount of government funding required to make up the shortfall from the income derived from council tax for locally provided services. In addition every year the UK government in its Public Expenditure Statistical Analysis publishes a chapter analysing public expenditure by country and region within the UK. The disparities indicated in this statistical series are presumably not entirely a matter of chance or automatic expenditure (as in the case of unemployment benefit). Presumably, at least within England in respect of devolved matters, the UK government takes cognizance of the varying funding needs across the country.

² See Eurostat news release 12th February 2008

- e. In Wales there is the Welsh Index of Multiple Deprivation, and similar indices exist for other parts of the UK. Although they are not necessarily uniform in their approach (indeed the WIMD was revised in 2005 to include the number of claimants of unemployment related benefits as this was included in the other indices) it is clearly the case that an appropriate UK index could be devised.
- f. If a simpler system were to be preferred, then it would certainly be possible to look at the work done in respect of inverse GVA/GDP ratios – i.e. that Wales should receive a budget allocation based on its population times the inverse that its GDP bears to the UK average GDP. This would be consistent with the general approach taken by the EU.
- g. The Big Lottery Fund, when deciding on how to make its own allocations across the UK has used a combination of these approaches since 1995 in making its own funding decisions, and it has recently confirmed to me that despite a number of reviews it regards its approach as a success, and it has no intention of changing (I attach a copy of their letter for reference). The Commission may wish to consult with the Big Lottery Fund and/or the New Policy Institute on this. It is interesting to note that under the Big Lottery formula Wales is entitled to receive 6.5% of funds allocated throughout the UK. This is massively different from the Barnett formula which is based on the percentage of the Welsh population bears to the UK as a whole of some 4.9%, although most calculations are made on the higher figure of its proportion of the England and Wales population. This gives some indication of how badly funded Wales is on the basis of need, and how the Barnett formula completely fails to recognise, much less deal with, the divergent economic situations of Wales and England, and the resources needed to correct the imbalance.
- h. It therefore seems clear that there are a number of methods at hand to deal with allocation on a needs basis which would be deliverable and fairer than the current system. Once a formula framework was agreed upon it would be possible to nominate a group of experts, who would be able to arrive at the amount of money that Wales would be entitled to under the formula, based on the UK government's spending plans. It is likely that given the four constituent parts of the UK it would be appropriate to have a body that dealt with this issue on a multi-lateral rather than a bi-lateral basis, and that each country would be able to nominate some of the experts. It would be sensible to have a permanent resource available to such experts, and the way in which various regulators' offices function could provide useful lessons for how such an institution might work in practice, even though there would be a committee, rather than a regulator. To the extent there were significantly divergent views it would be the responsibility of either the Finance Ministers or the Prime/First Ministers to resolve the deadlock.
- i. This system could work well where there is established practice. There would be slightly more room for disagreement on non-statistical grounds where new

categories of responsibility are devolved (e.g. Home Office functions in the case of Wales), or where there are differences as to what to treat as UK expenditure rather than English expenditure. The treatment of the Olympics as UK expenditure (and therefore with no concomitant Barnett allocation) is highly controversial and sits ill with the suggestion that much of the expenditure is justifiable because it is for regeneration of the Thames Gateway area. The very least that should be done is to disaggregate the sporting and regeneration strands. A funding commission of the type described above could deal with this kind of issue as well.

- j. However the issue of creating a needs based formula which deals fairly with the different parts of the UK is a relatively simple matter, with sufficient political goodwill, compared with the issue of changing the fiscal status of Wales.

2. The expansion of the fiscal and financial powers of the Welsh Government

- a. An appropriate needs based formula to replace the Barnett formula and the automatic stabilising effect of the UK wide social protection budget should provide a fairer way of ‘compensating Wales for its poverty’. However there is the separate issue of the resources required to change the situation, and to narrow the GDP gap between Wales and England. This area is also more complicated because it involves the European level of government as well. Although Regional Selective Assistance still exists to assist companies in depressed areas, it has been overshadowed by the amounts of money available from Europe under the Objective One and now the Convergence Programmes. One area of controversy has been that not all the money received by the Treasury for these programmes has been passed onto Wales, and another that in the absence of the UK government providing the match funding required by the EU to disburse the funds and without the capability of the Welsh Government to raise funding itself, it has been necessary for the Welsh Government to sacrifice spending in other areas such as health in order to provide the match funding needed where the private sector has not been able or willing to provide it. Any review of the funding framework of the Welsh Government will need to address this issue and with an understanding of how economic activity in Wales could be stimulated more efficiently, particularly after Convergence funding is no longer available.
- b. Before dealing with the issue of tax, the issue of borrowing powers can be dealt with relatively easily. It is clearly the case that the Welsh Government should have borrowing powers over and above the very limited powers currently at its disposal. The UK government is declaring very loudly that (increased) borrowing is necessary for the well being of the UK economy. It is perverse to suggest that the flexibility that borrowing provides is acceptable at a UK level and indeed at a local authority level, but not at a Wales level. There is, of course, the issue of the lack of fiscal resource, which both other levels of government have available, but the Welsh Government has a large income under current arrangements and it would be perfectly sensible to use this to accelerate expenditure and use part of

that income for debt service. The only issue is to what extent the amount of that debt should be capped by the UK government. It would seem reasonable, to the extent that any UK government had rules about this, to allow the Assembly government to borrow based on the ratio allowed at UK level. Alternatively it would be possible to require a balanced budget, in which case debt servicing would have to be at the expense of other expenditure. It is also the case that under the current formula Wales is entitled to receive a proportion of the PFI expenditure incurred by the equivalent English department (even though it does not have the corresponding projects). Whatever the Commission's conclusions it is right that Wales should continue to receive this same flow of funds, to the extent that the UK continues to honour its PFI obligations. It also highlights the issue of capital as opposed to current expenditure. There needs to be a 'smoothing' process so that Wales is entitled to the same capex as equivalent English departments over a period of time without being tied into the same cycle, and with the capacity, as now, to make different allocations between current and capital expenditure.

- c. There is, in addition, the question of the Welsh Government guaranteeing the debt of others, and thereby incurring a contingent liability. It appears to already have the power to do this, but it is a very important financial tool at its disposal and its ability to incur contingent liabilities in this way should be spelled out clearly. This power is particularly important in relation to enabling private sector financing of significant infrastructure projects.
- d. A change in the Welsh government's ability to tax, and what sort of powers it should have is clearly a complex issue and one which does not lend itself readily to a brief document such as this. The two key problems are what areas of taxation (e.g. corporation tax, income tax, VAT etc) to use and how variations of tax are dealt with between the UK government, Wales, and the European regulatory framework. This submission will mainly focus on corporation tax. The European institutions appear to have succeeded in establishing the proposition that while taxation is a matter for Member States, different levels of taxation within Member States are to be treated as 'selective measures' thereby constituting regional aid, and distorting competition.
- e. In the Azores judgement (September 2006), the European Court of Justice came to the conclusion that it was acceptable for regional governments with sufficient institutional, procedural and economic autonomy to change their tax rates, (and therefore not be a 'selective measure', as long as they suffered the consequences (i.e. were not recompensed for the shortfall in income by the central government). Since the Azores government would have been so compensated the ECJ decided that it was a special measure.
- f. What should not be forgotten is that the tax reduction measures proposed were regarded as type of regional aid. In the Guidelines referred to in clause 7 of the ECJ's judgement it is clear that such aid is permissible if it is consistent with the

degree of disadvantage suffered. Clauses 15 and 16 of the Guidelines (abnormally low standard of living, low GDP) are particularly applicable to West Wales and the Valleys. A reduction of corporation tax could therefore be consistent with EU rules within certain parameters.

- g. On the more general point of taxation, the current economic circumstances of Wales means that it will be dependent on some form of transfer from central government for the foreseeable future. The issue is whether it should be in a position to lower taxes without suffering the consequences (dealt with above), or be able to increase taxes without suffering a reduction of the amount it receives from the UK government. Although any type of tax causes anomalies and distortions there may be some scope to introduce an Assembly precept on council tax or any replacement thereof, as is done by e.g. the relevant police authorities or the Mayor of London. Such income could be used for economic regeneration, and therefore would legitimately be separate from the payments from the UK government in respect of a needs based formula for health, education etc. Another alternative would be to provide for the business rates to be paid to the Welsh Government rather than the Treasury. This would permit the Welsh Government to decide whether it wanted to provide a fiscal stimulus by reducing them, or using them to invest in infrastructure, housing etc. Either of these routes would provide a potential 'entry point' for tax varying powers which would be less controversial than income tax, although they undoubtedly cause some friction with local government, particularly in the case of business rates if these were to revert to local authorities in England at some later date.
- h. There is also the issue of additional UK government support to Wales in terms of reducing the GDP gap between Wales and England. It has been recognised by both the UK government (e.g. through regional selective assistance) and the European Union (Objective One, Convergence Funding) that financial assistance should be made available to poorer areas to achieve this. Independent members states of the EU, such as Ireland, have tended to benefit from this assistance more than dependent regions, where inequality, as in Wales, has sometimes increased, but the principle of financial assistance over and above immediate needs is well established, and the Commission will need to look at how such assistance can be delivered to Wales (including in the form of tax reductions) in the years ahead, taking into account the limited life of Convergence Funding.
- i. In conclusion therefore I would suggest that the Barnett formula is replaced by a needs based formula, with an appropriate institutional framework, and that the Commission should recommend borrowing powers for the Welsh Government. It should review the extent to which Corporation Tax could be reduced in the Convergence Funding area, and the establishment of tax powers through transfer of business rates and the use of a council tax precept.

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