Wales's Fiscal Future

Eurfyl ap Gwilym

In this paper I give a high-level description of how the revenue of government in Wales, and in particular the Welsh Government, is raised, the pattern of public spending, and sources of taxation. I then go on to anticipate the fiscal changes that could well take place in Wales in the coming years.

Constitutional developments

Fiscal developments in Wales, and by this is meant developments in taxation and public spending, cannot be divorced from the wider context of constitutional changes. Such developments are by their nature slow but, as will be seen, measured against the wider sweep of Welsh history, the last sixty years have witnessed rapid and accelerating change. In 1951, David Maxwell Fyffe was appointed as the first United Kingdom government minister with responsibility for Wales. In 1964, James Griffiths, the veteran MP for Llanelli, become the first Secretary of State for Wales with a seat in the United Kingdom cabinet. Initially, the responsibilities of the Secretary of State were very limited but over time, as so often happen in such cases, additional responsibilities were devolved. However, while the Welsh Office was responsible for spending on decentralized programmes, the Secretary of State had no powers over taxation or borrowing. The funds allocated by the United Kingdom government to pay for decentralized public services were the result of negotiations between the Treasury and the Welsh Office. Thus the arrangements were similar to that for other United Kingdom departments of state where every year departmental ministers would negotiate their budgets with the Treasury, which had responsibility for the overall macroeconomic framework.

In 1979, a referendum was held in Wales to decide whether a directly elected assembly should be established. The proposition was heavily defeated. In the same year, a referendum in Scotland proposing the establishment of a Scottish parliament failed to pass the hurdles set in the legislation. However, in the run-up to the two referenda a new way of determining how funds would be allocated to Scotland and Wales was implemented by Joel Barnett, the then Chief Secretary to the Treasury. The mechanism adopted has come to be known as the Barnett formula. This formula was meant to be a short-term measure until a more satisfactory means of allocating funds was agreed. Soon after the introduction of the Barnett formula there was a change of government in the United Kingdom, and in practice the formula has remained in force until now. The formula has no statutory basis. It is of interest to note that in 1978 the Treasury attempted to undertake an assessment of relative need in Scotland, Wales and the United Kingdom. It is assumed that this was done with the objective of putting funding in Scotland and Wales on a more rational basis by relating it to relative need. In the event, this approach was not adopted.

In 1997, another referendum was held and this time the people of Wales voted narrowly in favour of establishing a directly elected National Assembly, with limited executive powers and with spending responsibilities but with no powers to levy taxes or to borrow. In the same year, a referendum in Scotland led to the establishment of the Scottish Parliament, not only with legislative powers but also with limited powers over income tax. The Scottish referendum had two questions: the first regarding the establishment of the parliament and the second regarding income tax powers. Both propositions were passed. The Scottish Parliament and Scottish Government came into being in 1999. Nevertheless, further changes, including to the fiscal arrangements, were being pressed. As a result, a commission under Sir Kenneth Calman was established in late 2007 with representatives drawn from the three unionist parties. The Scottish National Party (SNP) declined to participate. In its final report in 2009, the Calman Commission recommended limited additional powers over income tax and the devolution of Aggregates Levy, Landfill Tax and Stamp Duty Land Tax. The Commission came out against devolving major taxes such as VAT and National Insurance. It is anticipated that many of the Calman recommendations will be included in a new Scotland Act to be tabled in the UK Parliament in 2012.

Following the Government of Wales Act 2006, a third referendum was held in Wales in 2011 and was passed with a substantial majority. As a result of this referendum the National Assembly was given primary law-making powers but continued to have no powers over taxation or borrowing other than a short-term 'bridging facility'. In 2011, the UK Government, as part of the coalition agreement, plans to establish another commission to consider whether the National Assembly should have taxation and borrowing powers.

Funding Wales

Public expenditure in Wales is funded from a number of sources. The principal sources are: a block grant from the UK Government; council tax which is levied by local authorities; non-domestic rates which are levied on commercial property; and European Union funding. As has been noted, at present the Welsh Government has no taxation powers. Other than council tax and non-domestic rates, all taxes in Wales are set and collected centrally by the UK Government.

1 The Block Grant

By far the greatest source of funding for the National Assembly is the annual block grant from the Treasury. In 2010–11 this will be approximately £15 billion. Changes to the block grant are determined by application of the Barnett formula.

- Determination of the size of the block grant: the Barnett formula

The Treasury sets the overall envelope of public spending in the UK in the light of macroeconomic considerations. The UK's departmental secretaries of state negotiate the changes to their departmental budgets. The Secretaries of State for Scotland, Wales and Northern Ireland do not negotiate in this way. After the UK departments have agreed their spending plans, the Barnett formula is applied. For each UK spending department, e.g. health, education, transport, the Treasury estimates the proportion of that programme that is devolved and derives what is called a comparability factor. In the case of health, the factor is 100 per cent because all health spending is wholly devolved to Wales. In the case of transport in Wales, the factor is 73 per cent because some of the expenditure on transport is controlled by the Department of Transport in London and may, or may not, be spent in Wales. The next step is to take the pound change in spending per capita for each UK department and multiply it by the comparability factor to determine the corresponding change in spending in Wales. The result is known in the jargon as the 'Barnett consequential'. This is a good description. The change to the Welsh block grant is a *consequence* of changes made to the spending programmes in England for those services which, in the case of Wales, are devolved. All the changes are added up and that is the change to the block grant of money that is allocated to the National Assembly. Thus the block grant that the National Assembly receives is in essence the block grant that existed in 1979 to which have been added each year the Barnett consequentials.

- Advantages of the Barnett formula:
  - An intrinsic feature of the Barnett formula is the block grant. Under the block grant arrangement, the National Assembly can determine how the funds are allocated between spending departments. In other words, the funding is not hypothecated and the National Assembly enjoys a high degree of flexibility. The only limitation is that capital funding cannot be diverted to current expenditure.
  - The level of funding is relatively stable and predictable. There are no spikes or shocks.
  - From the Treasury's viewpoint, there are three fewer secretaries of state with whom they have to negotiate.

- Disadvantages of the Barnett formula:
  - The foundation of the block grant is the grant that existed in 1979. An internal Treasury report undertaken at that time indicated that, in relation to need, Wales was underfunded and Scotland was overfunded. Nevertheless, no corrections were made to the base levels of funding.
  - The change in public expenditure is determined by the priorities of the English spending departments. The Secretary of State for Wales and the Welsh Government have no say in determining those priorities, save that the Secretary of State is a member of the UK cabinet and may have marginal influence on the allocation of spending in England which, in the case of Wales, is devolved.
  - The relative level of funding is not related to relative need: it is a mechanistic, needs-blind formula.
  - Changes are population-related, which does not always make sense, e.g. in the case of roads Wales has approximately twice as many miles of road per capita as England due to population sparsity.

- Between 1979 and 1997 only one adjustment was made to allow for changes in relative population. For the rest of the time, the Treasury has persisted in using the 1978–79 population ratios. This has been good for Scotland because its population declined over the period, and thus the spending per capita was boosted. In the case of Wales, our population grew but not to the same extent as England's. Thus this helped Wales slightly.
- Soon after the Barnett formula was introduced, there was a change of government in the UK, and during the Conservative party's tenure there were many examples of what is called 'Barnett by-pass', where changes to the block grant determined by the Barnett formula were then adjusted as a result of political negotiation. It is generally accepted that Scotland fared better than Wales in this bargaining due to the greater weight attached to Scottish interests.
- When Labour returned to office in 1997, the Barnett formula was applied and population changes were taken into account but there was no retroactive correction.
- The Barnett formula is a *convergent* formula, where spending per head in Wales will over time converge on to the lower level of England irrespective of whether or not this is justified by relative need.
- Between 1979 and 1997, convergence was muted, because the formula was not applied with full rigour, because of the changes in relative population as noted, and because nominal growth in public expenditure was modest.
- After 1997, convergence became a significant factor because the formula was applied rigorously and because nominal growth in spending was high between 1997 and 2007.
- There is limited transparency in the application of the formula and effectively no appeal mechanism. In theory, there is a mechanism, but it has never been invoked in practice.

The Barnett formula was a stop-gap measure, and it has been criticized by many, including: the Holtham Commission; the House of Lords Select Committee under Ivor Richard; the House of Commons Justice Committee; and by numerous academic studies including studies done by Nuffield College, Oxford.

Why has the formula not been replaced? The principal reason is that, given what is generally viewed as Scotland's generous treatment, it is regarded by successive UK governments as being too politically sensitive to change or replace.

2 Council Tax

Council Tax was introduced in Wales in 1992 and determines the way households contribute to the cost of local authority services. In 2010–11, council tax will raise £1.3 billion in Wales.

3 Non-domestic rates

This is a tax levied on non-domestic properties. They are the means by which businesses and other users of non-domestic properties contribute towards the costs of local authorities. Non-domestic rates raise approximately £1 billion year in Wales.

4 European Union funding
These are principally funds received by Wales from the European Regional Development Fund (ERDF), the European Social Fund (ESF) and payments under the Common Agricultural Policy. Until the advent of the National Assembly, ERDF and ESF funding meant for Wales, and for other parts of the United Kingdom, was treated by the Treasury as a central receipt and was not passed on to the intended recipient countries and regions. It was only after an intense debate, soon after the establishment of the National Assembly, that the Treasury agreed that such funding should be passed on to Wales and should be over and above the Barnett-determined block grant.

Expenditure

Expenditure is categorized as being either identifiable or non-identifiable.

1 Identifiable expenditure
Identifiable expenditure is that spending which is in a territory and for the benefit of people and communities in that territory. The Welsh Government and local authorities account for the majority of identifiable public expenditure in Wales. This is funded principally by the block grant with council tax and non-domestic rates making up most of the balance.

● Other identifiable expenditure
The central United Kingdom government retains control over a substantial proportion of identifiable public expenditure in Wales. This is direct expenditure in Wales by the UK Government for the benefit of people in Wales and includes:

○ 'Social protection' which includes sickness and disability payments, old age pensions and unemployment benefit incurs UK Government expenditure in Wales of approximately £9.0bn a year. This funding is needs-related insofar as the same payments are made on the same basis to citizens irrespective of where they live in the UK. The balance of Social Protection expenditure of £2.3bn is spent by local authorities and the Welsh Government.
○ Other non-devolved activities such as justice, the police and parts of economic development which total approximately £1.5bn a year. This is expenditure in Wales by those UK departments of state which are responsible for non-devolved activities. Probably the most notable is justice, which encompasses the courts and the police.

Table 1 sets out at a high level total identifiable expenditure in Wales in 2008–2009. The majority of local authority spending (approximately 80 per cent) is funded by grants from the Welsh Government.

National Assembly	£9.2 bn
Welsh local government	£7.9 bn
UK government departments	£10.5 bn
TOTAL	**£27.6 bn**

Table 1: Total identifiable expenditure in Wales 2008–09

Table 2 summarizes the programmes on which identifiable public expenditure takes place in Wales:

Health and social services	£5.6 bn
Social protection	£11.3 bn
Economy and transport	£2.5 bn
Education	£4.0 bn
Housing	£0.6 bn
Rural affairs	£0.5 bn
Heritage	£0.7 bn
Public order	£1.5 bn
Other	£0.9 bn

Table 2: Where is the money spent?

2 Non-identifiable expenditure

This is public expenditure which is deemed to be for the benefit of the UK as a whole no matter where it is spent. Examples are:

- defence;
- foreign affairs;
- international development.

In practice, Wales receives a low share of such expenditure which does, of course, have a valuable economic multiplier effect which can help the local economies in which the money is spent. In the case of defence spending, Wales, with 5 per cent of the UK population, receives less than 2 per cent of defence spending that takes place within the UK.

Taxation

As has been stated, the National Assembly has no tax powers and cannot borrow money. This is in contrast with local authorities, which can both levy taxes and borrow money. In the case of Scotland, the Scottish Executive has had since its inception the power to vary the rate of income tax by up to 3p. It has never done so for some fairly clear reasons. If it cut tax there is no assurance that the Treasury would not cut the block grant by a corresponding amount. If the Scottish Executive raised the rate of income tax there is no guarantee that the Treasury would not pocket all or part of the money raised. Remember that the Barnett formula has no statutory basis and the Treasury tends to be judge and jury in its own case. Another factor that became clear recently is that HMRC systems are not currently set up to collect tax on a territorial basis.

In the case of Wales, the fact that the National Assembly cannot control tax or borrow money is judged by many to be a major weakness of the current devolution arrangements. This is a major weakness because the National Assembly does not have responsibility or accountability for income and expenditure but simply for expenditure. This means that in determining its spending priorities the National Assembly does not have to concern itself with the impact of such measures on tax revenue. Gerald Holtham has rather provocatively described the National Assembly as a spending agency and, prior to the referendum which gave the National Assembly primary legislative powers, there was quite a measure of truth in this assertion.

The final report of the Holtham Commission looked into the questions of borrowing and tax powers. The conclusions of the Holtham Commission were that the Welsh Government should have some powers over taxation. In particular, the report recommended that powers over Aggregates Levy, Landfill Tax and Stamp Duty Land Tax should be devolved. More importantly, the Holtham Commission favoured devolving part of income tax, although the model differed in important detail from that recommended by the Calman Commission in the case of Scotland.

One area of particular concern to the Holtham Commission was the porous nature of the border between England and Wales and the potential impact of different tax rates on either side of that border. In this respect, Wales differs materially from Scotland where the border areas between England and Scotland are sparsely populated and likely to be less sensitive to differing tax rates. My own view is that the Holtham Commission placed too much weight on such considerations. After all, there are many examples in the world where tax rates and indeed structures differ markedly from one region to another. In the case of the US, there are major differences between the states of Vermont and New Hampshire despite the fact that they are, by American standards, quite small and are contiguous. In the case of Switzerland, taxes differ substantially between cantons such as Zug and neighbouring Zurich and this does not appear to create any insurmountable problems.

Wales's tax revenue

Although the Welsh Government does not have taxation powers it is possible to make estimates of the monies raised by taxation in Wales, and this was done by the Holtham Commission. Table 3 gives an estimate of the taxes raised in Wales in 2007-08.

Income tax	£5.2 bn
National Insurance Contributions	£3.7 bn
VAT	£3.6 bn
Corporation tax	£1.5 bn
Fuel duty	£1.2 bn
Alcohol/tobacco	£0.8 bn
Other	£1.1 bn
Total	**£17.1.bn**

Table 3: Revenue Wales 2007–8

As can be seen, taxes raised in Wales are materially lower than identifiable public expenditure. This is a reflection of the relatively low Gross Value Added per capita generated in Wales. In a unitary tax system such as the United Kingdom, there is a close correlation between relative GVA per capita and tax generated per capita. Given that Wales's relative GVA per capita is 74 per cent of the UK's average, it is to be expected that tax raised will be lower. This gap between taxes raised and public expenditure will inevitably limit the scope for fiscal decentralization if and until Wales improves its economic performance.

Will Wales follow Scotland and gain taxation powers? The current UK Government as part of the coalition agreement has agreed to establish a commission to look into whether taxation and borrowing powers should be devolved to Wales. This 'Welsh Calman Commission' is due to be established later in 2011 and will have the advantage of the work of both the Holtham and Calman Commissions.

Without pre-empting any conclusions that the new commission may reach, I would suggest that is likely that measures of devolution of both tax and borrowing powers will be recommended. Such developments would greatly enhance the powers of the Welsh Government as well as increasing its accountability. Giving the Welsh Government such powers might also lead to a greater differentiation in the policies advocated by the political parties in Wales and afford voters in Wales a sharper choice between the parties. Fiscal decentralization should also make any Welsh Government more conscious of the need for it to promote economic growth in Wales in order to enhance the tax base and its own income.

Looking further ahead, the United Kingdom may be moving to a quasi-federal system where most if not all public services that are devolved will be funded by taxes raised by the devolved government and the central 'federal' government will limit its spending to social protection and areas such as defence, foreign affairs and international aid, together with a transfer mechanism for balancing funding between the richer and poorer regions of the 'federal state'. This is a common pattern in many parts of the world.

To conclude: important changes are taking place in the field of fiscal decentralization in the United Kingdom. However, one should not be misled. Discussions with politicians, officials and ministers make it clear that the central United Kingdom Government is extremely reluctant to embrace decentralization, including fiscal decentralization. Changes are made on an ad-hoc basis and in response to political pressure. There is no overall philosophy or design. Centralization is deeply embedded in the United Kingdom. Perhaps it goes back almost a thousand years to Norman times. In the thirteenth century, King Edward I of England had to borrow £122,000 from Tuscan bankers in order to build a chain of castles in north Wales in an attempt to subdue the Welsh. The need to raise and service this colossal debt led to a much greater centralization of financial powers in England. Fiscal centralization was further reinforced in the fifteenth century when Henry Tudor became King of England and, as Henry VII, was famed for his centralizing control of state finances. Perhaps it is against this sweep of history that we need to recognise the rapidly changing face of fiscal decentralization in the United Kingdom.