Accountability, fairness and growth: proposals to reform the funding arrangements of the National Assembly for Wales

The Welsh Liberal Democrat submission to part one of Commission on Devolution in Wales

February 2012
Introduction and Context

1. Liberal Democrats, in Wales and across the UK, believe that power and authority derive and flow upwards from the people and that power must be exercised at the most appropriate local level. Wales, as one of Europe’s oldest nations, has a long-standing cultural, political, national and linguistic identity with historically separate emphases and traditions in education, religion and law. We have long supported a federal system as part of our vision for the UK’s constitutional future.

2. In order to ensure that our central principles of dispersing power as widely as possible and of ensuring that Wales’ distinct challenges can be addressed, we have advocated and supported devolution strongly. We have argued consistently since the establishment of the National Assembly that it should possess additional financial and legal competencies.

3. This support was evident, from the nineteenth-century, in our campaigns for Home Rule, our work for the disestablishment of the church and our campaigning for a Yes vote in all three referendums on devolution. This support has been coupled with a belief that additional responsibility must be accompanied by both additional accountability and additional capacity to deliver. That is why we have regularly supported reforms to increase the responsibility that Welsh ministers have over the money they spend, but also to ensure that they have the right legal and financial powers to deliver a wide range of solutions.

4. Similarly, we have supported the strengthening of the Scottish Parliament and, until a more comprehensive constitutional solution can be found, of local government in England. The situation in Northern Ireland is more complex, but we have supported devolution there too.

5. We believe that the United Kingdom is slowly moving towards a federal state. However, its constitutional and financial systems have not been developed sufficiently to compensate for these changes. The Silk Commission presents politicians across the UK with the opportunity to strengthen the framework as far as Wales in concerned.
6. We believe that the obvious solution to the growing complexity of the UK state is to move to a federal structure. For us, federalism is a political arrangement whereby sovereignty is shared between the central government and the national and regional governments. Each regional or national government would have significant control over its economic, social and political fortunes. These governments will be able to use a wide-range of mechanisms to achieve improvements for their citizens. By mutual consent, some areas of policy would remain at the federal level.

7. An example of the failure of the UK constitution to meet the demands of a multi-layered democracy is the continued existence of the discredited Barnett formula. This formula was established as a short-term fix in the early 1970s and has been retained despite the fact that it is an inequitable solution to the funding needs of the United Kingdom.

8. The Barnett formula has been widely recognised as unfair but has been left unchanged for a number of years. This is despite the fact that the advent of devolution has demonstrated the inadequacies of the formula on numerous occasions. Nonetheless, successive governments have not addressed this, even during periods of rising public expenditure.

9. In our submission to the Holtham Commission in 2008, we stated that

\[\text{the Barnett formula is unfair as it is based primarily on population, although it also takes into account the level of spend and the extent of devolution. Welsh Liberal Democrats find this unacceptable. We believe that Wales is a more challenging nation within which to deliver public services, thus needing a greater amount of funding to allow for the effective delivery of these services. This is due to the higher levels of deprivation, lower levels of economic prosperity and a much higher degree of rurality.}\]

10. We identified that the basis for any new formula should include, but not be limited to; the levels of deprivation and the extent of deprivation, the percentage of GVA as a percentage of the UK average, rurality and the quality of public health. We believe that these four factors represent some of the most challenging barriers to the effective delivery of public services. The Holtham
11. Reform of the Barnett formula on a needs basis is an essential part of an overarching funding system that can cope fairly and progressively with the territorial politics of the UK as a whole.

12. The proposals included in the rest of the document are predicated on the replacement or reform of the Barnett formula in a way that ensures that Wales no longer loses out on money that it would receive if it were a region of England. We do not believe that the issues below can be considered without taking into account the underfunding of Wales through the Barnett formula. Keeping this issue entirely separate, and dealing with it through a series of bilateral discussions that do not inform the work of the Commission in a purposeful manner will not deliver a comprehensive solution. We recommend the commission consider the issue of reform of the Barnett formula.

13. We would also like to make it clear that we recognise the flexibility that the Welsh government receives within the current arrangements for the Welsh block grant. Currently, the money may be spent on the Welsh government’s own priorities and on any programme within those priorities. In order to ensure that the Welsh government remains accountable for its own spending decisions, this flexibility must remain.

14. These two principles, of equity of funding and of freedom to choose spending priorities, form the basis of our position on financial reform and must to be addressed together.
1) What, if any, tax powers including possible new taxes and levies should be devolved to Wales?

1.1 Our approach to devolving tax powers to Wales is based on three principles: effectiveness, accountability and ease of operation.

- **Effectiveness**: The devolution of various taxes must enable the Welsh government to achieve specific policy aims. This means the government should have control over taxes and charges for subjects which are already devolved to ensure that the government has the most control over areas that are already devolved.

- **Accountability**: No devolved parliament should be wholly reliant for its revenue on another Parliament nor it should it be responsible for its spending without also being accountable for how at least some of it is raised. Without this accountability, there is too little incentive for achieving economic growth because successful economic development does not then lead to higher revenues for the devolved administration. It should also be clear which taxes are levied by which government.

- **Ease of operation**: We believe that any system of taxation should be simple to operate, efficient to collect and enforce and provide the least instability for the Welsh government’s fiscal planning.

1.2 The most commonly cited proposals for taxes to be devolved are income tax and corporation tax. We support both these proposals, although we note that there are significant legal and technical barriers to overcome in order to do so. However, it is vital that the mechanism for the devolution of these taxes ensures that the budget of the National Assembly increases when the government pursues successful economic development policies. The Welsh government should be rewarded for creating more jobs and more businesses by an increase in its budget, as is the case with other national governments. However, they must also be given the powers to influence these policy areas sufficiently.

1.3 We believe that proposals similar to those in the Scotland Bill should be developed, giving the National Assembly responsibility for raising a proportion of income tax from within Wales. This will
1.4 We note that, after the passing of the Scotland Bill, Scotland will have had control over its income tax through two different mechanisms. The first was the ability of the Scottish Parliament to vary the rate of income tax in Scotland by 3p. The Scotland Bill will replace this by reducing the rate of income tax in Scotland by 10p in the pound and giving the Scottish government the onus to raise its income tax rate beyond that.

1.5 We believe a model for Wales will rest somewhere between these two mechanisms. Given that wages are lower in Wales than in England or Scotland, it is essential that any system should not disadvantage Wales. Therefore, we expect that, at least initially, the ability of Welsh Ministers to vary income tax may need to be restrained.

1.6 The Holtham Commission suggested that rates of income tax should be lowered by 50% in Wales (as is the case with the proposal in Scotland) to 10p, 20p and 25p respectively and the National Assembly should be required to vote annually to raise the remaining taxes. However, the Assembly would be required to set a tax rate that was within 3p (either way) of the UK tax rate. We believe that this proposal should form the basis of the Commission’s approach.

1.7 We also believe that the requirement that the National Assembly vote each year to raise taxes is essential to ensuring the government is accountable for its spending decisions, even if the government decides to set taxes at a level that is the same as HM Treasury.

1.8 We note that most of the discussion about devolving income tax has revolved around the rate of tax and not the structure of the tax bands. We accept this current limitation because altering the structure of the tax system will seriously undermine the efficiency of the system.
1.9 Clearly, as a poorer nation within the UK, Wales will require some form of equalisation funding. Any formula seeking to achieve this is likely to include a measure of economic prosperity. As a result, any progress from the Welsh government on economic development is likely to see this element of the formula reduced. This would undermine the principle that effective economic development should lead to increased tax revenues. Any formula should ensure that, should the prosperity of Wales increase relative to the prosperity of other nations and regions in the UK, this will not cancelled out by a consequent reduction in equalisation funding. The reduction in the grant should not be more than the increase in tax revenue as this would act as a disincentive to the Welsh Government to pursue economic growth.

1.10 We also believe that a long-term aspiration should be for the Welsh government to have control over some element of corporation tax in Wales. However, we acknowledge that there would be significant difficulties in deciding which companies were “Welsh” and addressing the potential of a race to the bottom. The development of proposals for Northern Ireland may well lead to proposals which can be adapted to the Welsh context.

1.11 The two taxes discussed above (income tax and corporation tax) produce the greatest yield of the taxes suggested for devolution to the Assembly but also carry with them the greatest risk. The choice over what proportion of the tax-levying responsibility should be held at a Welsh and at a UK level is clearly a complex one. Given the economic challenges facing Wales, too high a proportion could lead to a reduction in the size of the Welsh block grant. As the Welsh block grant is already lower than is equitable, a further reduction would not be acceptable. However, if the proportion was set correctly, the Welsh government would receive the same benefits from pursuing successful job-creation and business-friendly policies as most other governments.

1.12 Other taxes that we believe should be devolved, as they are part of a policy area which is already largely devolved, include:

- **Housing:** In order to address the acute crisis in Wales, stamp duty should be devolved to the National Assembly in order to help lower the cost of buying a house in Wales.
• **Environment:** As waste management and recycling are largely devolved to the National Assembly, taxes relating to this policy area, most notably, Landfill Tax and Aggregates Levy should be devolved to enable the government to take a strategic approach to environmental matters.

• **Industry-specific taxes:** As part of the Welsh government’s approach to economic development, they have chosen to identify specific sectors for development. We propose that there should be regular, formal discussions between Ministers on the most effective taxation of these sectors in Wales, including some taxes on the financial and insurance sectors, some taxes and tax credits relating to green jobs and other tax and tax credit issues that affect industries that Wales has identified as a priority.

• **Business rates:** Greater freedom should be given to the Welsh government to reform legislation relating to local government rates, both domestic and non-domestic. The legal and financial situation surrounding both of these taxes, and which elements of the process are reserved to Westminster, is complex despite the fact that local government is devolved and business support is perceived to be devolved. Greater control over business rates beyond the multiplier would allow the Welsh government to deliver a more coherent reform of business rates.

1.13 In the future, the Welsh government may seek to introduce new taxes that do not exist across the UK as a whole, whether to discourage certain activities or to promote others. (The Welsh government has already done this, although in a roundabout way, with the introduction of a compulsory levy on carrier bags). A formal mechanism should be established to allow the UK government to confer, by Order in Council, the power to levy new taxes, provided both governments are satisfied that no tax base is being over-taxed.

1.14 We would like to re-iterate our belief that any reform of Wales’ financial relationship with the United Kingdom must be concomitant with reform of the Barnett formula and must preserve the ability of Welsh ministers to determine their own spending priorities.
2) What, if any, borrowing powers should be devolved to Wales?

2.1 In our submission to the Holtham Commission, we said,

*We would support the development of borrowing powers for the Welsh government and believe that the Assembly is mature enough to use borrowing powers sensibly and frugally. As Welsh Liberal Democrats, we would seek to use borrowing powers for strategic capital investment and for substantial one-off investments into public services... [We] do not believe that borrowing powers should be limited to borrowing from the Treasury.*

This remains our position. As we explain later, this should be pursued immediately by the UK government immediately.

2.2 At the time, we noted that the Northern Ireland Executive had borrowing powers and had used it to for infrastructure investment and for public service investment. Since the submission, there has been substantial development in the borrowing powers for the Scottish parliament. Failure to award similar powers to Wales will mean that the Welsh government is unique amongst devolved parliaments and local government in not being able to borrow.

2.3 We believe, given the economic challenges facing Wales and the consensus that infrastructure in Wales is underdeveloped, that speedy investment in infrastructure and capital projects can help stimulate the economy in both the short- and long-term. However, it is not possible for the Welsh government to fund such a programme of investment out of its general expenditure, and it would need borrowing powers to fund it.

2.4 The proposals in the initial draft of the Scotland Bill will allow the Scottish government borrowing powers. For capital borrowing, there will be a limit of up to 10% of the Scottish capital budget each year (approximately £230 million) with a cumulative limit of £2.2 billion. Loans will be available from the National Loans Fund. However, the Scottish Government will also be able to borrow from additional sources such as commercial banks. This borrowing will need to be self-financed through increased revenue from taxation in Scotland or a reduction in public spending and the Scottish
2.5 The Scottish revenue borrowing limits are £200m per year up to a cumulative limit of £500m and can only be from the NLF.

2.6 Initially, borrowing would have been available from April 2013 for specific projects based on HM Treasury consent and full borrowing powers would have come into force from 2015. However, the UK government has been speeding up this timescale. We believe that the Welsh government should have the same powers, with limits adjusted to reflect the smaller size of the Welsh budget, delivered within a similar timescale.

2.7 Given that the maximum debt the Welsh government could accumulate would be approximately £1.2 billion and that this will be accumulated over a ten year period, we do not expect that this will have a significant impact on the UK’s debt liabilities. Capital borrowing should be available from a variety of sources to stop future governments from refusing borrowing for purposes with which it does not agree. If revenue borrowing is only available from the treasury then there should be a presumption of consent.

2.8 We think that this issue should be pursued as a matter of priority for the Welsh government. As the legal arrangements and language have already been agreed for the Scotland Bill, the Welsh equivalent should be easy to adapt. We recommend that the UK government immediately act to introduce legislation devolving borrowing powers or amend an existing economic development of local government finance bill to do so. This will enable the Welsh government to invest in capital development as soon as possible and stimulate economic growth in, and tax receipts from, Wales.
3) Do you have any other proposals for improving the financial accountability and empowerment of the Welsh government?

3.1 We are concerned about the complexity of various funding streams that exists from legislation that pre-dates the law-making powers of the National Assembly. These funding streams do not reflect the need for transparency and clarity on which issues are devolved to the National Assembly and which are not.

3.2 For example, the Housing Revenue Account is a funding stream which is administered on an England and Wales basis despite the fact that Wales and England (through the UK parliament) are pursuing different, and divergent, policies towards social housing. Wales loses over £80 million to the Treasury every year as a result of this legislation. Scotland is exempt from this transfer of funds, and we believe money raised from social housing in Wales should be retained in Wales. The government should reform the Housing Revenue Account to ensure the Treasury is not able to claw back this funding from councils in Wales. The recent reforms to the social housing model in England should facilitate this.

3.3 Likewise, we are concerned about the complexity of some elements of the council tax arrangements. For example, it is anomalous that the Welsh government should be in charge of issues such as the number of tax bands, the values of properties that fall within them and the level at which a cap or floor may apply but not of other issues such as the dates of the variation. It also leaves the National Assembly unable to replace it with a more radical, fairer system. Given that many people consider the funding of local government to be a devolved issue, reform is needed to ensure greater clarity on this issue.

3.4 Finally, we would like to see a greater codification of the arrangements for the meetings between the Finance Ministers of each nation. We believe that the Joint Ministerial Committees should be the basis of this new arrangement and that meetings should be held regularly between the Finance Ministers. Likewise, we believe that a Treasury Minister should be made available to a committee of the Assembly to answer questions on the UK government’s budget each year. We appreciate that the Chief Secretary to the Treasury has given evidence to the National Assembly’s finance committee recently, but this process should be formalised.