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

full text

July 2009

Content

CHARTS AND TABLES

Page

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. 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

Overview

1.1   This chapter sets out the scope of the Commission's work. It addresses:

i)   the background to the current fiscal settlement;

ii)   the context within which the Commission is undertaking its work;

iii) an initial overview of the options for change; and

iv)   the principles that have guided the Commission's thinking.

Background

1.2   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").

1.3   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.[1] The Secretary of State transfers these funds into the Welsh Consolidated Fund after first deducting the running costs of the Wales Office.[2] In this report, the bulk of these funds are referred to as "the Welsh block grant".[3] 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.[4] 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.[5]

---

[1]   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 2.7-2.12)

[2]   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.

[3]   Chapter 2 provides further information on what is covered by the term "Welsh block grant" (paragraphs 2.5-2.6).

[4]   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.

[5]   Annex 3 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.

Context

1.4   In recent years, the financing of public spending in the devolved administrations has become increasingly contentious. Dissatisfaction with current arrangements is being expressed in various parts of the UK though for diverse reasons. In England, the current financial settlement is viewed by some as being excessively generous to the devolved administrations. In Wales, the opposite claim is often made, with a perception that Wales is not receiving its "fair share" of public resources in accordance with its needs. The Assembly Government's position is that, after almost a decade of devolution, the time is right to review the present funding arrangements and to consider the case for the transfer of some fiscal powers to Wales.

1.5   Growing discontent has led to a flurry of activity across the UK to review the fiscal settlement. In March 2007, the UK Government commissioned Sir David Varney to undertake a review of tax policy in Northern Ireland.[6] In August 2007, the Scottish Government launched its "National Conversation", to engage the Scottish public in discussing the options for further self government (greater devolution, fiscal autonomy or full independence), with the intention of holding a referendum in 2010 to decide on Scotland's constitutional future.[7] The Commission on Scottish Devolution (the Calman Commission) was established by the Scottish Parliament and supported by the UK Government, to examine the current constitutional arrangements in Scotland and to recommend any improvements to the devolution settlement, including to the financial accountability of the Scottish Parliament.[8] In December 2008, a House of Lords ad hoc Select Committee was appointed to examine the purpose, methodology and application of the Barnett Formula.[9] In May 2009, the House of Commons Justice Committee concluded in a report that the Barnett Formula was "overdue for reform".[10]

1.6   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.

---

[6]   The Chancellor of the Exchequer charged the review with reporting on "how current and future tax policy, including the tax changes announced in the Budget 2007, can support the sustainable growth of businesses and long-term investment in Northern Ireland" (Varney, 2007 p.3). The "Varney Report" rejected the rationale for lowering corporation tax rates in Northern Ireland.

[7]   The Scottish Government set out the options as follows: "First, retention of the devolution scheme defined by the Scotland Act 1998, with the possibility of further evolution in powers, extending these individually as occasion arises. Second, redesigning devolution by adopting a specific range of extensions to the current powers of the Scottish Parliament and Scottish Government, possibly involving fiscal autonomy, but short of progress to full independence. Third, which the Scottish Government favours, extending the powers of the Scottish Parliament and Scottish Government to the point of independence" (Scottish Government, 2007 p.vii).

[8]   The remit of the Commission on Scottish Devolution was to "review the provisions of the Scotland Act 1998 in the light of experience and to recommend any changes to the present constitutional arrangements that would enable the Scottish Parliament to serve the people of Scotland better, improve the financial accountability of the Scottish Parliament, and continue to secure the position of Scotland within the United Kingdom" (Commission on Scottish Devolution, 2008 p.3). At the time of going to press, the Commission was due to issue its final report.

[9]   In 2008, the House of Lords Liaison Committee considered and agreed to a request from Lord Barnett for the establishment of an ad hoc select committee on the Barnett Formula, with terms of reference:
"to examine the purpose, methodology and application of the Barnett Formula as a means of determining funding for the devolved administrations of the United Kingdom, to assess the effectiveness of the calculation mechanism to meet its purpose, and to consider alternative mechanisms. These orders of reference are intended to exclude consideration of: the overall system of funding the devolved administrations - in particular the question of whether greater tax-raising powers should be accorded to the devolved administrations; other political aspects of the devolution settlements; and the distribution of funds within the different regions of the United Kingdom" (House of Lords Liaison Committee, 2008 p.3). The House of Lords announced the establishment of the Committee on 10 December 2008.

[10]   House of Commons Justice Committee, 2009.

Approach to the terms of reference

1.7   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.

1.8   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.

1.9   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.

1.10   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[11], 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.

1.11   This Commission's members have been appointed for their knowledge of economics, fiscal affairs in an international context and other aspects of public economic policy. There is no political representation on the Commission and it therefore has no status to offer opinions on matters that are essentially political in nature. We conceive our job as being to assess technical solutions to issues where there is a political consensus on objectives. Where political divergences exist we can identify those and point out the consequences of different choices. In that way we seek to illuminate political decisions, without presuming to make them.

1.12   That presents a choice for a Commission such as this. We could try to propose an entirely new formula for the block grant, with clearer objectives and therefore more justification for the distributions that it entailed. The risk would be that the system would lack political support and be impractical. Alternatively we could accept Barnett as the "revealed preference" of the democratic political process but ask whether it was leading to outcomes of such egregious unfairness or difficulty as to be likely to cause political embarrassment in future; if the answer were yes, we could propose ad hoc "fixes" to ameliorate the situation.

---

[11] The scope of devolved responsibilities is different in Wales, Scotland and Northern Ireland.

1.13   We have proceeded as follows. In this first report we shall review the desirable elements and shape of a satisfactory distribution formula but we shall also propose a number of immediate and practical changes to the operation of the present one. In the final report we plan to sketch out an improved system as well as examining alternative possible sources of revenue for the Assembly Government.

Options for change: block grants and taxation

1.14   The Barnett Formula is, in principle, a relatively simple mechanism by which the UK Government makes changes to the funds that it allocates to Wales and the other devolved administrations of the UK. Wales is allocated a block grant (£14.3 billion in 2008-09[12]), which is rolled over from one period to the next. Changes to the Welsh block are determined by changes to spending in England on services that are devolved (partially or wholly) to Wales. For wholly devolved services, the Welsh increment is the English cash increment scaled by relative population. Although this arrangement was originally introduced as an interim measure, it has survived with minor adjustments for almost 30 years.

1.15   Possible alternative 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.

1.16   Along this spectrum of options there are, broadly defined, four possible models for financing devolved government in Wales (summarised in Table 1.1):[13]

    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

---

[12]   HM Treasury, 2008.

[13]   For a discussion of the options as they relate to Scotland, see: Hughes-Hallett, Peat, Scott, Sutton and Zuleeg, 2008 and Scottish Government, 2009.

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").

1.17 While up to date official statistics are not available, plausible estimates of the fiscal balance of Wales (i.e. the difference between revenue raised in Wales and the amount spent on services for people living in Wales) suggest that Wales currently runs a significant fiscal deficit.[14] Economic shocks can have a major impact on governments' tax and spending plans. By raising and sharing taxes at the UK level, each of the countries of the UK benefits from a degree of risk pooling that mitigates the impact of regionally specific shocks on their budgets. There are therefore advantages in continuing to contribute to, and receive funds from, a UK-wide revenue pool. Even if Wales were a net contributor to, rather than a net recipient from, the UK budget, the benefits of risk pooling at a UK level would continue to provide a strong case for an element of tax sharing.

1.18 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.

1.19 We expect to focus mainly on options i), ii) and iii) in our final report. Each of these options includes at least an element of block grant. We can therefore discuss the block grant confident that it will remain important in any plausible reformed system. Box 1.1 provides further discussion of the role of the block grant in alternative funding systems. Our initial view is that option ii) is relatively unattractive for Wales. The assignment of tax revenue without also devolving powers to vary these taxes would increase uncertainty about the future size of the Welsh block grant, without giving Welsh Ministers the fiscal powers to manage and offset this uncertainty.

---

[14] See Oxford Economics, 2008. The balance between total revenue raised in Wales and expenditure on devolved services alone is less clear. The Commission intends to undertake a comprehensive analysis of the fiscal balance of Wales in the next stage of its work.

Table 1.1: Funding reform options

Possible funding system	Description	Implications for borrowing powers
i) Block grants	Funds from the UK Government to Wales would be allocated as at present in the form of an unhypothecated block. The allocation process could be based on a modified Barnett Formula, or could be driven by a wholly new mechanism.	Under a block grant-based funding system, the Welsh budget would not be directly exposed to fluctuations in Welsh tax receipts, reducing the need for borrowing powers. Nonetheless, Wales would still be exposed to UK-wide fiscal shocks. There may be scope for borrowing powers that help to manage lumpy investment expenditures. These powers would be exercised within limits set by the UK Government since the Assembly Government would not have its own revenue stream against which to borrow.
ii) Block grant plus assigned tax revenue	As above, plus revenue from some taxation raised in Wales would be allocated to Wales. Control over the base and rates of these taxes would remain with the UK Government. The size of the block grant would be reduced initially by an equivalent amount to offset the funds provided by any assigned tax revenue. Fluctuations in the assigned tax revenue would not be offset by compensating changes to the Welsh block grant.	There would be a clear need for devolution of borrowing powers to offset swings in tax receipts driven by the business cycle. There would also be a strong rationale for borrowing powers, as Wales would have a specific revenue stream against which to borrow.
iii) Partial fiscal autonomy	As in the previous case, certain tax revenue raised in Wales would be assigned to Wales, though some powers to determine the tax base and tax rates would also be devolved. It would be possible for these powers to be very limited in scope, or very broad. The benefits of pooling risk at the UK level would provide a strong case for Wales to contribute to, and receive a block grant from, a UK fund, even with quite extensive fiscal autonomy.	As above.

Possible funding system	Description	Implications for borrowing powers
iv) Federal systems/full fiscal autonomy	All taxes raised in Wales would be paid to a Welsh exchequer and that exchequer would have to pay for all devolved public spending in Wales. There could still be financial transfers between Wales and the UK (federal system) or at the limit there may be none (full fiscal autonomy).	Independent borrowing powers would be essential under this model in order to offset fluctuations in Welsh tax receipts.

Box 1.1 Options for reform and the role of an expenditure grant

The following example demonstrates that a grant from the UK Government to Wales would remain a central component of all financial systems that fall short of full fiscal autonomy.

Assume that for the UK as a whole there is balanced budget, so that total tax raised (T) equals total spending (G), expressed in per capita terms. Suppose for simplicity the average tax rate is t for the whole country and the tax base is Y. Subscripts with a d (for devolved) are the equivalents in Wales.

It is possible to express the following two systems algebraically:

System 1: the UK Government gives Wales G_d, and takes all "Welsh" taxes tY_d to the central pot. This is effectively the method by which Wales is currently funded, although in theory the size of Gd could be determined by population, by needs or by some other method.

Under this system, Wales gets G_d and contributes tY_d.

System 2: Wales keeps all its tax revenue but receives two top up payments, one to reflect differences in spending and the other to reflect differences in the tax base. The sum of the top ups, which could be positive or negative, is:

$$G_d - G + t(Y - Y_d)$$

Although system 1 is simpler to operate (i.e. a block grant is paid to Wales and all tax revenue goes to a central pot), in practice both systems generate identical resources for Wales.

Even though differing points on the spectrum of options would give the devolved administration very different tax raising powers, most points would preserve the key features of this scheme - i.e. an adjustment for a different tax base (a degree of revenue equalisation, proportional to $t(Y - Y_d)$) and some needs-based adjustment (proportional to $G_d - G$ where G_d reflects needs or the cost of providing the same service).

A consideration of how to set G_d will therefore be relevant for a wide range of points on the spectrum described above.

Options for change: borrowing

1.20   Other than an extremely limited facility for short term borrowing from HM Treasury (set out in Annex 3), 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.

1.21   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.

1.22   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.

1.23   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. Table 1.1 sets out both the need and the rationale for devolving borrowing powers under each of the main options for reform. Our conclusions on borrowing will depend on the overall fiscal settlement, to be considered in our final report.

Principles for reform

1.24   The Calman Commission's Independent Expert Group has set out a series of principles to guide that Commission's work when considering how to reform current arrangements.[15] 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:[16]

- **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;

---

[15]   Independent Expert Group to the Commission on Scottish Devolution, 2008 p7.

[16]   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.

- **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;[17]

- **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.

1.25   While these principles are generally uncontentious, their application will give rise to political issues. In particular the criterion of accountability would imply that the devolved administration should have responsibility for raising some of its own revenue, which implies tax-varying powers. We regard that argument as powerful but we acknowledge that there is no clear consensus for such a conclusion in Wales. Moreover the criteria cited are conflicting to some extent so each country's arrangements for funding sub-national governments represent a trade-off between these competing objectives. A fundamental tension observed in funding systems around the world is between equity and autonomy; countries that place a high value on treating citizens equally in all regions generally restrict the degree of autonomy possessed by sub-national governments, while countries that prioritise local autonomy generally accept that this will lead to differing outcomes for citizens in different regions.[18]

Summary

1.26   The purpose of the first report is to provide an informed assessment of the Barnett Formula as it has been applied to Wales and to consider 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.

1.27   The recommendations in this report are designed to be applicable both to a modified Barnett Formula and also to a more fundamentally reformed system involving devolution of taxation and/or borrowing powers. In the latter instance, the recommendations would apply to whatever mechanism was in place to transfer resources between the UK Government and Wales.

1.28   Although there is a broad spectrum of possible models that could be applied to finance devolved government in Wales, in the Commission's view these can be grouped into four broad categories. They are:

   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;

---

[17] 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.

[18] Independent Expert Group to the Commission on Scottish Devolution, 2008.

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 Welsh budget and would not be offset by compensating changes to the block grant; and

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").

1.29   We expect to focus mainly on options i), ii) and iii) in our final report. Early reflection inclines us to think that, apart from option i) (the status quo, perhaps with modifications), option iii) is the alternative most worthy of detailed consideration.

1.30   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 our final report.

1.31   In assessing the case for change, the Commission will be guided by the objectives for a system of funding sub-national governments, as set out in the Calman Commission's Independent Expert Group, namely:

- equity;
- autonomy;
- accountability;
- stability/predictability;
- simplicity/transparency; and
- efficiency.

Chapter 2: The impact of the Barnett Formula on Wales

Overview

2.1   This chapter analyses the impact of Barnett on public expenditure in Wales, and considers the following topics:

    i)   the origins of the Barnett Formula;

    ii)   the role of the formula in explaining current and historic public spending patterns;

    iii) the extent to which Barnett is leading to a "squeeze" on spending in Wales;

    iv)   the ways in which population changes, extra-Barnett arrangements and changes in the budgetary process impact on the operation of the formula; and

    v)   projections of likely spending trends if Barnett remains in place.

2.2   The analyses in this report make extensive use of information published by the Treasury on an annual basis in Public Expenditure Statistical Analyses (PESA). In order to estimate comparable spending in England, PESA information has been combined with the Barnett comparability factors (these are described in paragraphs 2.7-2.12). Many of these analyses have not been published before and, as such, they provide a new insight into the current system of devolved finance. Annex 2 provides more detail on the methods used. The absence of published information to make these comparisons directly means that there are unavoidable uncertainties in the analyses, particularly with regard to precise consistency over longer time periods. However, we are confident that the broad inferences drawn are robust.[19]

The origins of the Barnett Formula

2.3   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.[20] 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.[21] 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.[22] 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.

---

[19] At the time of this report going to press, HM Treasury was due to release new PESA data. Any material changes to our analysis resulting from the new data will be addressed in our final report.

[20] 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).

[21] House of Commons Library, 2007 p.8.

[22] House of Commons Library, 2007 p.9.

2.4   Lord Barnett himself has said that formula was a temporary expedient not expected to last "a year, or even twenty minutes".[23] In plain language it was a fudge. Politically it was not found possible to secure agreement on a formula that allocated resources on the basis of needs, although the Treasury had devoted time and effort to developing such a formula, the results of which were published in 1979.[24] The outcome was simply to take expenditure per head as it was in Wales, Scotland and Northern Ireland as a baseline. Presumably that expenditure had evolved from some previous view of needs but was anyway a line of political least resistance. The Barnett Formula, if strictly applied, was then a mechanism that subjected that expenditure per head to a slow squeeze so that it converged on the average level for England as a whole (we explain the mechanics of this process in detail later in this chapter). No-one argued that it was appropriate for all regions of the UK to have the same level of expenditure per head but insofar as this effect of the formula was intended, it was supposed that the formula would be superseded long before that point was reached.

The Welsh block grant

2.5   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. Box 2.1 provides further information on how the UK Government determines its overall spending limits.

2.6   Chapter 1 (paragraph 1.3) 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 which is set by the UK Government, 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.

> **Box 2.1: The UK budgetary process**
>
> The UK Government's spending plans are set in advance for three year periods. The plans are announced following a spending review that aims to align spending with the Government's priorities. Allocations to Wales and the other devolved administrations are announced at the time of the publication of the spending review. This process was most recently undertaken in the 2007 Comprehensive Spending Review (CSR), with plans published for the three financial years 2008-09 to 2010-11.

---

[23] House of Commons, 1997 p.1.

[24] HM Treasury, 1979. The 1979 exercise assessed Welsh need at 109 per head, in relation to an English average of 100. This assessment was updated by HM Treasury in 1994, when it was concluded that Welsh need had increased to 112 (HM Treasury, 1994).

The UK Government announced the temporary suspension of its fiscal rules in the 2008 Pre-Budget Report.[25] However these rules have underpinned the budgetary process for the last decade and therefore merit consideration here. The two rules the UK Government adopted were:

    i)   over the course of the economic cycle, the government would only borrow to finance capital expenditure (the "golden rule");

    ii)   the UK's net public sector debt would not rise above a threshold of 40 per cent of Gross Domestic Product (the sustainable investment rule).

Along with a forecast of government receipts and an assessment of the progression of the economic cycle, these two rules have effectively provided overall envelopes for future public expenditure. Chart 2.1 provides a graphical illustration of how public expenditure in the UK is categorised. The budget is split into two categories for planning and management purposes; Annually Managed Expenditure (AME) and Departmental Expenditure Limits (DEL), as described in the text (paragraph 2.6). Forecasts and projections for the volatile or largely demand-led AME programmes are deducted from the overall spending envelope and the remainder is allocated to the DEL.

DEL and AME are split into resource elements covering recurrent costs and capital elements covering long-term assets, which are controlled and accounted for separately. The resource DEL includes both cash and non-cash items. The main non-cash items relate to the consumption of fixed assets and the cost of holding them. These depreciation and cost of capital charges are controlled separately from the cash elements of the resource DEL.

Chart 2.1:   Categories of public expenditure in the UK

---
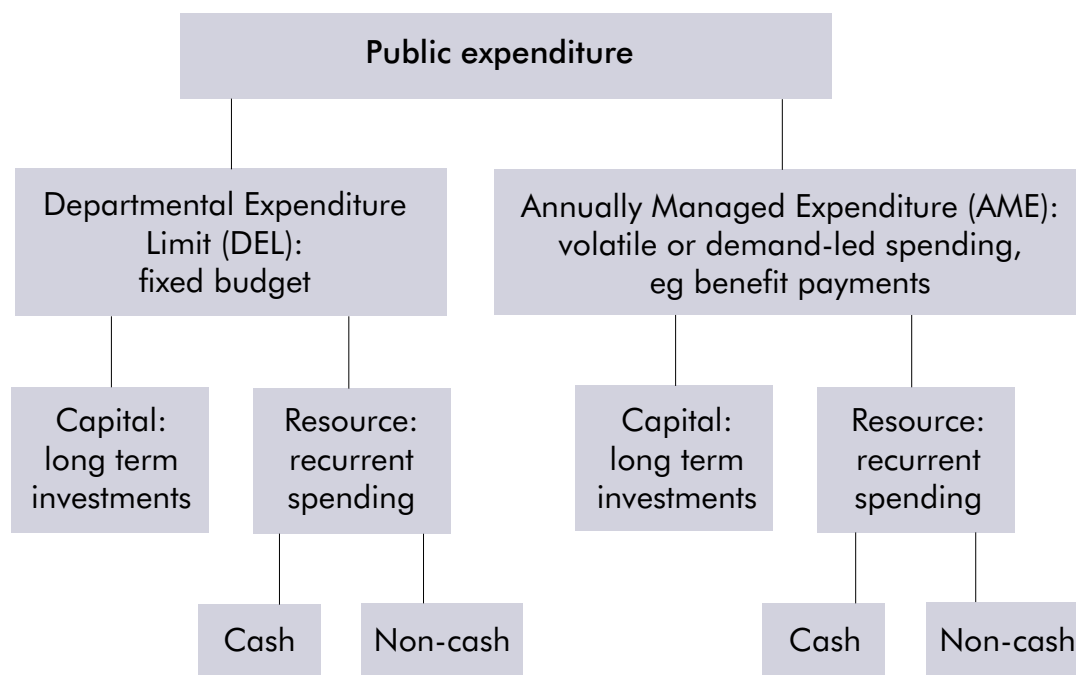
25   In place of the fiscal rules the UK Government has adopted a temporary operating rule: to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full.

15

Description of the Barnett Formula

2.7   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:

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.

2.8   Under the formula, changes in the funding allocated to Wales are explicitly linked to spending decisions in England. If spending in England on matters that have been devolved to Wales increases or decreases, the block grant allocated to Wales will also increase or decrease. Conversely, if spending in England on areas that have been devolved remains unchanged, then the block grant allocated to Wales also remains unchanged.

2.9   Spending by the UK Government on wholly non-devolved matters, such as defence, has no impact on the size of the Welsh block. The extent to which spending in a particular area is devolved to Wales will differ from case to case. To account for these differences, the Barnett Formula includes comparability factors, which range between zero (for wholly non-devolved matters) to 100 per cent (for areas that are completely devolved to Wales).

2.10   Changes in English expenditure on matters that are wholly devolved to Wales will result in changes to the Welsh block that are in line with the Welsh population as a proportion of the English population. In 2007, the population of Wales was 5.83 per cent of the population of England.[26] This means that Wales receives 5.83 per cent of any change to English spending on wholly devolved matters.

2.11   In summary, changes to the Welsh block grant equal the change in spending in England, multiplied by the comparability factor for that spending, multiplied by the Welsh population share. Box 2.2 provides a hypothetical example of the operation of the formula.

2.12   The Assembly Government (and before it, the Welsh Office) has over time seen a steady increase in the scope of its responsibilities and, as a consequence, the range of activities to be funded from the Welsh block grant has grown. In order to allow for this, when functions are transferred from UK Government departments to Wales additional funding is generally transferred into the Welsh block. The amount of the transfer is determined on an ad hoc basis. Once responsibility for a particular function has been transferred to Wales, in subsequent years the Welsh block receives consequentials resulting from changes to the budget for the comparable function in England.

---

[26] Population estimates are generated by the Office for National Statistics (ONS) and the Barnett Formula is adjusted annually to incorporate the most recent estimates.

Box 2.2: 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:

Change to Welsh   =   change to equivalent   x   comparability   x   Welsh to English
block grant   English programme   factor   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 million x 90 per cent x 5.83 per cent = £5.25 million[27]

Scope of the Barnett Formula

2.13   A significant proportion of public spending in Wales is wholly outside the scope of the Barnett Formula, which, as explained above, is used to determine changes in the size of the Welsh block grant. Table 2.1 shows the range of sources that support expenditure on public services in Wales. The Welsh block grant, at £12.8 billion in 2006-07, was the largest single source of public expenditure, but accounted for only 53 per cent of total public spending on services in Wales (known as Identifiable Expenditure on Services, or IES).[28] The remaining 47 per cent of public spending on services in Wales was determined outside of the Welsh block grant.

Table 2.1: Expenditure on services in Wales, £ billion, 2006-07

	Assembly Government/local	UK Government	Total
Departmental Expenditure Limit (DEL)	12.8 Barnett Formula	1.8	14.7
Annually Managed Expenditure (AME)	1.3 Mainly locally financed	8.2	9.6
Total Identifiable Expenditure on Services (IES)	14.2	10.1	24.2

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

Source: HM Treasury PESA 2008 and Commission calculations

---

[27] For a detailed description of the operation of the Barnett Formula, see HM Treasury, 2007a.

[28] IES is total public expenditure in Wales recognised as being for the benefit of individuals, enterprises or communities in Wales. It excludes certain expenditures incurred in Wales, because they are deemed to be for the benefit of the UK as a whole, e.g. defence. 2006-07 is the latest year for which full outturn data are available.

2.14   The UK Government spent around £1.8 billion in Wales on a range of programmes inside the DEL of various Whitehall departments, covering non-devolved areas such as policing and justice. The UK Government also spent £8.2 billion in Wales on volatile or demand-led AME programmes. The bulk of this spending relates to social security benefits and tax credits managed by the Department for Work and Pensions and HM Revenue and Customs respectively. There was an additional £1.3 billion of AME in Wales, which mainly reflects spending financed through revenue raised by local authorities via the council tax.[29]

2.15   While resources allocated through the Barnett Formula are therefore the largest single component of public spending in Wales, it is important to note that a substantial proportion of Welsh public spending is determined by other means.

Chart 2.2:   Government expenditure in Wales £ million (current prices), 1994-2011
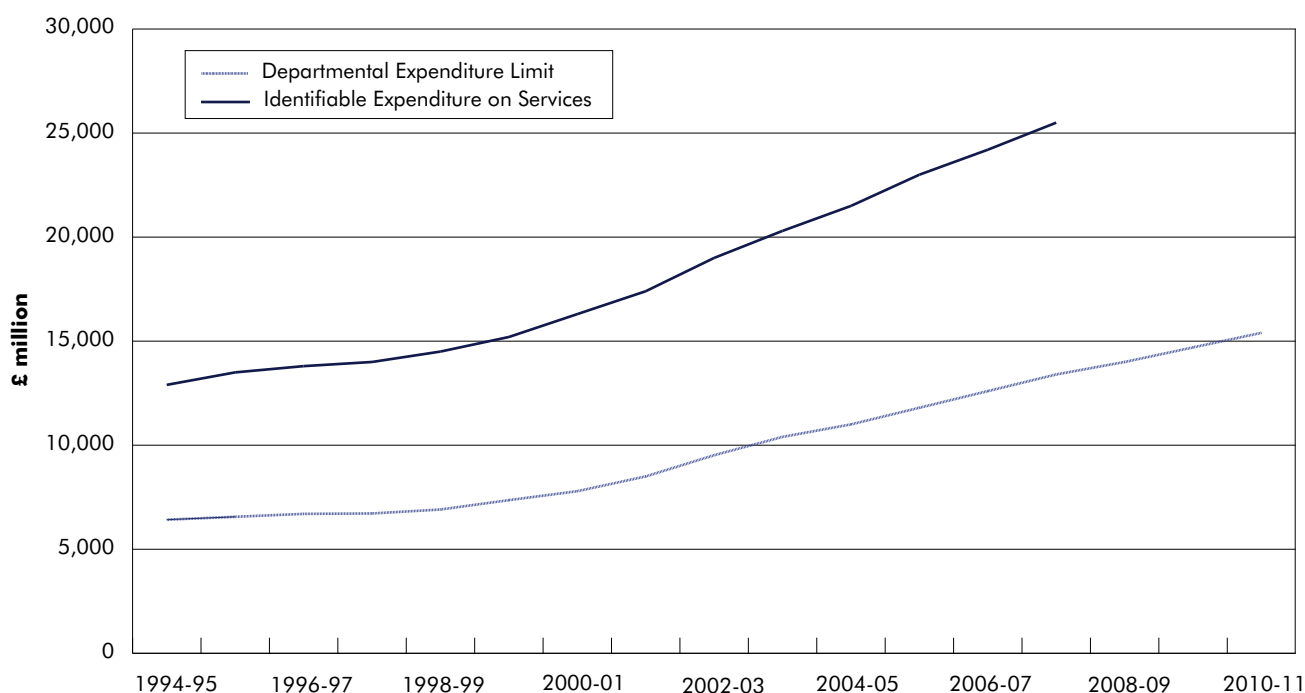
Source: HM Treasury PESA 2000-2008. IES data not available from 2008-09 onwards

---

[29]   This amount also includes adjustments to allow for differences in accounting treatment and coverage between DEL and IES.

Chart 2.3:   Annual real growth in government expenditure in Wales (per cent), 1994-2011
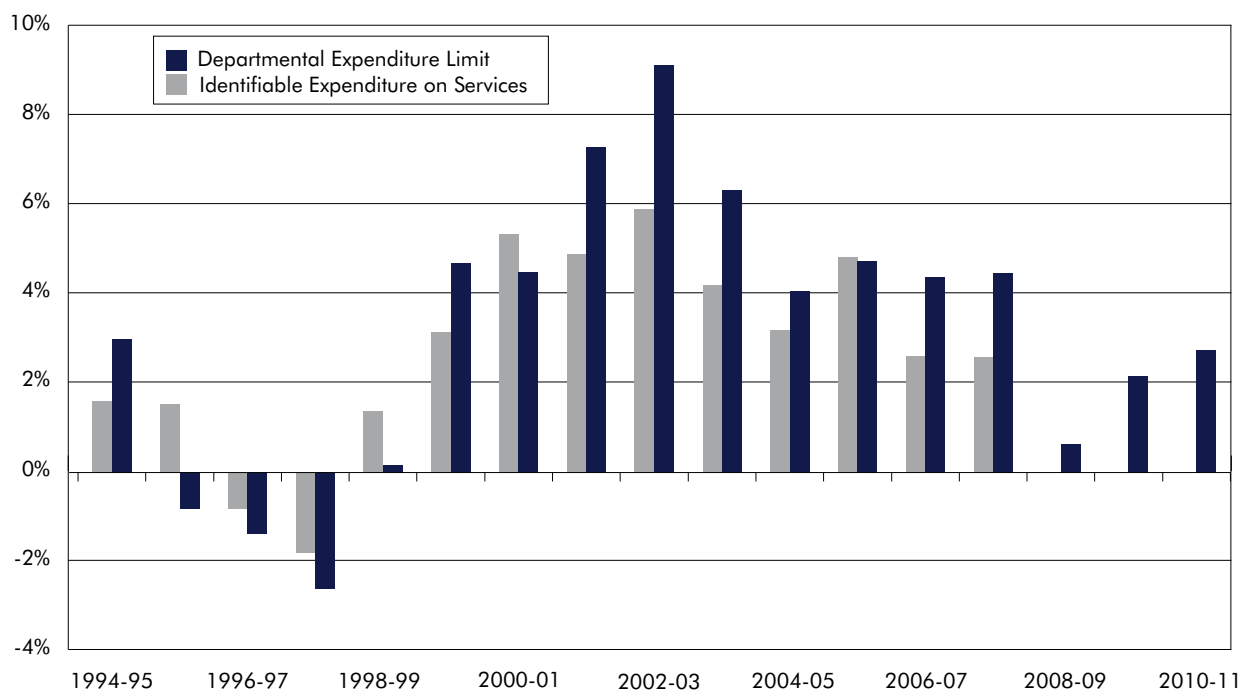
Source: HM Treasury PESA 2000-2008. IES data not available from 2008-09 onwards

Public expenditure trends across the UK

2.16   Charts 2.2 and 2.3 show that public expenditure in Wales has increased steadily since the early 1990s, with large and sustained increases in both the Barnett-funded Welsh DEL and in the IES, which encompasses both resources received through Barnett and those from other sources as set out in Table 2.1. The budget allocated to Wales has risen from £7.4 billion in 1999-00, the first year of devolution, to £14.3 billion in 2008-09, and is planned to increase to £15.8 billion at the end of the current spending period in 2010-11.[30]

2.17   Chart 2.4 shows how Assembly Government and locally financed expenditures in Wales were allocated in 2006-07. Health and education were by far the largest budget items, and between them accounted for 60 per cent of total spending. Economic affairs, which includes economic development, agriculture and transport accounted for 12 per cent of spending, while social protection (which mainly covers spending on personal social services) was responsible for a further 11 per cent of overall expenditure.[31]

---

[30] For resource and net capital DEL, see HM Treasury, 2008 table 1.12.

[31] HM Treasury, 2008 table 9.17, and Commission calculations.

2.18   Public expenditure per head in Wales and the other devolved administrations is higher than in England. The most recent figures show that, on an IES basis in 2007, public spending was £8,600 per head in Wales, £9,200 in Scotland and £9,800 in Northern Ireland, compared with £7,500 in England. Chart 2.5 shows how IES spending in the devolved administrations has changed over time relative to England. To some extent, these spending differentials reflect different needs across the countries of the UK. However, it has been argued both that Wales gets too much, and not enough, public spending, given its relative needs. This issue is explored in depth in Chapter 4.

Chart 2.4:   Assembly Government and locally-financed spending in Wales by function, 2006-07
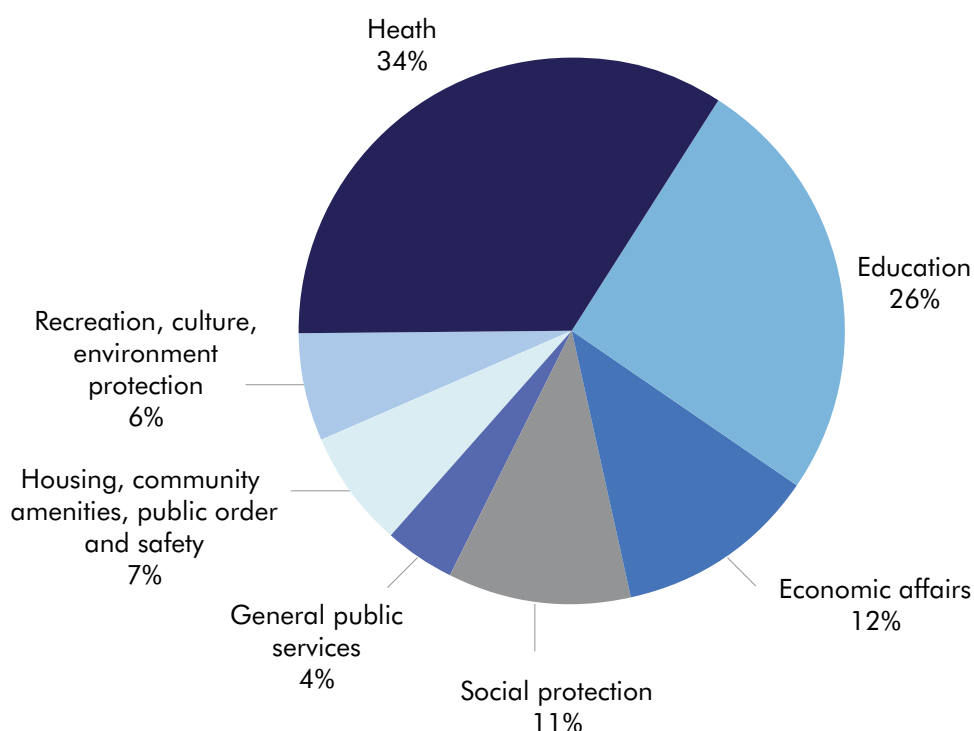
Source: HM Treasury PESA 2008 and Commission calculations

Chart 2.5:   Identifiable expenditure per head in Wales, Scotland and Northern Ireland (England = 100), 1994-2007
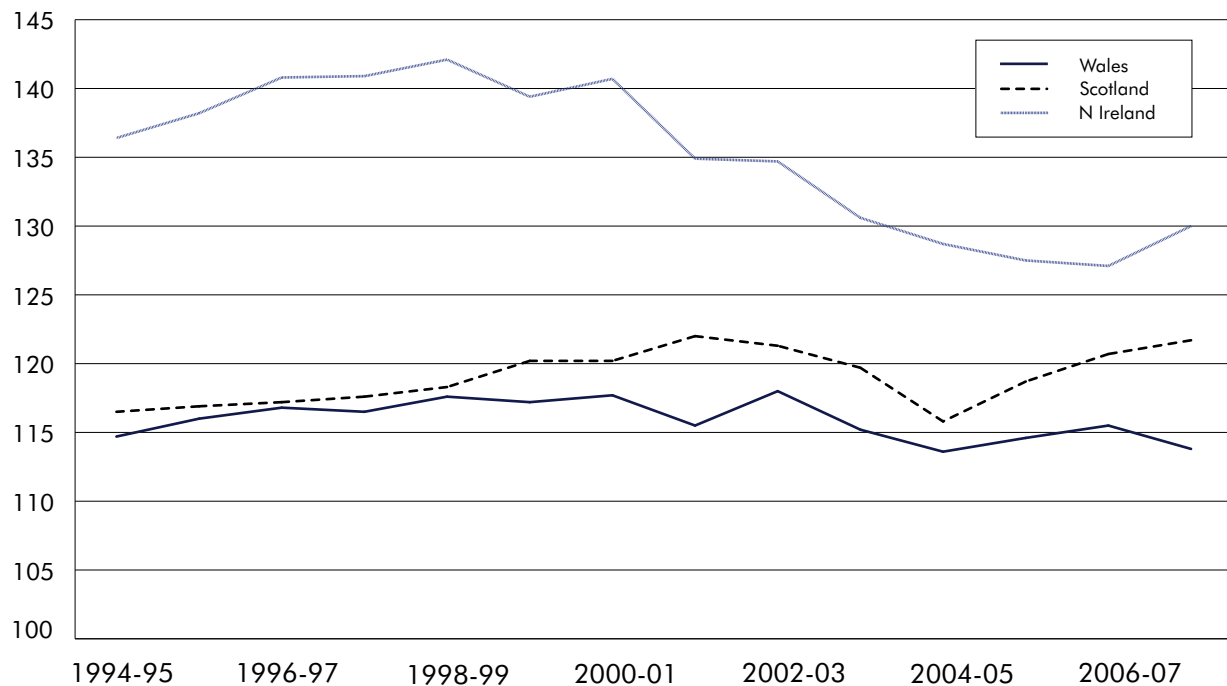
Convergence in spending: the Barnett "squeeze"

2.19   As Chart 2.5 shows, 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. Box 2.3 provides a hypothetical example of the Barnett squeeze.

2.20   Chart 2.5 suggests that there was no convergence in spending per head during the 1990s in any of the territorial administrations of the UK. Between 1993-94 and 1999-00, spending per head on an IES basis moved from 116 to 117 in Wales, from 119 to 120 in Scotland and from 142 to 139 in Northern Ireland (where spending per head in England is set to equal 100). Since the turn of the century, Chart 2.5 indicates that there has been quite significant convergence in IES spending in Northern Ireland (declining from 141 to 130), limited convergence in Wales (moving from 118 to 114) and no convergence in Scottish spending levels (from 120 to 122).

Box 2.3: An example of the Barnett squeeze

	England		Wales		
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.

2.21   Regardless of whether or not public expenditure convergence across the UK is desirable, Chart 2.5 suggests that in practice convergence has only been a limited feature of total public expenditure in Wales and only in recent years. However the picture is distorted because IES includes expenditure outside the Assembly Government's DEL. As already mentioned, only a little over half of IES expenditure in Wales is determined by the Barnett Formula, with the remainder being funded either by revenue raised by local government or by UK Government expenditure on non-devolved activities.

2.22   A more accurate method of assessing the extent of the Barnett squeeze is to restrict the analysis to those functions that are funded in Wales via the Assembly Government's DEL. Chart 2.6 makes this comparison over time for Wales and England, and shows clear evidence that, since the late 1990s, Barnett-related spending per head in Wales has been converging with comparable spending per head in England.[32] 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.

---

[32]   Calculated from PESA data using Barnett comparability factors to estimate comparable spend in England. This comparison and those in the remainder of the chapter relate to near-cash DEL; total resource and capital budgets excluding notional transactions such as depreciation, cost of capital charges and the taking and release of provisions.

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.

Chart 2.6: Wales's relative expenditure per head on programmes covered by the Barnett Formula (England = 100), 1994-2011
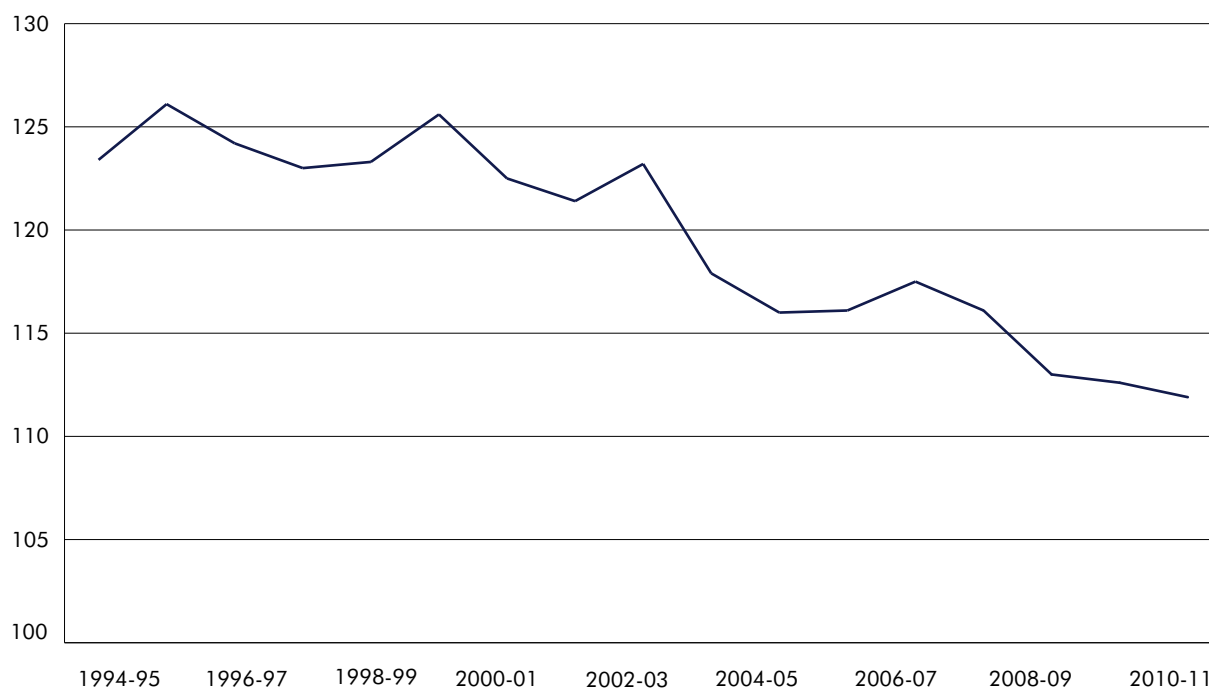
Source: Commission calculations

2.23 The convergence shown in Chart 2.6 is not smooth because for most years it is based on expenditure outturns rather than planned allocations. Differences between planned spending and outturns are usually caused either by an accumulation of end year flexibility (EYF) credits (via underspends) or by a draw down of EYF accumulated in earlier years (see Chapter 5 for further discussion of EYF). These year-to-year variations from planned allocations will affect both the Wales outturns and the outturns for comparable programmes in England and may cloud the pattern of convergence in relative expenditure per head. However over time, such fluctuations should even out. To illustrate this, Chart 2.7 includes a modelled relative expenditure line for Wales, generated by applying the Barnett Formula to year-on-year changes in outturns for comparable English programmes. This smooths out relative EYF movements by assuming the same net movements in Wales as in England. Starting in 1999-00, this modelled outturn for Wales arrives at much the same relative expenditure in 2010-11 as the actual outturn and current plans.

2.24 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. It is possible to produce estimates of English regional expenditure per head on broadly equivalent programmes to those covered by the Assembly Government DEL for 2002-03 to 2007-08 from PESA data. These show no pattern of convergence on the England average.

Chart 2.7:   Impact of End Year Flexibility on relative expenditure per head (England = 100), 1999-2011
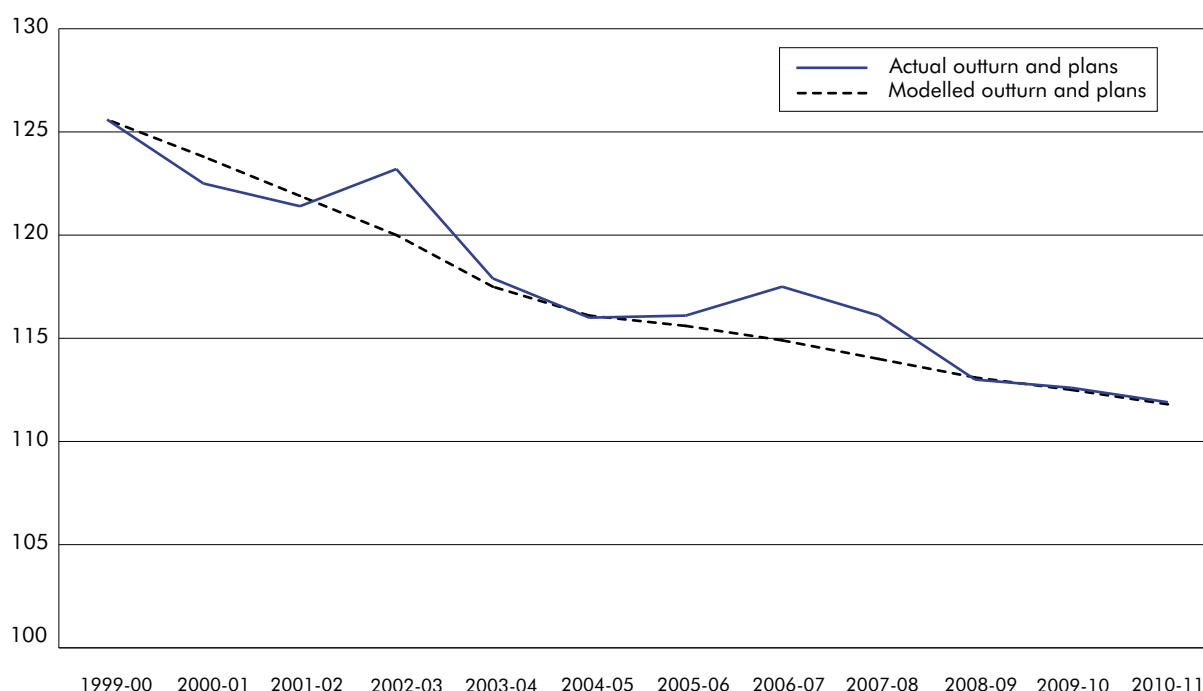
Source: Commission calculations

The impact of changes in population

2.25   The size of the population of Wales relative to the population of England is a key factor in the operation of the Barnett Formula. Changes in the size of the population of Wales should be expected to have a significant impact on the amount of public spending allocated to Wales over time. The population of Wales has grown somewhat more slowly than the population of England in recent decades. As a consequence, the population share of spending increases allocated to Wales through the Barnett Formula has declined slowly, from 5.93 per cent in 1999 to 5.83 per cent in 2008.

2.26   This shift in the relative size of the Welsh population has two effects on relative public spending. On the one hand, a smaller relative population reduces the size of the incremental budget increases that Wales receives, and so tends to support spending convergence towards English levels. On the other hand, declines in the relative population of Wales mean that the total budget allocated to Wales will be spread across relatively fewer people, thus tending to reduce spending convergence with England. Chart 2.8 shows that the overall impact of changes in Welsh population over time has been to reduce the amount of convergence in spending by a modest amount. Since 1999, spending per head in Wales has fallen from 125 to 112 relative to England. However, if the populations of Wales and England had stayed fixed at their 1999 values, convergence would have been more rapid, with relative spending per head falling to 110 over the same time period.[33] The overall impact of these shifts in population has therefore been to somewhat reduce the magnitude of the squeeze that would otherwise have occurred.

---

[33]   The same technique as was applied in Chart 2.7 has been used to generate the modelled line in Chart 2.8, with the additional assumption of fixed 1999 populations.

Chart 2.8:   The role of population changes in spending convergence (England = 100), 1999-2011
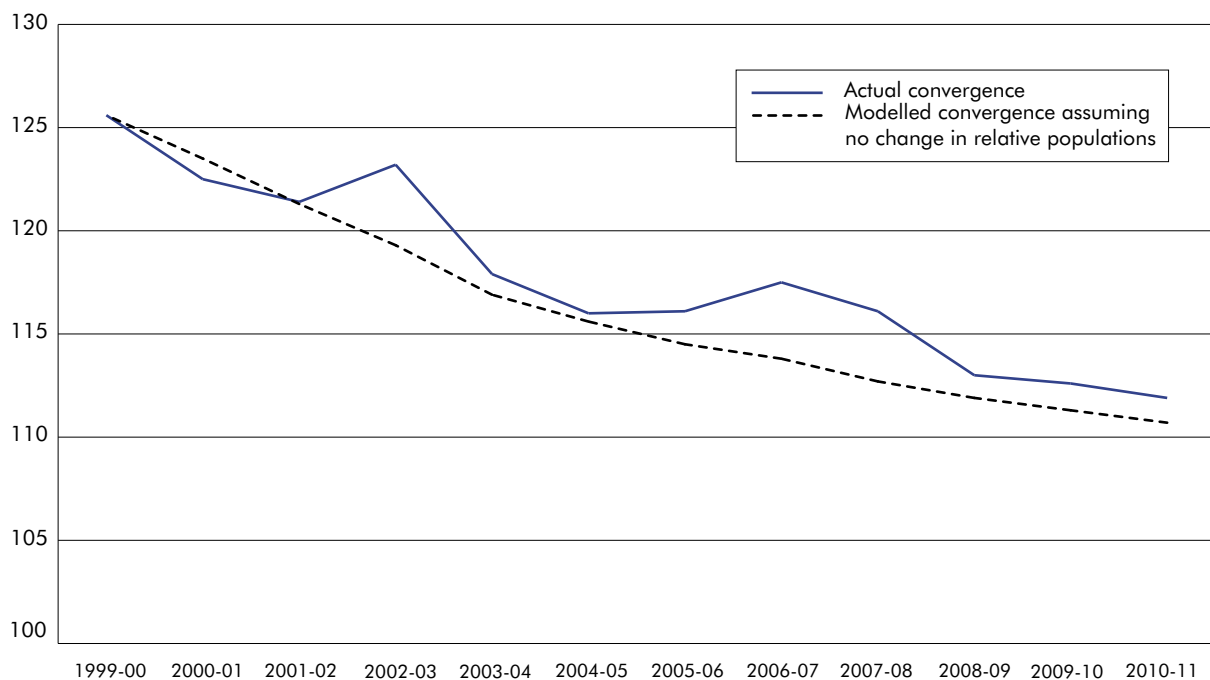
Source: Commission calculations

Other factors: budgetary changes, devolution of new functions and extra-Barnett funding

2.27   Changes to the process for setting budgets across all UK Government departments (including the then Welsh Office) were introduced in 1992-93 that altered the way in which inflation was handled. The impact of this change, which has been maintained ever since, has led to faster convergence than would have happened if the previous budgetary process had remained in place. Additional analysis of the impact of this change is provided in Annex 2.

2.28   Further difficulties in assessing the impact of the Barnett Formula over time arise from the changing scope of the budgets under consideration. The Assembly Government has acquired a number of new functions in recent years with accompanying transfers of resources from UK Government departments. The management of loans for Welsh domiciled students and the Wales rail franchise are two of the larger examples. These transfers have a one-off impact on the size of the block grant that is separate from the increments arising from the Barnett process. Such transfers also affect the stock of comparable spending in England - as more functions are transferred to Wales, the comparable proportion of English spending increases.

2.29   Changes in the budgetary treatment of certain programmes also need to be taken into account when assessing the impact of Barnett over time. On occasion there have also been extra-Barnett deals, i.e. instances where additional funding has been made available outside the Barnett Formula. The funding of European programmes in Wales provides examples that cover both of these issues. Before 2005, any increases in European structural funds programmes in Wales could be accommodated only by reductions in other expenditure programmes or by extra-Barnett increases to the Welsh block. In the 2005 Pre Budget report the UK Government made changes

to the budgetary treatment of European programmes, which effectively neutralised their impact on the Barnett process. As such, these programmes have no impact on the convergence detailed above. Even if the gross expenditure related to structural funds programmes were included in the comparisons above, they would have little impact on the pattern of convergence (further details are given in Annex 2).

2.30   Finally in relation to the Barnett squeeze, there is a widespread perception that, prior to the introduction of devolved government in the UK, the Barnett Formula was less strictly applied than it has been in recent years. The lack of convergence in relative spending levels before 1999, and the sustained convergence that has been seen in Wales since, is consistent with that view.

Likely scale of the future squeeze: projections

2.31   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 2.9 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 2.9 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.

2.32   Chart 2.9 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.[34]

2.33   Barnett was originally introduced as a temporary measure but it has nonetheless lasted almost 30 years. If it lasts another 30 years, Chart 2.9 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.

---

[34]   Both of the scenarios illustrated assume no change in the population of Wales relative to England.

Chart 2.9: Projected convergence in spending per head (England = 100), 1999-2040

Legend:
.... Outturn and current plans
– – – Projection assuming nominal 0% then 4% growth per annum
——— Projection assuming nominal 3% then 6% growth per annum
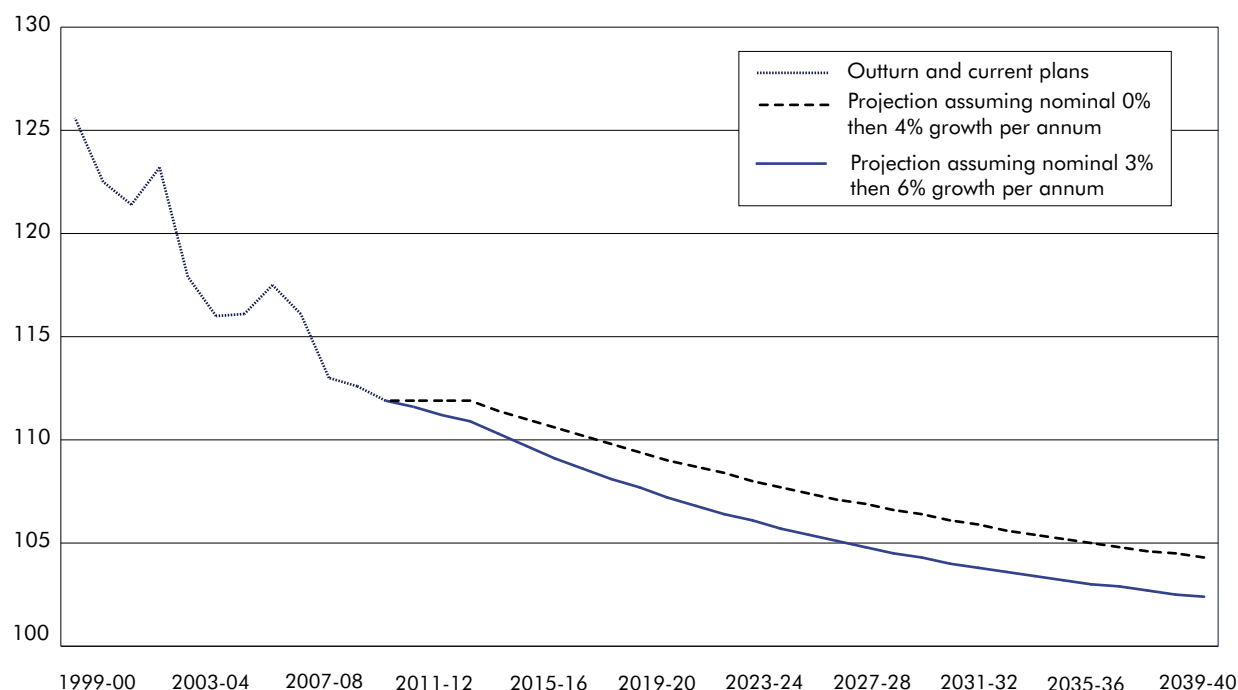
Source: Commission calculations

Summary

2.34   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:

   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.

2.35   Changes to the Welsh block grant equal the change in spending in England, multiplied by the comparability factor for that spending, multiplied by the Welsh population share.

2.36   While resources allocated through the Barnett Formula are the largest single component of public spending in Wales, a substantial proportion of Welsh public spending is determined by other means.

2.37   Public expenditure in Wales has increased steadily since the early 1990s, with large and sustained increases in both the Barnett-funded Welsh DEL and in the total IES, which encompasses both resources received through Barnett and those from other sources. The budget allocated to devolved activities in Wales has risen from £7.4 billion in 1999-00, the first year of devolution, to £14.3 billion in 2008-09, and is planned to increase to £15.8 billion at the end of the current spending period in 2010-11.

2.38   The Barnett Formula, if strictly applied, should lead to convergence in public spending per head in Wales and England.

2.39   Despite being applied to Wales since 1980, there is not much evidence of a Barnett-driven squeeze in spending prior to the establishment of the National Assembly for Wales in 1999 but there is clear evidence of convergence in recent years. In 1999-00, 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 government.

2.40   Population shifts have somewhat reduced the magnitude of the squeeze, while changes to the budgetary process have somewhat strengthened the squeeze. It is likely that before devolution of elected government to Wales, there was a greater likelihood of Barnett bypass, though it is not possible to demonstrate this conclusively.

2.41   Looking ahead, it is highly likely that if the Barnett Formula is left unchanged the trend towards convergence in spending per head between Wales and England will continue. If the annual increase in spending on comparable programmes in England matches that seen in recent years then, even allowing for an initial period of very low growth, spending per head on devolved activities in Wales will decline over the ten years following the end of the current spending review period to £107 for every £100 spent in England on comparable activities.

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

Overview

3.1   This chapter provides an assessment of the current funding system against the principles for reform set out in Chapter 1, including a discussion of the extent to which it delivers an equitable allocation of funds to address the relative needs of the different parts of the UK.

Assessing the principles

3.2   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.

3.3   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.

3.4   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

3.5   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.

3.6   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. To take a hypothetical example, this means that if it could be demonstrated that the overall relative need to spend on public services in Wales were 10 per cent greater per head than the equivalent need in England, then (other things being equal) spending per head in Wales should be 10 per cent above that in England within a predetermined total.

3.7   Needs and equity are of course contested concepts that are fundamentally political in nature. Box 3.1 and Annex 3 provide a discussion of what is meant by these terms in the context of public resource allocation. 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 (definition (i) in the typology of needs that is presented in Box 3.1). That is the definition adopted by the Treasury in its 1979 needs analysis. 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.

3.8   It is not in the Commission's competence to make the political decision about how needs are to be defined. In assessing the needs of Wales in Chapter 4 we have used formulae or approaches that are already in use within the UK Government and which, therefore, may be taken to embody an existing consensus. It is important to note that the Commission's adoption of those implicit definitions of equity is in no sense an endorsement that they are correct in an objective sense. Rather, our aim has been to select a widely accepted minimum standard that avoids any accusations of cherry picking a definition to suit Welsh circumstances.

3.9   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. In the absence of such broad consensus, a move by the UK Government to impose a new settlement would lead to perceptions of inequitable treatment, and would be self defeating. Joint agreement would be essential with regard to both (i) the process by which needs were assessed and (ii) the way in which the outcome of the joint assessment of needs was reflected in the budget setting process. We are aware that any significant changes to the status quo will require a process of consultation, which will take time and will inevitably induce political difficulties, but international experience suggests that these need not prove insurmountable.

3.10   Governments across the UK and internationally make frequent use of needs-based formulae to allocate resources across territories. While these formulae vary hugely in complexity, those that attempt a comprehensive assessment of needs generally take account of demographics, deprivation and the cost of service delivery. We envisage that any revised funding formula for Wales that broadly reflected needs would attempt to capture these three factors.[35] In order to avoid creating adverse incentives, measures of need that are used to allocate funding must be beyond the direct control of the grant recipient.

---

[35] Preliminary analysis suggests that actual allocations of public expenditure can be modelled to a high degree of accuracy with relatively simple formulae that include standard proxies for demographics, deprivation and cost.

3.11   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.

3.12   One notable advantage of Barnett is its extremely low administrative cost. Moving to a needs-based model will create the potential for budgetary allocations to be complicated by protracted discussion and lobbying from interest groups, keen to ensure that their area of specialism is given prominence in the calculations. Other countries have tended to reduce this risk by passing responsibility for the implementation of the formula to an independent body.

3.13   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.

> ### Box 3.1: Alternative definitions of equity and needs
>
> In its 1979 Needs Assessment Report, the Treasury[36] stated that "It is a long-established principle that all areas of the UK are entitled to broadly the same level of public services and that the expenditure on them should be allocated according to their relative needs".[37]
>
> This principle has support across the political spectrum but there is an ambiguity in the definition of needs. The determination of what counts as a "need" rather than something merely desirable is essentially political. The fact that services like health and education are provided universally indicates we regard them as meeting needs. Evidently the need is greater where there are more people likely to require the service, e.g. young people in the case of education, older people and infants in the case of health. The demographic structure of the population is therefore an uncontentious indicator of need. In practice, certain groups make more use of public services than others; poorer people have generally poorer health, for example. Moreover some groups derive less benefit from standard public services than others, for example children from deprived backgrounds typically do less well at school. We could say that they require more resources and therefore greater public expenditure per head, but that raises the question of what public services are trying to achieve and different answers to that question will entail different definitions of needs. The objective could be to:

---

[36] HM Treasury, 1979 p.4.

[37] HM Treasury, 1979 p.4.

i) compensate for disadvantage;

ii) remediate the effects of disadvantage on life chances (promoting equality of opportunity by, for example, costly early years interventions with disadvantaged children); and/or

iii) eliminate the effects of disadvantage on life chances (promoting equality of outcome).

Each of these objectives raises further questions. For instance, how much extra funding would be needed to compensate for disadvantage? If the stated goal is to promote equality of outcome, how could this be delivered without producing perverse incentives that "reward failure"? These issues are beyond the scope of this report.

Below is a typology of possible definitions of needs, presenting variations on an assumed base case in which the allocation of expenditure is proportional to population. For the purposes of this report, the Commission has not been prescriptive but has attempted to draw conclusions based on existing approaches to allocating expenditures on public services. We have tried to reflect the existing consensus, such as it is, on objectives. It is perfectly possible to argue that the existing allocations of public expenditure are inappropriate and we should be more ambitious, for example, in tackling relative disadvantage. That is a legitimate matter for political debate but one which goes beyond our terms of reference.

Typology of needs

i) **Equal level of service**

Determine the level of expenditure required to provide a standard level of service.

ii) **Compensation for disadvantage**

a) **Individual**: expenditure aims to compensate to some degree for low income or other adverse circumstances.

b) **Collective**: payments to an organisation or group to permit it to compensate for average levels of disadvantage amongst its members or clients.

iii) **Remediation of disadvantage (towards "equality of opportunity")**

a) **Individual**: funding of policies to reduce disadvantage and improve equality of opportunity - i.e. going beyond a standard level of service.

b) **Collective**: as above, but focused on attributes of area or community rather than the individual.

iv) **Towards "equality of outcome"**

a) **Individual**: redistribute income to achieve greater equality.

b) **Collective**: redistribute income to an organisation in order to help in deliver greater income equality for its members/clients/citizens.

Recommendation

In the medium term the funding arrangements for Wales should be based on relative needs. The Commission is mindful that the ultimate decisions on how this should be achieved are fundamentally political in nature. Nonetheless, we believe that we can provide useful guidance on this issue. We will undertake further analysis of how this can best be accomplished, which we will include in the final report. Joint agreement from Ministers of the UK Government and the devolved administrations concerned would be essential with regard to both (i) the process by which needs were assessed and (ii) the way in which the outcome of the joint assessment of needs was reflected in the budget setting process.

Summary

3.14   Within the constraints of a fixed overall block grant, the current system of funding public services in Wales gives the Assembly Government a high degree of autonomy over spending priorities and also generates few if any incentives to move resources in a way that would distort economic efficiency. The Barnett Formula has provided a reasonably stable funding stream to Wales, and is both cheap and relatively simple to operate.

3.15   However, Barnett provides little accountability - spending decisions made in Wales do not impact on taxes paid by Welsh citizens and vice versa. Welsh Ministers have to balance competing claims for resources but do not have to weigh the benefit of marginal expenditure against its cost to Welsh taxpayers.

3.16   In the medium term the funding arrangements for Wales should be based on needs. The Commission is mindful that the ultimate decisions on how this should be achieved are fundamentally political in nature. Nonetheless, we believe that we can provide useful guidance on this issue. We will undertake further analysis of how this can best be accomplished, which we will include in the final report. Joint agreement from Ministers of the UK Government and the devolved administrations concerned would be essential with regard to both (i) the process by which needs were assessed and (ii) the way in which the outcome of the assessment of needs was reflected in the budget setting process.

Chapter 4: Assessing the relative needs of Wales

Overview

4.1   The analysis presented in Chapter 2 demonstrated that public spending per head of the population in Wales on services that are funded by the Welsh block grant is higher than spending on equivalent services in England. At present (in 2009-10) £113 per head is spent on these services in Wales for every £100 that is spent in England. At the end of the current spending review period in 2010-11, it is expected that this will decline to £112 per head.

4.2   Chapter 2 also demonstrated that the Welsh block grant has been subject to a significant "Barnett squeeze" since the establishment of the Assembly in 1999; the amount of additional spending per head in Wales relative to England has been in steady decline. The squeeze will continue over time if current funding arrangements are maintained. This chapter applies a range of techniques to assess the relative needs of Wales, in order to gauge whether Wales is radically over- or under-funded and to determine whether a further squeeze on Welsh relative spending per head is justifiable. It provides:

   i)   an approximate assessment of Welsh relative needs using general needs proxies; and

   ii)   a more thorough assessment of Welsh relative needs in each of the Assembly Government's main areas of responsibility by establishing the level of funding that Wales would receive if the Welsh block were calculated using English funding formulae.

Indicators of need: our approach

4.3   In this section, we highlight a range of indicators of needs, in order to set the socio-economic characteristics of Wales in a wider context. As discussed in Chapter 3, need is a contested concept. Nonetheless needs-based funding formulae that are currently in use generally attempt to take account of the impact of demographics, deprivation and the cost of delivering a service. We have therefore grouped the needs indicators into these three categories.

4.4   The indicators set out below are not capable of proving the precise difference in need for spending on public services between Wales and England, but they do facilitate a broad assessment. While comparisons of needs across the UK as a whole provide useful context, it is changes in English (rather than UK) spending that drive changes to the Welsh block grant, and therefore England is our main comparator in the following analysis.

Demographics

i)   Dependency ratio

4.5   On average, the greater the proportion of children and older people in a region, and the lower the proportion of working age individuals, the greater will be the demand for public services. One simple measure of the demographic profile of a population is the dependency ratio, which measures the number of children and people above retirement age relative to the

number of working age individuals. Chart 4.1 presents the dependency ratio for each part of the UK, and shows that the dependency ratio in Wales is higher than in every other region except the South West of England. This indicator therefore suggests that Welsh relative needs are higher than they are on average in England. The dependency ratio in Wales is slightly higher now than 15 years ago, relative to England. Wales has seen a small relative reduction in the ratio for children, which has been more than offset by a relative increase in the ratio for older people.[38]

Chart 4.1: Dependency ratio by region, 2007
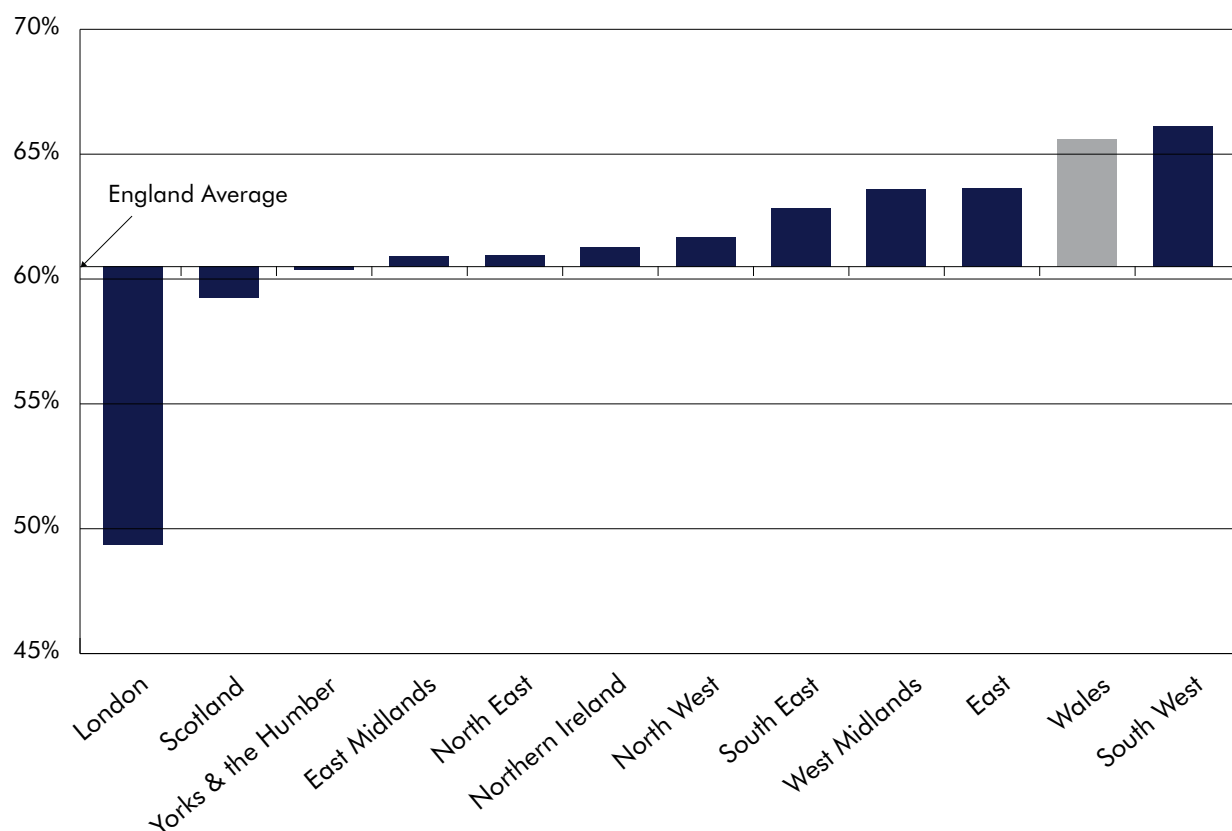
ii)   Ethnicity

4.6   While the links between ethnicity and disadvantage are complex, certain minority ethnic groups are disproportionately likely to experience disadvantage, and so generate a relatively high need for public expenditure. Wales has relatively few people from a black and minority ethnic background (Chart 4.2), so in this respect relative needs in Wales are likely to be below those of most other parts of the UK.

---

[38] Office for National Statistics, mid-year population estimates.

Chart 4.2: Black and minority ethnic percentage of adult population by region, year to June 2008
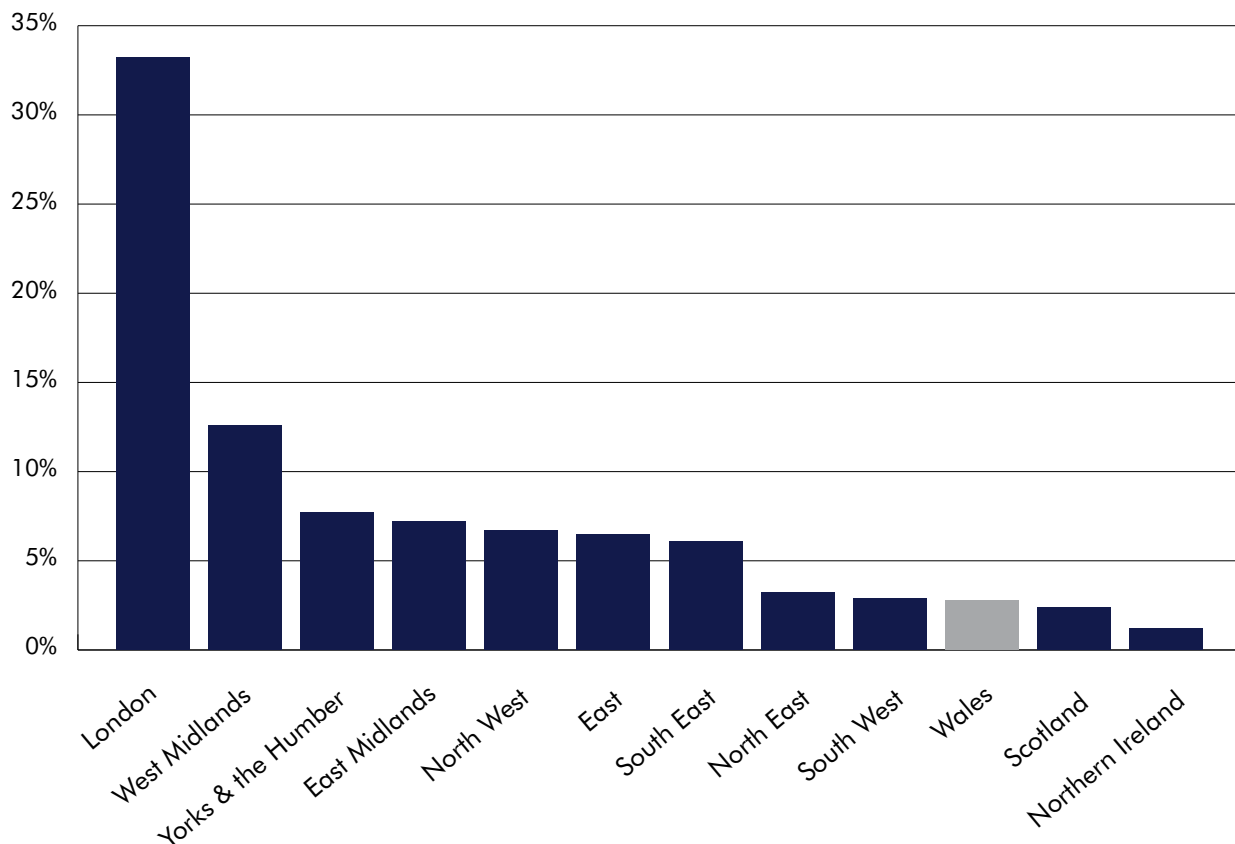
Source: Office for National Statistics, Annual Population Survey

Cost

i)   Sparsity

4.7   In areas where the population is thinly spread or congregated in small isolated communities, the cost of providing public services will tend to be relatively high. A bigger proportion of the population in Wales lives outside major settlements than in any English region, and Wales has a particularly large percentage of people living in small settlements or isolated dwellings in sparsely populated areas (see Chart 4.3). This indicator therefore suggests a relative need to spend on public services that is above the English average.

Chart 4.3:   Percentage of population outside settlements of 10,000 or more, Wales and English regions, 2001

Legend:
- Village, hamlet or isolated dwelling - sparse
- Village, hamlet or isolated dwelling - less sparse
- Town and Fringe
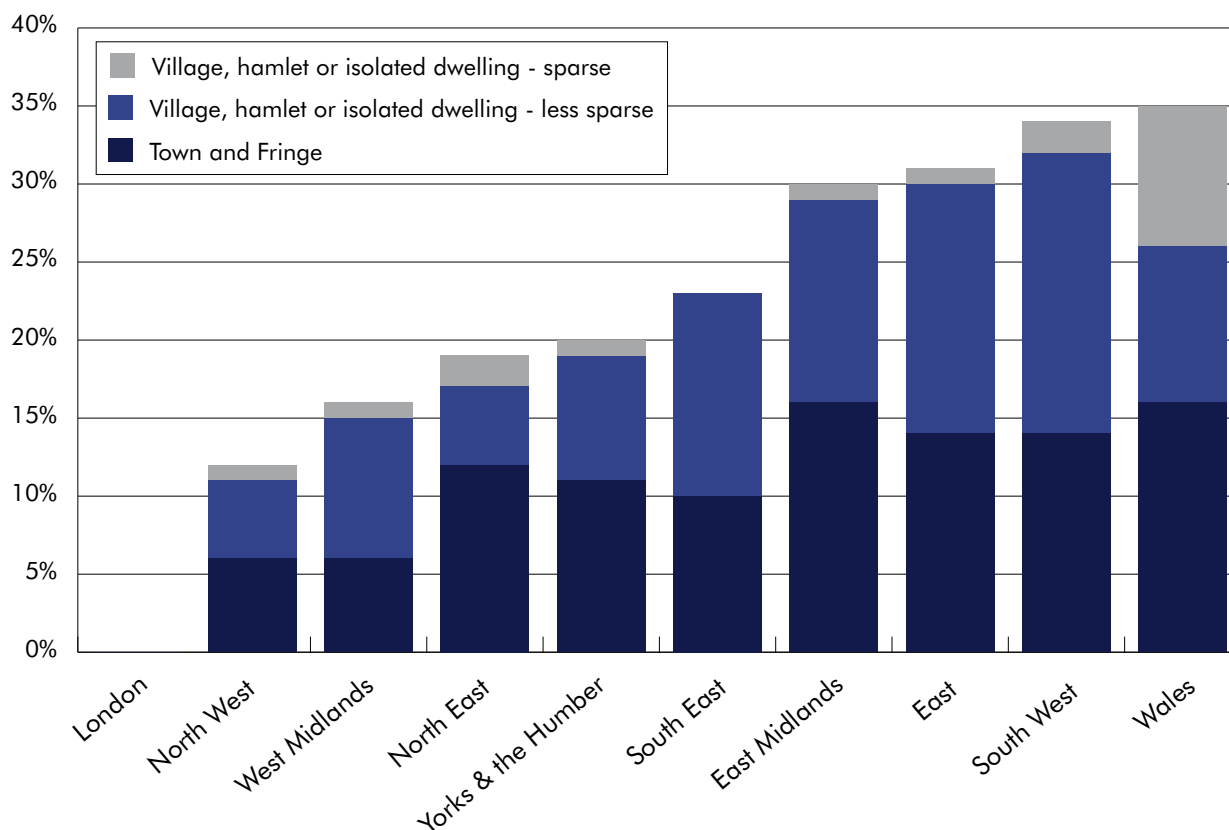
Source: Office for National Statistics, Census 2001

ii)   Labour costs

4.8   Wages are a major component of the overall cost of delivering public services.[39] Many public sector employees are paid according to nationally agreed pay scales as a result of legislation or widely-accepted norms. For example, teachers' pay in Wales is a non-devolved matter, and while pay within the NHS is devolved to Wales, NHS employees are in practice paid in accordance with nationally set pay scales. In Wales, the level of average full-time earnings in the public sector is 92 per cent of the average in England.[40] Much of this difference is due to high wage levels in London. Public sector pay levels in Wales are similar to those in the North of England and the Midlands.

iii)   Other costs

4.9   With a uniform capital market the major element of capital cost, namely the rate of interest, will be the same across the UK. Rental costs will vary across the UK, although outside London the effect of this is unlikely to be large and, in any case, such costs represent only a small proportion of the total cost of delivering public services.[41] Utility costs are another potential source of regional cost differences. The limited available evidence suggests that utility costs in Wales are higher than the average for England. For example, a recent report showed that Welsh consumers typically pay

---

[39] For example, employee costs account for 54 per cent of total revenue expenditure for Welsh local authorities (Commission calculated figures based on local authority revenue outturn forms).

[40] Office for National Statistics, Annual Survey of Hours and Earnings 2008.

[41] Local expenditure revenue outturn data for England show that expenditure on rent represents less than 1 per cent of total expenditure (Department for Communities and Local Government, 2008).

more for electricity network charges than their counterparts in England.[42] In addition, average household water bills in Wales are higher than the average for Great Britain as a whole.[43]

4.10   The English funding formulae examined in the second part of this chapter include adjustments designed to allow for the varying costs of delivering public services in different parts of the country. These have been fully taken into account when applying the formulae to Wales and therefore the impact of any regional variation in costs is reflected in the overall assessment of relative needs at the end of this chapter.

Deprivation

i)   Gross Value Added

4.11   In areas where economic activity is relatively subdued, it is likely that deprivation will be greater and the need for public spending will be relatively high. Gross value added (GVA) is the standard metric for measuring the economic activity of a region and can therefore be viewed as a coarse proxy for deprivation.[44] In Wales, GVA per head expressed as a percentage of the English average has been on a downward trend since at least the early 1990s, and in 2007 was less than 73 per cent of the England average (Chart 4.4). This indicator therefore suggests that Welsh relative needs have been increasing over the past decade. GVA per head in Wales is currently lower than in the other devolved UK countries or any of the English regions (Chart 4.5).

Chart 4.4:   Gross Value Added per head in Wales (England = 100), 1989-2007
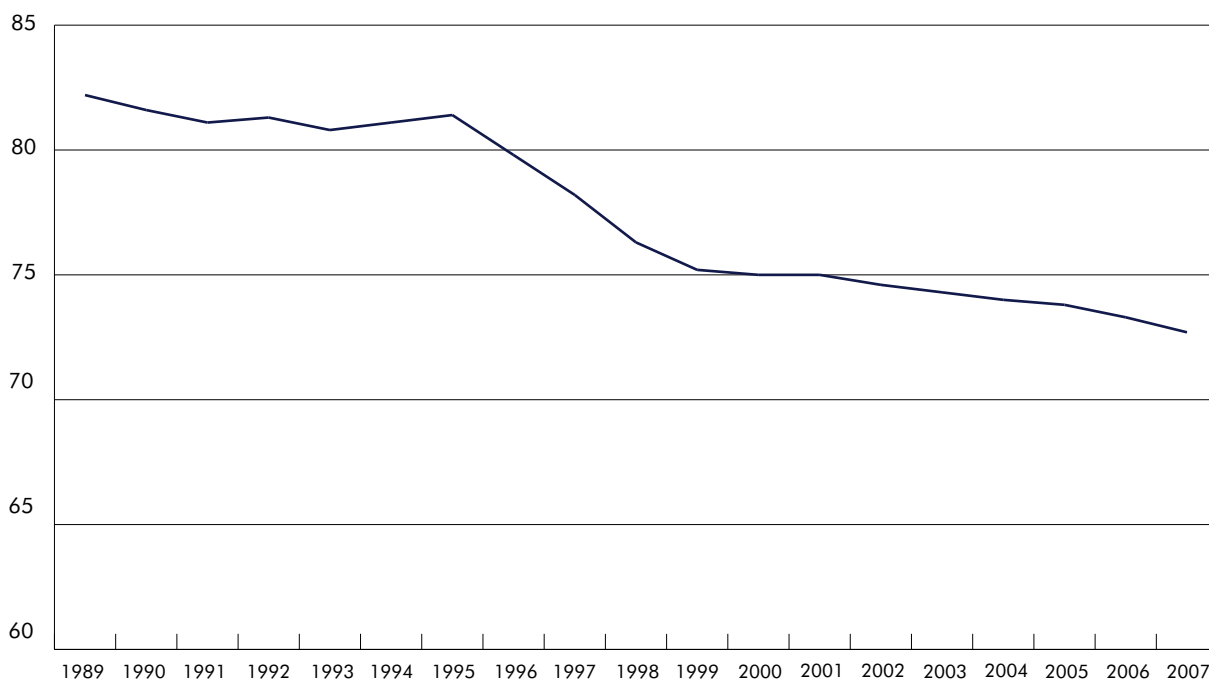
Source: Office for National Statistics, Regional Accounts

---

[42] Cornwall Energy, 2009.

[43] Water and sewerage charges 2007-08 (OFWAT, 2007).

[44] For a more detailed discussion of the use of GVA as a measure of economic activity see: McLean, Lodge and Schmuecker, 2008.

Chart 4.5: Gross Value Added per head, by region (England = 100), 2007
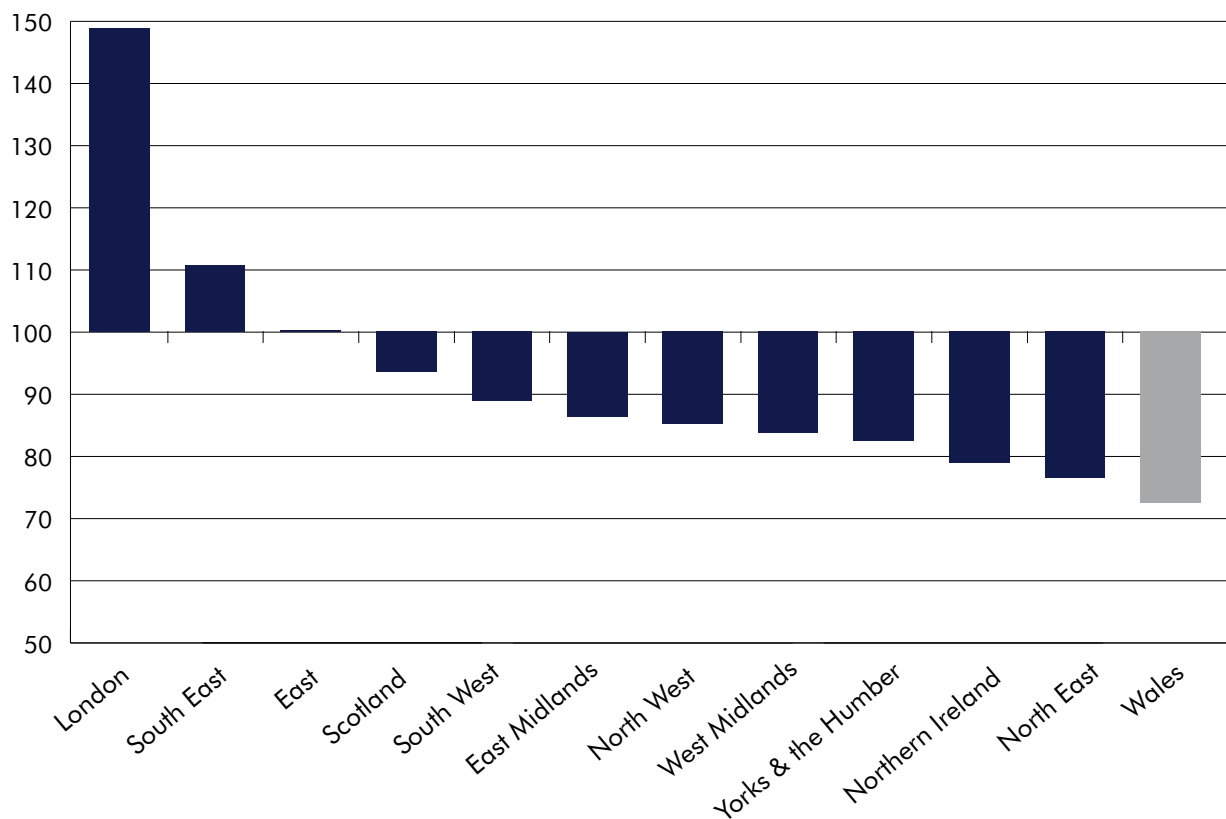
ii) Skills and labour market performance

4.12 Adults with no formal qualifications are more likely than other adults to become disengaged from the labour market, and as a consequence both they and their families are at greater risk of poverty and disadvantage. This in turn is likely to result in a relatively high demand for public services. Chart 4.6 shows that Wales has a relatively high proportion of adults with no qualifications, with only the West Midlands having a higher proportion of unskilled adults.

4.13 The employment rate in Wales has historically been below that of both England and the UK as a whole. Despite improvements in the early part of this decade, the recent deterioration means that the working age employment rate in Wales remains 4 percentage points below that of England (Chart 4.7). Both of these indicators therefore point to a relatively high need to spend on public services in Wales.

Chart 4.6:   Percentage of the working age population with no qualifications, Wales and English regions, 2007

England Average

25%

20%

15%

10%

5%

0%

South West   South East   East   London   East Midlands   North East   Yorks & the Humber   North West   Wales   West Midlands
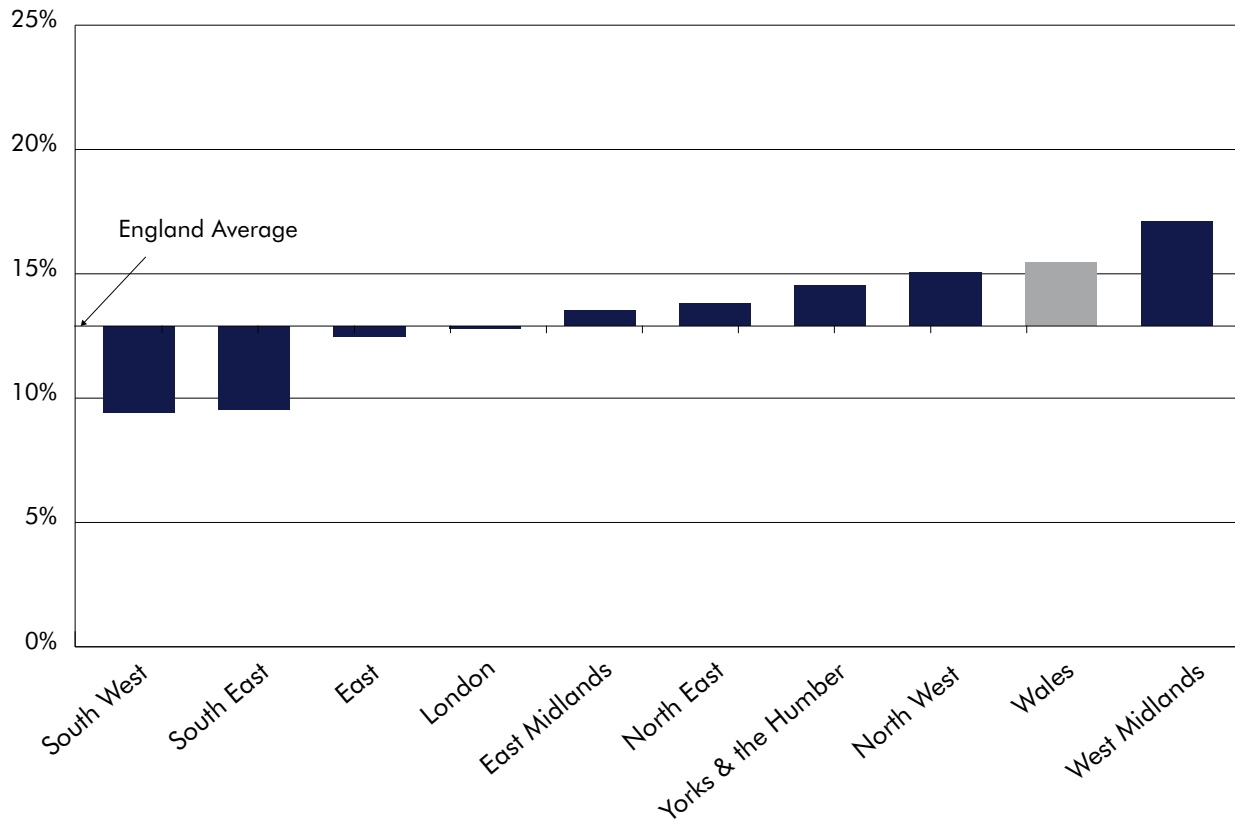
Chart 4.7:   Working age employment rate, Wales and England

78

76

74

72

70

68

66

64

62

60

58

1993   1994   1995   1996   1997   1998   1999   2000   2001   2002   2003   2004   2005   2006   2007   2008

——— Wales   ·········· England
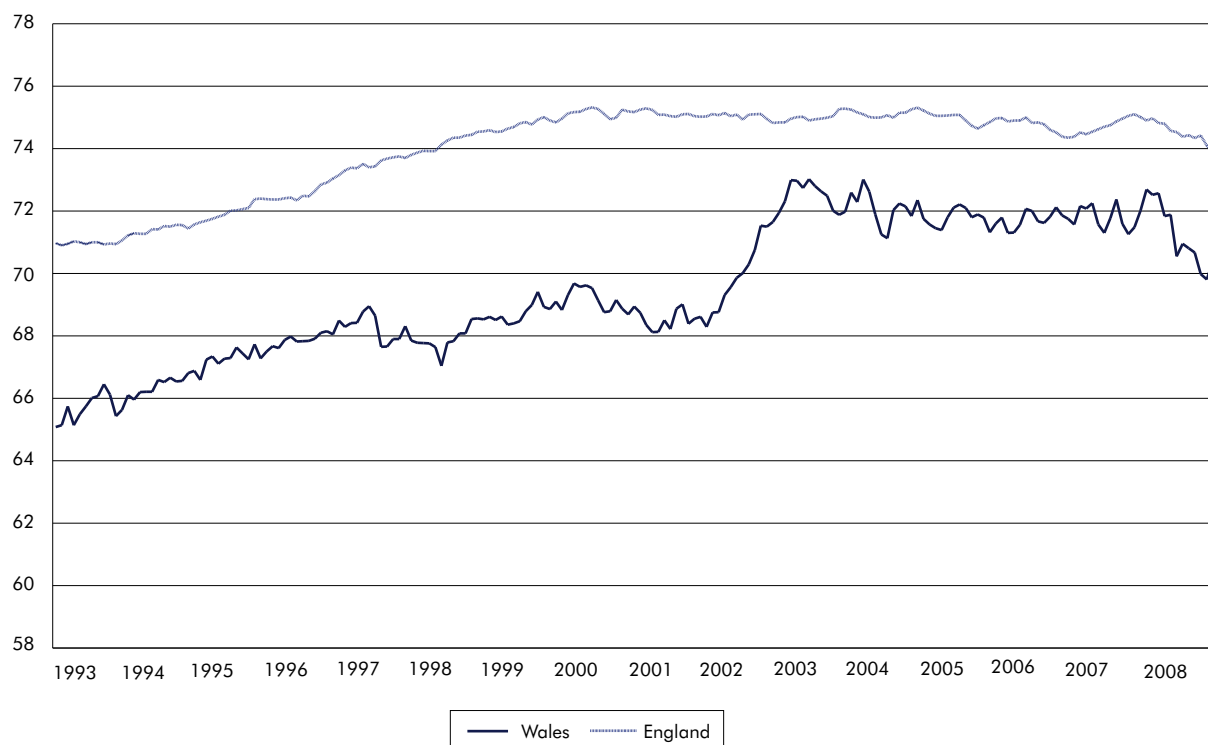
iii)   Health

4.14   Health is the biggest area of expenditure amongst the devolved functions in Wales and is therefore very important when considering overall relative need. Chart 4.8 shows that in 2001 Wales had a higher proportion of the population with a limiting long term illness than any of the English regions. More recent information for the working age population alone suggests that Wales's position relative to England has changed little since then.[45]

Chart 4.8:   Percentage of the population with a limiting long term illness, Wales and English regions, 2001
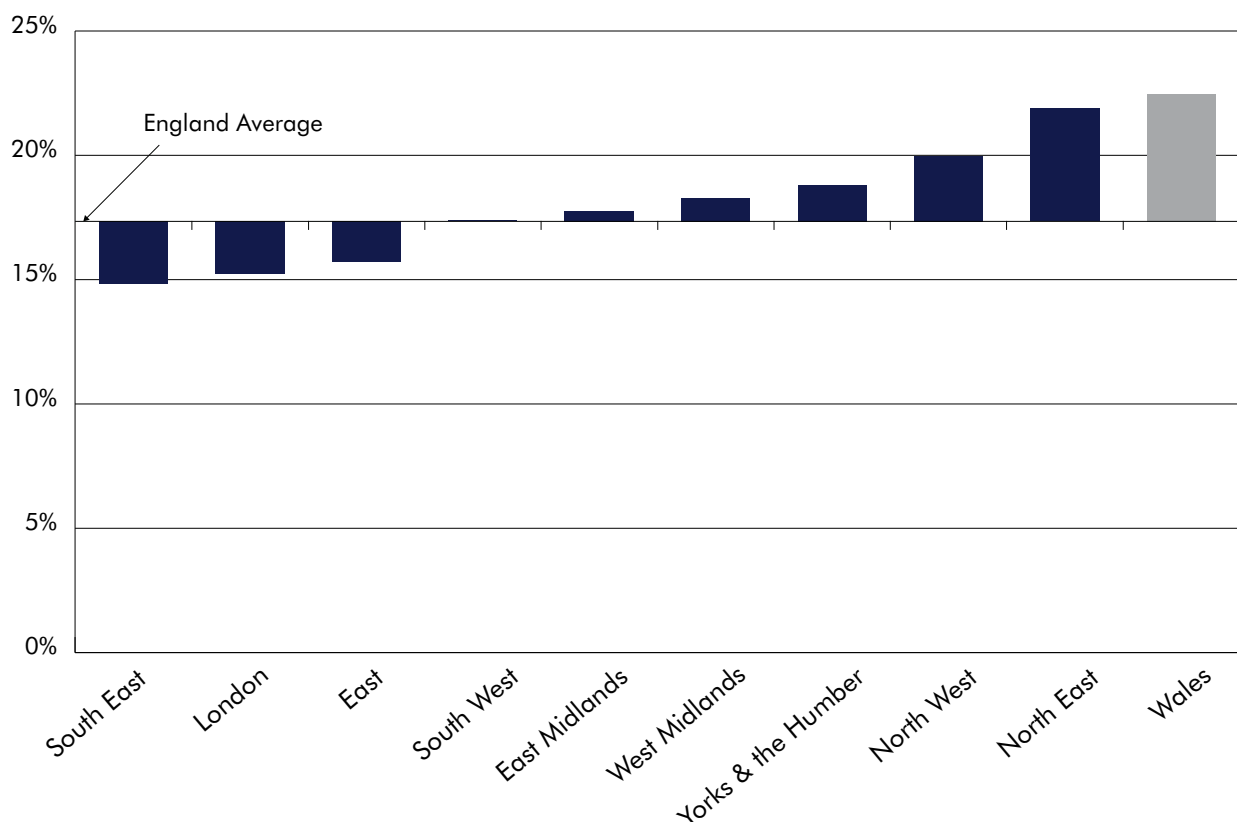
Source: Office for National Statistics, Census 2001

iv)   Benefit claimants

4.15   Higher rates of ill health and worklessness, and lower levels of economic activity in Wales, all contribute to a higher than average claimant rate for social security benefits. Chart 4.9 shows that over 18 per cent of working age residents in Wales claim social security benefits, compared to an England average of less than 14 per cent. Social security payments are not devolved to Wales and are funded by the UK Government, but variables based on benefit claimant rates are widely used in England to allocate health and local government funding. This indicator can therefore be seen as a broad spectrum proxy for the need to spend on public services.

---

[45] Office for National Statistics, Annual Population Survey, year to June 2008

Chart 4.9: Percentage of the working age population claiming social security benefits, Wales and English regions, August 2008

England Average

North East · Wales · North West · West Midlands · Yorks & the Humber · London · East Midlands · South West · East · South East
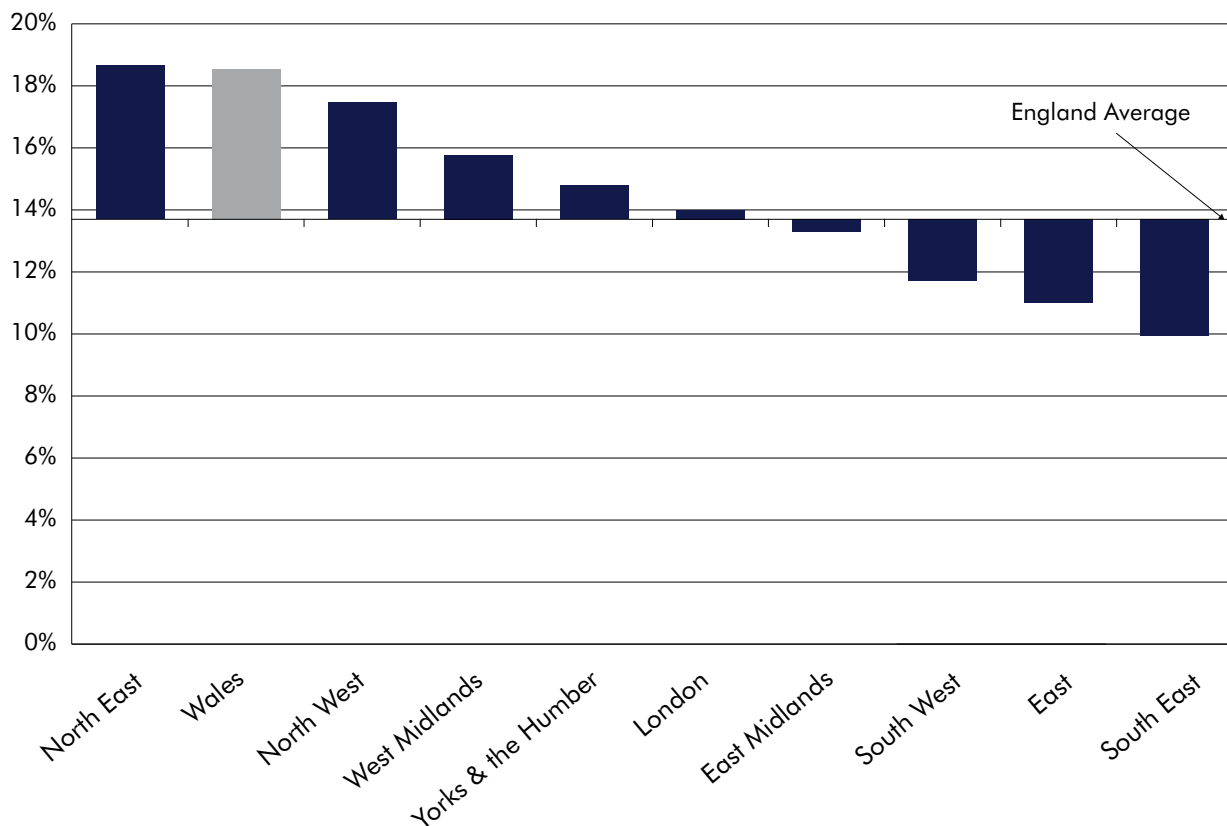
Source: Department for Work and Pensions, via NOMIS

v)   The Index of multiple deprivation

4.16   There are separate indices of multiple deprivation for each of the UK countries, employing similar though not identical methodologies. Each index provides a weighted score across a number of domains of deprivation, producing a ranking of small areas from most to least deprived.

4.17   Because methodologies differ across the countries of the UK, it is not possible to compare directly the index scores for Welsh and English areas. However, it is possible to match very small areas of Wales to their closest English equivalents using a wide range of socio-economic indicators (see Annex 2 for a detailed description of how this has been done). Chart 4.10 shows where the areas of England that most closely match areas in Wales are located. Although some matches occur in every region of England, the parts of England that most closely resemble areas in Wales are heavily concentrated in the North East, the South West and the North West. The relatively prosperous regions of London, the South East and the East of England provide few matches.

Chart 4.10: Areas of England that most closely match areas in Wales

Number of occasions where English lower super output area (lsoa) matches an lsoa in Wales

1
2
3
4
5
6
7
8
15
16

Govt. Office Regions

NE
NW
Y&H
EM
WM
WALES
EE
SE
L
SW

0   12.5   25   50   75   100
Kilometres

© Crown copyright 2009. All rights reserved. Welsh Assembly Government. Licence Number: 100017916
© Hawlfraint y Goron 2009. Cedwir pob hawl. Llywodraeth Cynulliad Cymru. Rhif trwydded 100017916
Produced by Cartographics, Statistical Directorate, Welsh Assembly Government
Cynhyrchwyd gan Cartograffeg, Y Gyfarwyddiaeth Ystadegol, Llywodraeth Cynulliad Cymru
257.08-09

Source: Commission calculations

4.18   By matching small areas of Wales to their closest English equivalent, it is possible to calculate a value of the English index of multiple deprivation for Wales. The results of this exercise are shown in Chart 4.11. If deprivation in Wales were similar to that in England, we would expect 10 per cent of Welsh LSOAs to be found in each deprivation decile. In fact, Chart 4.11 shows that Welsh LSOAs are over represented in relatively deprived deciles and under represented in relatively advantaged deciles. On average, the areas of England that most closely match areas in Wales are disproportionately likely to score highly on the English index of multiple deprivation (i.e. to be relatively disadvantaged). Over half of small areas in Wales are matched to areas in England in the most deprived four deciles (40 per cent), while only a quarter are matched to areas in the least deprived 40 per cent in England (Chart 4.11). Applying the highest rank to the most deprived area (i.e. ranking from most to least deprived, with a higher rank corresponding to greater deprivation), the average rank of the English areas that most closely match Welsh areas, is in the 58th percentile of the overall English distribution. In other words, the average rank of the matched areas is 16 per cent above the average rank for all English areas. In fact, using a consistent social security benefits dataset for both England and Wales, it can be shown that on average small areas in Wales have higher income-related benefit claimant rates than their most closely matching area in England. As benefit claimant rates underpin nearly half the index of deprivation, it is therefore likely that this matching exercise understates relative deprivation in Wales.

Chart 4.11: Distribution of English LSOAs most closely matched to Welsh LSOAs, overall index, Index of Multiple Deprivation 2004
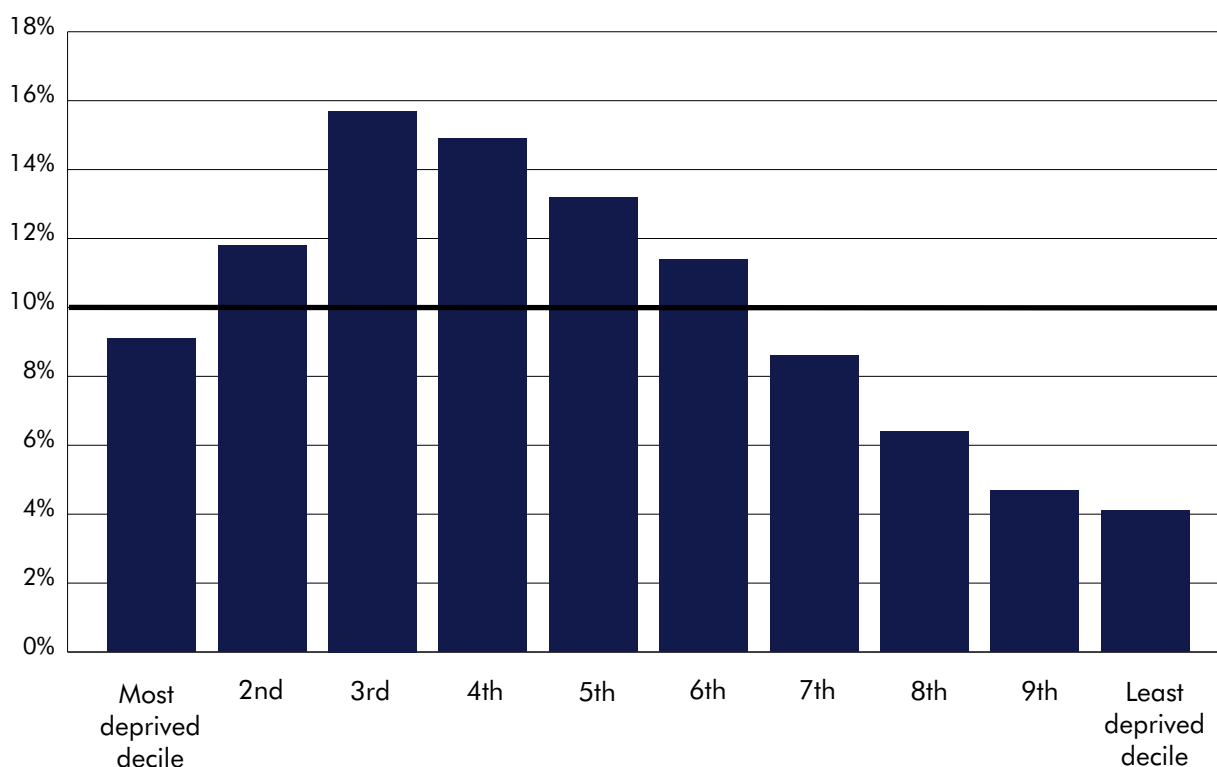
Source: Commission calculations

Applying English needs criteria to Wales: rationale

4.19   The previous section has made 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?"

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

4.21   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 under funded, *using the UK Government's own current criteria for assessing needs*. We emphasise that we do not necessarily regard these criteria as optimal and it may well be possible to find others that are simpler or otherwise more appropriate. However, those could be adopted only by a political decision.

Applying English needs criteria to Wales: methodology and results

4.22   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.

4.23   In some cases (e.g. local government and health), resources in England are allocated on a geographical basis through a needs-based formula. Those two funding formulae alone cover over half of the devolved budget allocated to Wales. Wherever such formulae are available and where data limitations allow, we have applied them directly to Wales.[46] In certain cases, a lack of publicly available information or comparable data has made it impossible to apply an English formula directly to Wales but we have been able to apply the formula indirectly, by identifying factors that have strong explanatory power over actual English allocations and using these factors to predict an allocation for Wales. In areas of spending where no regional needs-based formulae exist, we have modelled the English allocation using indicators of demand that are not under the control of policy. Where such unambiguous indicators are not available we have taken actual spending per head in the closest comparable region of England. In the remaining part of the budget where no assessment of relative needs has been possible, we have assumed that relative needs are equivalent to the weighted average of the relative needs in the parts of the budget where a calculation has

---

46   We have only applied formulae which allocate funds on the basis of geographical units, not those that operate at the institutional level.

been possible. Box 4.1 sets out our approach and Annex 2 provides a detailed description of our methods in the main spending areas.

4.24   Such an analysis inevitably involves a degree of judgement and approximation. Wherever we have been faced with more than one possible measure of the 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.

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.

4.25   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. The results for these areas will dominate the overall assessment.

4.26   **Health.** The UK Government uses a needs-based formula to determine target allocations of resources between National Health Service (NHS) areas in England. This accounts for around four fifths of the comparable £108 billion near-cash health budget in England in 2010-11.[47]

---

[47] The bulk of the remaining one fifth of the English health budget that is not allocated via a regional formula is spent on functions that support the delivery of health services. PESA data show that this is allocated across English regions in very similar proportions to the formula-driven budgets. Accordingly we have assumed that the relative need to spend on these activities is equivalent to the relative need calculated by the formula (as set out in Box 4.1).

The formula takes account of geographical variations in the age distribution, additional needs, and costs. Applying this formula directly to Wales generates a Welsh relative need of 114. This is very close to the relative need in the North East of England arising from the formula-driven target allocations.

4.27   Given the importance of health spending in the overall arithmetic, we have checked this result using category 2 of the approach outlined in Box 4.1. A set of independent indicators (available consistently for areas in England and Wales) was used to explain the variation in allocations between areas in England. At a regional level, the model generated from these indicators accurately predicted the target allocations from the needs-based formula. For example, the model produced a relative need in the North East of 115, the same as the formula driven target allocation in 2010-11. The model was then used to produce allocations for areas in Wales and again closely replicated the relative need generated by applying the needs-based formula directly. Chart 4.12 illustrates these results, showing the close correspondence between the actual and modelled target allocations at the regional or Strategic Health Authority level. We are therefore confident that the result for Wales is robust. The result is further supported by evidence from the health domain of the English index of multiple deprivation. This, together with the direct application of the needs formula to Wales and the modelling approach, is discussed in more detail in Annex 2.

Chart 4.12: Actual and modelled Strategic Health Authorities target allocations per head, Wales and English regions (England = 100), 2010-11
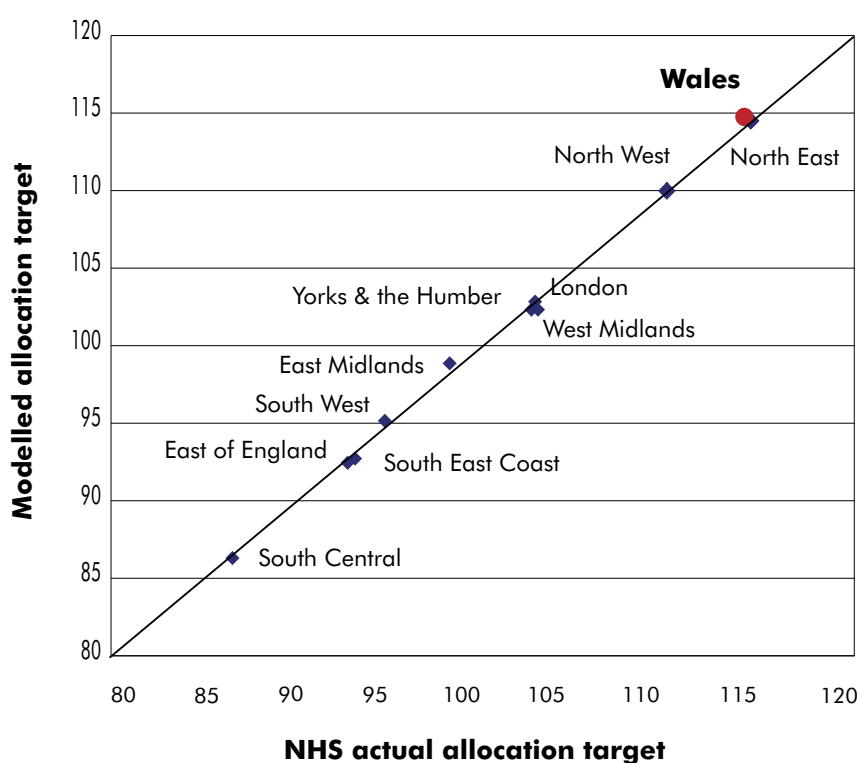
Source: Department of Health and Commission calculations

4.28   **School age education.** School budgets in England were allocated as part of the general local government needs-based formula until 2006-07. Since then there has been a dedicated schools grant funded directly by central Government, with budgets based largely on historic spend. Applying the now defunct English education formula to Wales generates a relative need of 102. Given that this formula is no longer in use in England, an alternative and arguably more appropriate approach could be to take pupil numbers as a proxy for the need to spend. Wales has roughly the same number of school age pupils per head of population as England but there are

relatively more pupils in state-funded schools in Wales because fewer pupils are privately educated. As a consequence, there are 5 per cent more pupils per head in state funded education in Wales than in England or, using our index terminology, Wales is at 105 with England equal to 100. However, in order to ensure that our overall estimate of relative needs is conservative we have taken the lower formula-derived figure of 102 as our measure of the relative need to spend on schools in Wales. This is likely to be an under-estimate of Welsh relative need for several reasons:

    i)   as Chart 4.3 demonstrated, a higher proportion of the population lives in sparsely populated areas in Wales than in England, which inevitably results in smaller average school sizes. The UK Government has acknowledged that smaller schools are more costly to run;[48]

    ii)   the school age population of Wales is more deprived than that of England. The UK Government's Department for Children Schools and Families (DCSF) has recently developed a deprivation indicator based on the percentage of children in families in different income brackets, defined by receipt of different levels of child and working tax credits.[49] Using this indicator, the average level of deprivation amongst children in Wales is 112 with England equal to 100;

    iii)   unlike England, Wales is required to fund both Welsh medium and English medium school systems. This requirement should be considered a need rather than a choice, since the requirement for public services in Wales to be provided bilingually "on a basis of equality" is enshrined in UK legislation (the Welsh Language Act (1993)).

4.29 **Pre-school education.** Sure Start is a programme that offers a broad range of services to children aged less than 5 years and their parents. Sure Start was initially targeted at the most disadvantaged children and families in England, although services are now being provided universally. While funding is allocated based on a formula, details of the formula are not published. We have therefore applied the formula indirectly (category 2 in the approach set out in Box 4.1). Regression analysis reveals that a small number of indicators covering demographics, deprivation, sparsity and cost explain much of the variation in local authority budgetary allocations in England and so serve as appropriate proxy variables for relative spending needs. Based on this same set of objective measures of need, Wales's relative need per head is 114, compared to an English average of 100.

4.30 **Further education.** We have split further education into provision for 16 to 18 year olds and for older people, in the same way as it is split between the DCSF and the Department for Innovation, Universities and Skills (DIUS). For 16 to 18 year olds, we have used the relative number of students as an objective measure of demand (category 3 in the approach set out in Box 4.1). The measure is based on the number of 16 to 19 year olds for whom child benefit is claimed, less the number of 16 to 19 year olds in private schools. This gives Wales a figure of 106 with England at 100. For the older age group, while noting Wales's relatively unskilled working age population, we have not been able to produce an objective and independent metric for further education needs. This programme therefore falls under category 5 in the approach set out in Box 4.1. The part of DCSF expenditure not covered by the programmes outlined above, mostly schools-related, has been allocated a relative need taken from the school funding formula (102). This approach is in line with our methodology set out in Box 4.1.

---

[48] Dedicated Schools Grant Formula Review papers.

[49] Department for Children, Schools and Families, 2007 School funding deprivation indicator.

4.31   **Local government.** The UK Government uses a complicated needs-based formula to allocate the main block of central government support to local authorities in England, known as the formula grant distribution system. The formula takes account of variations in relative needs, costs, and the ability of local authorities to raise tax locally. The grant funding covered by this formula is planned to be £25 billion in 2010-11 and will account for around 10 per cent of total comparable DEL in England; that is 10 per cent of total expenditure in England on programmes for which the Assembly Government receives a consequential via the Barnett Formula. Applying this formula to Wales produces a Welsh relative grant allocation per head of 132 compared to an English average of 100. In other words, for every £100 per head of the population spent on formula grant to local authorities in England, the UK Government's own formula would allocate £132 per head of the population to spend on support to local government in Wales. This result seems plausible when compared with how the formula treats regions of England; for example, it also calculates an allocation per head in the North East of England of 132, relative to an all-England average of 100.

4.32   **Higher education.** There is no regional English allocation formula for funding higher education (there are institution-level allocation formulae but these are not defined in terms of geographical areas) so we have taken relative student numbers as the best proxy for relative need to spend. Wales has 117 students per head of population for every 100 students in England. Wales is a "net importer" of undergraduate students, most of whom come to Wales from England. If these students were not educated in Wales (and funded out of the Welsh block grant) they would in all likelihood attend universities in England and so generate a need to spend that would fall on the UK Government. (Student support via loans and grants cannot be proxied in the same way and therefore has not been included here but instead falls under category 5).

4.33   **Economic development.** Economic development expenditure in England is spread across a number of UK Government departments and programmes. The biggest identifiable regional programme is delivered via the Regional Development Agencies (RDAs). The overall RDA budget for 2010-11 is £2 billion. The funding of the RDAs was determined in large part by a formula for 2005-06 to 2007-08, while the allocations for the current spending review period continue to use similar shares. There are many economic indicators available to provide comparisons between Wales and the English regions on a consistent basis. Foremost amongst these is GVA per head. As shown in Chart 4.5, Wales has lower GVA per head than any English region. The North East of England is Wales's closest comparator amongst the English regions and receives RDA funding per head of 223, with England as a whole set to equal 100. Wales would be very likely to receive at least this level of funding if the Welsh block were calculated using English funding formulae.

4.34   With the exception of London, there is a close relationship between relative RDA funding across the English regions and relative GVA per head, illustrated in Chart 4.13. Based on this estimated relationship and given its relative GVA per head, RDA funding per head in Wales would actually be 275. However, we have taken North East England's RDA funding as a more conservative estimate of Wales's relative need to spend in this field.

4.35   The RDAs are also responsible for the management of some European regional development programmes in England. All such programmes are treated in net terms in the DEL; the expenditure and the receipt from the European Commission are both included. As a result, they have no impact on the overall comparison being made here. However it is worth noting that part of Wales currently qualifies for the highest level of regional funding from the European Commission, and that this has enabled Wales to maintain a relatively high level of economic development expenditure compared with England. The current round of European Structural Fund programmes is due to finish in 2013 (with spend continuing until 2015). It seems highly unlikely that West Wales and the Valleys will qualify for convergence funding after this date, although it is possible that the region will qualify

for some form of transitional funding. However, Wales's need to spend on economic development, relative to England, is unlikely to be substantially reduced on the same time scale.

Chart 4.13: Regional Development Agency budgets 2008-09 and Gross Value Added, Wales and English regions, 2007[50]
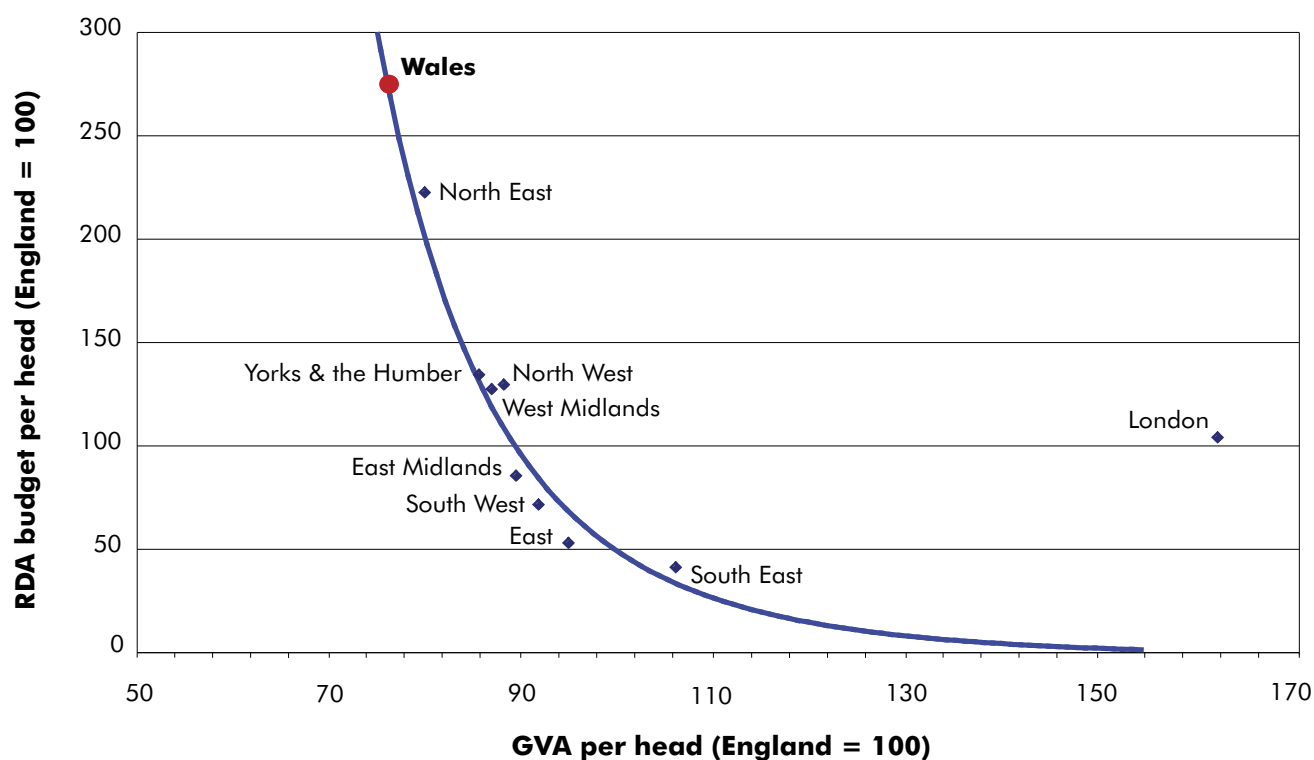
Source: Department for Business, Enterprise & Regulatory Reform, Office for National Statistics and Commission calculations

4.36   **Housing: Supporting People.** Supporting People is a programme designed to provide housing-related services to vulnerable individuals. In England funding to each local authority is allocated via a distribution formula. The formula is subdivided according to the main Supporting People client groups. Each client group has a separate formula but a common approach is applied, consisting of three elements: the population of each client group relative to the total population of the area, deprivation and an adjustment for the relative cost of delivering services. The grant funding covered by this formula is planned to be £1.7 billion in 2010-11 and will account for around 1 per cent of total comparable DEL in England. Applying the distribution formula to Wales produces a Welsh relative need of 145 compared to an English average of 100. This result seems plausible given the relative need that the formula generates for English regions; for example, it calculates the relative need of the North East of England to be 143.

4.37   **Other areas.** In line with our stated methodology, we have assumed that the relative need to spend on remaining functions (which in total account for 14 per cent of the overall budget and mainly relate to spending on communities, transport and further education) is equivalent to the weighted average of relative need in the 86 per cent of the budget for which we have been able to calculate relative needs. Annex 2 provides information on the spending areas that are in this category, and discusses alternative ways of assessing their relative needs.

---

[50]   The estimated relationship shown in the chart is:

   log (RDA budget per head) = 13.2 - 5.8 log (GVA per head) + 1.6 (London dummy) R^2 = 0.9

4.38 **Overall result.** 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 detailed above. 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 £114 of public funding per head for its devolved public services for every £100 spent per head in England. Even if we assume that relative need is 100 in those areas where no assessment of needs has been possible, the overall relative need for Wales drops only to 112. We consider this to be an excessively low estimate, since in every spending area where we have identified relative needs, the result has been greater than 100.

4.39 Paragraphs 2.31-2.33 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.

4.40 Chart 4.14 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.[51]

---

[51] 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.

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
Schools and other DCSF programmes	*£51 billion*	*21*	*1. Old schools element of local government formula applied to Wales*	*102*
16-18 Further Education	*£7 billion*	*3*	*3. Relative numbers of 16-18 year olds in state funded education used as best available proxy*	*106*
Sure Start	*£2 billion*	*1*	*2. Unpublished needs based formula, applied indirectly*	*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
Total	**£237 billion**	**100**		**114**

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

4.41 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, since there is no justification for such convergence nor for the resultant increase in underfunding.

Chart 4.14: Projected cumulative underfunding in Wales arising from the Barnett Formula, £ billion, 2011-2021
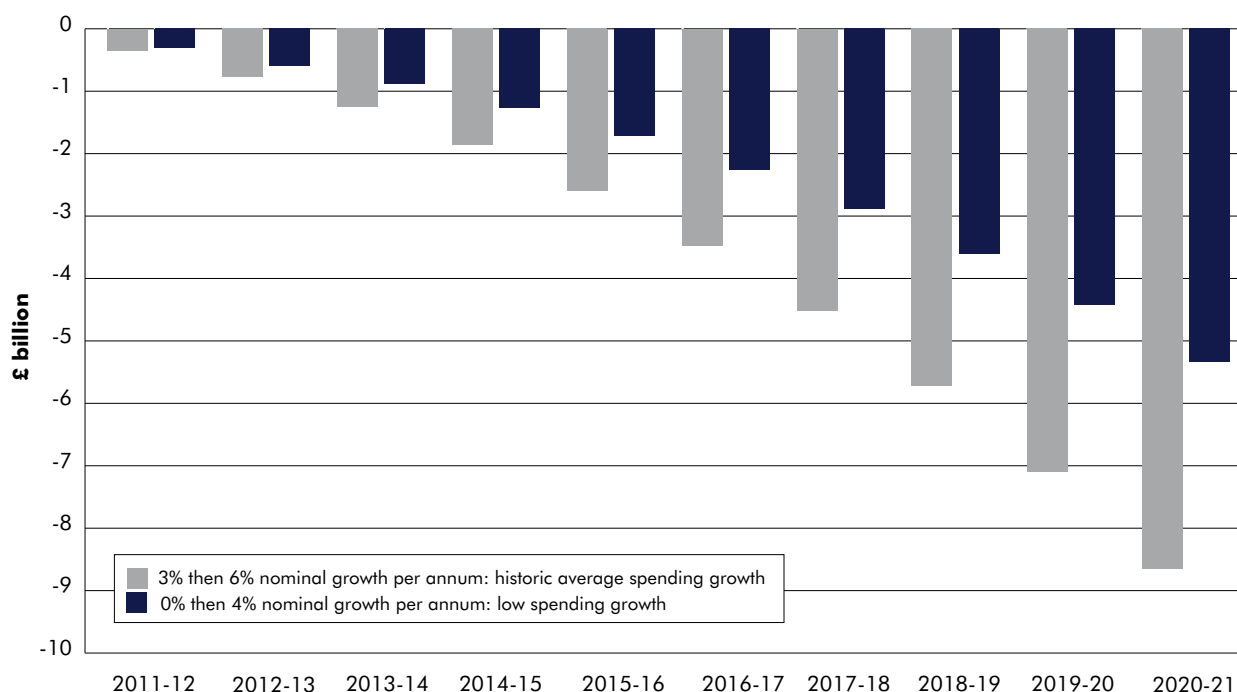
Source: Commission calculations

Summary

4.42 Plausible proxies for needs strongly suggest that the relative need to spend on devolved public services is greater in Wales than it is in England.

4.43 If devolved public services in Wales were funded directly by the UK Government using the funding formulae that applies in England, we estimate that spending per head on these services in Wales would be 114, compared to an English average of 100.

4.44 Since current spending on devolved services will be 112 at the end of the current spending review period in 2010-11, and is projected to fall to 107 over the subsequent decade if spending growth is in line with recent trends, public services in Wales will become increasingly underfunded according to the UK Government's own criteria of relative needs. If spending on comparable programmes in England increases at the same nominal rate as in recent years, cumulative under-funding of Wales over the next decade will total £8.5 billion, even allowing for a period of low growth over the next 3 year spending review period. This is equivalent to £2,900 per resident of Wales. We conclude that there is an urgent requirement to reform the funding arrangements for Wales.

Chapter 5: Operational issues

Overview

5.1   At present, fiscal arrangements are implemented in a way that more than reflects the primacy of the UK Government over the devolved administrations. The settlement is applied as if the devolved administrations were mere departments of the UK Government, without a democratic locus of their own. A reformed relationship is required which recognises the primacy of the UK Government and its responsibility for taking final decisions but which provides sufficient flexibility for Welsh Ministers to set their own priorities, coupled with adequate fora for discussion and resolution of disputes.

5.2   This chapter considers how the Barnett Formula has been implemented in practice. It makes a number of specific recommendations that would significantly improve the current settlement. The following topics are addressed:

i)   the particular difficulties in managing capital expenditures under the current system whereby the Welsh block grant is separated into capital and resource elements;

ii)   the process of End Year Flexibility that allows underspent funds to be carried forward to future years;

iii)   dispute resolution;

iv)   means of enhancing the transparency of the current funding arrangements; and

v)   the funding of devolved government in the UK.

Managing capital budgets

5.3   As explained in Chapter 2 (Box 2.1), 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. Alterations to the size of the Assembly Government's capital and resource budgets are determined by the Barnett Formula, but changes in capital spending in England on functions that are devolved to Wales generate a consequential for Wales that can only be spent on capital projects. The rationale for this restriction is to protect the fiscal rules that guide the UK Government's budget planning process.

5.4   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. An example of how changes to health capital investment in England have caused large and arbitrary shifts in the Assembly Government's capital budget is presented in Box 5.1.

5.5   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.[52] 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. Such a facility would provide a smoother profile to the capital budget allocated to Wales and would permit capital investment in excess of the arbitrarily-determined capital budget allocated to Wales via Barnett.

Box 5.1: An example of how variations in capital baselines in England can drive large swings in the capital budget available to Wales

The profile of the Assembly Government's budget can be significantly affected by policy or budgetary issues in England which do not pertain to Wales.

Shortly before the publication of the outcome from the 2007 CSR, the Assembly Government was informed by the Treasury of adjustments to its baseline for the 2008-09 to 2010-11 period covered by the Review. It had been expected that this baseline, to which Barnett consequential increments over the three forward years are added, would be close to the resource and capital DEL for Wales in 2007-08. In the event, the resource baseline was more than £60 million (or 0.5 per cent) lower and the Capital baseline was nearly £140 million (or 8.5 per cent) lower. These reductions were largely consequentials from reductions in Department of Health baselines. There was no impact on provision in 2007-08, but the lower starting point for adding the Barnett increments for subsequent years meant lower than expected growth between 2007-08 and 2008-09 and a lower profile of spending across all three years. For the capital DEL this meant a 6 per cent reduction in real terms between the budget for 2007-08 and the new budget for 2008-09.

---

[52] At present, unspent funds that are saved via End Year Flexibility (see next section) do not earn interest. For the sake of consistency, no interest should therefore be charged on funds that are drawn forward or borrowed from future years.

End Year Flexibility (EYF)

5.6   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.

5.7   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.

5.8   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.** This would make it easier for the Assembly Government to undertake spending decisions that are aligned with Welsh needs. The only case for this facility to be temporarily suspended would be in the unlikely event that draw down of accumulated EYF by the Assembly Government would cause the UK Government to breach its overarching fiscal rules.

Moving funds from capital to resource budgets

5.9   As set out at paragraph 5.3, 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.

5.10   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 paragraphs 5.3-5.5), 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. In the event that the Assembly Government were granted this facility and was also given the power to draw forward future capital budgets, 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.

Dispute resolution: current arrangements

5.11   Prior to devolution in 1999, the Welsh block grant was under the control of the Secretary of State for Wales, who was a member of the UK Government. This meant that disagreements between the Welsh Office and the Treasury were generally resolved within the Government, ultimately in Cabinet, and there was no requirement for formal dispute resolution mechanisms. Following the establishment of the National Assembly for Wales, there is for the first time the potential for significant tensions over budgetary matters between the Welsh and UK levels of government. 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; however more significant tensions arose over the settlement provided in the 2007 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 (see Box 5.2), have not been tested.[53]

---

[53] The terms of reference of the Joint Ministerial Committee (JMC) are:

    a. to consider non-devolved matters which impinge on devolved responsibilities, and devolved matters which impinge on non-devolved responsibilities;

    b. where the UK Government and the devolved administrations so agree, to consider devolved matters if it is beneficial to discuss their respective treatment in the different parts of the United Kingdom;

    c. to keep the arrangements for liaison between the UK Government and the devolved administrations under review; and

    d. to consider disputes between the administrations.

Box 5.2: Current dispute resolution arrangements

In the event of disputes arising, the Treasury's Statement of Funding Policy sets out the steps that are open to the Assembly Government:[54]

   a) in the first instance, the relevant devolved administration or Secretary of State can pursue the issue with Treasury Ministers, as is the case with UK Government spending departments;

   b) matters can also be raised at the Joint Ministerial Committee (JMC), which will include the relevant Ministers from the UK Government and devolved administrations;

   c) finally, in cases where disagreements still cannot be resolved, devolved administrations can request that the respective Secretary of State raises the issue at Cabinet for a final decision.

5.12   Some instances of disagreement that arose at the time of the 2007 CSR serve to illustrate the failings of current dispute resolution arrangements. One source of dispute was the reduction in the capital baseline of the Department for Health in England, which in turn resulted in a reduction of the capital budget allocated to Wales (see Box 5.1). The Treasury applied the Barnett Formula in reducing the Assembly Government's capital budget, but it did so only weeks prior to the publication of the 2007 CSR. This late change significantly impacted on the Assembly Government's own budget plans, which had been developed on the basis of informal understandings with the Treasury at an official and Ministerial level. While it is not possible to prohibit the Treasury from making late changes to its budget plans that have knock-on effects for Wales, every effort should be made to avoid such changes as they are harmful to the efficient operation of devolved government.

5.13   A further source of disagreement between the Treasury and the devolved administrations at the time of the 2007 CSR occurred over the funding arrangements for the 2012 Olympic Games. The UK Government took the view that the Olympic Games were a UK-wide event and that the immediate costs of staging the Games should not result in spending consequentials for the devolved administrations. An Olympics DEL was created to fund all Olympics-related activity, with a comparability factor of zero for the purposes of the operation of the Barnett Formula.

5.14   However, in addition to the direct costs of the Olympics, the Olympics DEL was used to fund a range of regeneration and transport activities in the East of London. The money to fund these initiatives was ring-fenced within the budgets of the Department for Transport (DfT) and the Department of Communities and Local Government (DCLG), creating a distinct Olympics DEL. This was viewed as non-comparable. If these initiatives had been funded from the budgets of DfT and DCLG in the usual manner, they would have resulted in spending consequentials for Wales. By ring-fencing money from these departments into a new Olympics DEL, the UK Government avoided paying consequentials to the devolved administrations.[55]

---

[54] HM Treasury, 2007 p.29.
[55] Further information on the funding of the Olympics is available in: HM Treasury, 2007.

5.15   This may be a rare, but clear, example of the UK Government choosing to interpret the rules around funding of devolved administrations in a way that is less than even-handed. While the decision not to provide consequentials for the direct financing costs of the Olympics was fair, the top slicing of budgets that would otherwise have generated consequentials to fund transport improvements and regeneration constitutes a breach of the spirit, if not the letter, of the current fiscal settlement.

Reducing the likelihood of future disputes

5.16   The way in which the Treasury handled the funding of the Olympics, and to a lesser extent the way in which devolved administrations were informed of changes to their capital budgets at the time of the 2007 CSR, caused a significant loss of good will. Despite this, no attempt was made to appeal the matter to the JMC or to the UK Cabinet. We understand that at the time the JMC had not met for several years. There was no expectation amongst Assembly Government officials or Ministers that such an appeal would have resulted in the decisions being overturned. As things stand, the UK Government is both judge and jury when it comes to the operation of the Barnett Formula and the Assembly Government's representation to the UK Government has to be made by a UK Government Minister.

5.17   To a certain extent, some tensions and disagreements are inevitable in any system of financing sub-national governments. Moreover, under the current constitutional arrangements it is right that in the final analysis decisions over public spending lie with the UK Government. Equally however, under the current constitutional settlement the Assembly Government is not, and should not be, treated as being equivalent to a spending department of the UK Government. The Assembly Government has its own budgetary process, backed by a separate democratic mandate. A mature devolution settlement requires mature and robust structures and processes to underpin it.

5.18   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.

5.19   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. The arm's length body need not be a new organisation, but could be a relatively small unit located within an appropriate existing institution. Such a body would have the following key responsibilities:

    i)   assessment of whether spending programmes should have consequentials, and if so what these consequentials should be. This assessment would need to take place at an early stage in the spending review process to enable the Treasury to calculate the UK-wide cost of spending programmes;

    ii)   calculation of amounts to be transferred as a result of transfers of additional responsibilities to the devolved administrations (so-called "machinery of government" changes);

    iii)   publication of an annual report on the financing of devolved administrations, giving an explanation for all its decisions over the previous year; and

    iv)   in the event that a needs-based component is incorporated in the funding mechanism in future, responsibility for technical aspects of the operation of this formula.

5.20   By placing responsibility for technical aspects of the funding settlement with a body that is not under the direct control of either the Assembly Government or the Treasury, the machinery to ensure that the Assembly Government's fiscal arrangements are transparent and fair would be strengthened. Any disagreements could be thrashed out on a more symmetrical basis than at present where one side generally has an informational advantage. International experience (particularly from Australia) suggests that a process starting with an independent technical body would reduce the likelihood of future disagreements between Welsh and UK levels of government.[56]

5.21   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.[57] Welsh Ministers are consulted on the content of the SFP but are not signatories to the document.[58] 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.[59]

5.22   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. The concordat should also retain a set of principles that both UK Government and Assembly Government Ministers would endeavour to uphold.

5.23   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".[60] 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.

---

[56]   For a review of various aspects of the fiscal system in Australia, see: McLean, 2002; Pickernell, Bristow, Kay and Ryan, 2008; and the Independent Expert Group to the Commission on Scottish Devolution, 2008.

[57]   HM Treasury, 2007a p.1.

[58]   The Secretaries of State for each of the devolved nations are co-signatories to the SFP.

[59]   HM Treasury and Welsh Assembly Government, 2005.

[60]   HM Treasury, 2007a p.1.

5.24   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.

5.25   In summary, under our proposals the specification of the way in which the Assembly Government is financed would ideally be transferred to a new concordat that was under the joint control of Welsh and UK Government Ministers. The concordat would also include a statement of the principles that would underpin inter-governmental relationships. In the absence of complete agreement, a slimmed down SFP would cover the limited number of issues where the UK Government decided to impose its decision. This document would be owned by the Treasury. Implementation of technical aspects of the funding settlement would be the responsibility of the arm's length body. The JMC would retain its role as the forum for discussion of political matters and would provide the route for the UK Government, if necessary, to impose a decision where no consensus is possible. Table 5.1 summarises the reformed dispute resolution process that we propose.

5.26   In the longer term, there would be a good case for placing the financing of the Assembly Government (and other devolved administrations) on a statutory basis. However, the recommendations made in this chapter could be implemented without the requirement for legislation.

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 Treasury and the Assembly Government. Such a body would have the following key responsibilities:

i)   assessment of whether spending programmes should have consequentials, and if so what these consequentials should be;

ii)   calculation of amounts to be transferred as a result of transfers of additional responsibilities to the devolved administrations (so-called "machinery of government" changes);

iii)   publication of an annual report on the financing of devolved administrations, giving an explanation for all its decisions over the previous year; and

iv)   in the event that a needs-based component is incorporated in the funding mechanism in future, responsibility for technical aspects of the operation of this formula.

Recommendation

The UK Government and the Assembly Government should jointly agree a new Ministerial concordat on the detailed funding arrangements for Wales. Ideally, all of the topics covered in the Statement of Funding Policy should be transferred to a new concordat that would be subject to the joint approval of UK Government and the Assembly Government. The concordat should also retain a set of principles that both UK Government and Assembly Government Ministers would endeavour to uphold. The UK Government would retain the ultimate right to impose a solution in the absence of agreement and any imposed elements could be set out in a unilateral Treasury-owned Statement of Funding Policy.

Table 5.1:   Reducing the likelihood of future disputes: an overview of the recommended roles of the arm's length body and the JMC

	Remit	Membership	Key documents	Specific functions
Arm's length body	Technical aspects of the financing of devolved government.	It is currently envisaged that this would be a relatively small team of officials located in an existing organisation that has an arm's length relationship with governments.	The new joint Ministerial concordat would provide detailed technical instructions for the arm's length body. If necessary this would be supplemented by a Treasury-owned SFP. The concordat would also provide guidance on matters of principle.	i) Assessment of whether spending should generate consequentials and calculation of those consequentials; ii) Machinery of government changes; iii) Publication of an annual report including explanation for decisions; and iv) Operation of a needs-based funding formula (in the event that such a formula is adopted).
JMC	Political issues, matters of principle, appeals against decisions made by the arm's length body.	As at present, Ministers of UK Government and devolved administrations, supported by a secretariat of officials.	The new Ministerial concordat would be the key document guiding discussions of disputes at the JMC.	The Committee would continue to provide a forum at which disputes between administrations could be aired. However, such discussions would be grounded in the principles set out in the Ministerial concordat. In the absence of consensus, the UK Government would retain the right to impose a decision.

Improving transparency

5.27   The Treasury publishes detailed statistics on public expenditure in the UK, by country and by English region, on an annual basis in PESA. The quality and scope of the country and regional information in PESA has improved markedly in recent years. However, the available statistics still do not provide a ready basis for assessing the operation and impact of the Barnett Formula. In particular, they do not provide estimates of expenditure in England on those areas that are devolved to Wales. This means that a direct comparison of expenditure in Wales covered by the Barnett Formula and similar spending in England is not possible from published data without undertaking significant additional analysis. There is also no clear audit trail of transfers of funds between UK Government departments and the Assembly Government or classification changes affecting the treatment of certain programmes and transactions. Such information would enable precise comparisons between Wales and England over time in a consistent manner. It is highly desirable that all relevant information relating both to the direct operation of the formula and its wider impact on spending patterns across the UK is placed in the public domain to ensure that the funding of the Assembly Government is transparent.

5.28   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. Although Treasury Ministers are of course not accountable to the National Assembly, this would nonetheless provide a public forum for UK Government Ministers to engage in a public discussion on the level of resources being made available to Wales.

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.
The publication should also provide details of changes to the Assembly Government's budget arising from policy, transfer, and classification changes.

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.

Funding devolved government

5.29   The devolution Acts passed by Parliament have created a range of new governmental bodies across the UK. In Scotland, a separate executive and legislature were established from the inception of political devolution in 1999. In Wales, the National Assembly for Wales was originally established as a corporate body under the Government of Wales Act (1998), before being legally separated under the Government of Wales Act (2006) into the National Assembly for Wales with limited legislative powers and the Welsh Assembly Government with executive responsibilities. Northern Ireland also has a devolved legislative assembly and a separate executive. Although the transfer of executive responsibilities from central government to devolved executives need not of itself necessarily lead to additional costs being incurred, the creation and operation of three new elected bodies has inevitably resulted in additional costs being incurred, irrespective of whether or not they have legislative powers. However, as far as we can glean, no transfer of funds to meet these costs has ever been made to any of the devolved administrations (although it is not easy to uncover exactly what was agreed during the establishment of the devolved bodies). If that is so, it suggests that a slice of the monies intended to pay for public services in each of the devolved countries, calculated on the basis of public service expenditure in England, must instead have to be used to cover the costs of the elected bodies. The funds provided for public services in England are not subject to an equivalent 'top slicing', since the UK Parliament is financed through an entirely separate funding stream.

5.30   The sums involved are likely to be small in relation to the total budgets involved; however the accepted principle under Barnett requires that a transfer of functions to the devolved administrations should be accompanied by a one-off transfer of funds, with the devolved administrations receiving a consequential from comparable spending in future years. We believe that this should hold as true for the creation of elected bodies with legislative functions, primary or secondary, as for policy functions. We note that the apparent failure to transfer funds to contribute towards the inevitable costs of devolution seems highly anomalous.

Summary

5.31   To facilitate efficient capital investment, the Assembly Government should be permitted to draw forward its capital budget across the period of a spending review, provided the drawn forward funds are used to undertake additional capital investment.

5.32   The Assembly Government should have unrestricted access to the End Year Flexibility resources that it has accumulated in prior years.

5.33   The Assembly Government should be able to switch funds from its capital budget to its resource budget, provided that such transfers would not cause a breach of the UK Government's overarching fiscal rules. In the event that the Assembly Government were granted this facility and was also given the power to draw forward future capital budgets, 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.

5.34   In order to reduce the likelihood of future disagreements between different levels of government, the technical aspects of the Barnett Formula (i.e. the calculation of the comparability factors, the machinery of government changes, the publication of information and the operation of any future funding formula that is needs-based) should be undertaken by a body that is at arm's length from both the Assembly Government and the Treasury.

5.35   The UK Government and the Assembly Government should jointly agree a new Ministerial concordat on the detailed funding arrangements for Wales. The concordat would, ideally, cover all topics that are currently contained in the Statement of Funding Policy. In the absence of consensus, the UK Government would have the final say. In such circumstances, the Treasury would issue a separate Statement of Funding Policy setting out the rules to be followed in those areas where it was proceeding without the agreement of Welsh Ministers. Perceived breaches of the concordat or disagreements with a decision of the arm's length body should be referred to the JMC and the UK Government would retain ultimate power to impose a decision.

5.36   A lack of detailed and robust statistics makes it difficult to analyse the impact of the Barnett Formula and undermines transparency. There should be an annual statistical publication that includes direct comparisons between aggregate Assembly Government expenditure covered by the Barnett Formula and similar expenditure in England, together with details of changes to the Assembly Government's budget arising from policy, transfer, and classification changes.

5.37   In order to enhance transparency, a Treasury Minister should be invited to meet the National Assembly for Wales's Finance Committee at least once in every spending review period.

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.[61] 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   The history of the block grants can therefore be summarised as follows. Their relative size started from a largely unexamined base and proceeded as the random outcome of formula-driven increments, unforeseen population movements and ad hoc adjustments. Since the Barnett Formula has never been explained or justified in terms of relative need or benefit in the devolved areas there is no government commitment or declared objective against which to assess it. A House of Commons Research Paper has noted: "disparities in public spending per head between the different parts of the UK have led to criticisms that the Barnett Formula is unfair...".[62] Yet since no particular criterion of fairness has ever been publicly adopted the formula in effect responds with a shrug.

6.4   Within England, public expenditure per head varies quite widely by region, the result of expenditure formulae or practices within government spending departments. Why should expenditure in the devolved areas converge on an English average, when English regions themselves are disparate and do not converge? The Barnett Formula is silent. Just as there is no available justification for the starting point, there is no public justification for the end point either.

6.5   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".[63] The Barnett Formula

---

[61] HM Treasury, 1979.

[62] House of Commons Library, 2007 Summary.

[63] HM Treasury, 2007a p.7.

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.

6.6   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 of public funds with a minimum of public political conflict.

6.7   Apart from minimising the time spent on horse-trading, the current system has two unquestioned advantages for a devolved administration. First it results in a block grant that is not hypothecated; the recipient administration has discretion over how the money is spent. Second it protects the administration from fluctuations in tax receipts from its own area; the UK Government takes on the risk of the business cycle and devolved expenditures always follow the trend established for the UK as a whole. These are very great advantages but they are not peculiar to the present system. They could be retained in other systems. And the automaticity which is so prized in the Barnett Formula could be retained in any alternative formula-based approach.

Where next?

The medium term solution

6.8   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 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.

6.9   We are aware of the limitations of a technocratic and apolitical Commission such as ours in attempting to prescribe in a detailed way how needs should be accounted for in a funding formula. Nonetheless we intend to produce material in our final report that will assist those charged with producing formulae to achieve a better alignment between relative spending and relative needs.

6.10   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

6.11   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.

6.12   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.

6.13   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.[64]

6.14   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.

6.15   The recommendation that convergence should cease when countries' budgets are no larger than they would be were they funded as an English region is applicable in principle to all devolved administrations, as are all our recommendations. Different countries will have different relative needs and there is therefore no particular reason to believe that the floor would be in the same place for each country. The Commission has not attempted to determine whether other devolved administrations are receiving more or less than they would do were they funded as an English region. We therefore make no judgement as to whether or not it would be appropriate to introduce a floor for these administrations at the present time. It would be a matter for those devolved administrations to make that case should they choose to do so.

---

[64]   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.

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 2.2:

Change to Welsh = change to equivalent x comparability x Welsh to English x 114%
     block grant   English programme   factor   population ratio

This can be illustrated using the same hypothetical example as in Box 2.2, 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 million x 90 per cent x 5.83 per cent x 114 per cent = £5.98 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. This simple arithmetic adjustment to the current formula would place a floor under the funding provided to Wales, and would prevent any further convergence, pending wider reform.

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. The Commission is mindful that the ultimate decisions on how this should be achieved are fundamentally political in nature. Nonetheless, we believe that we can provide useful guidance on this issue. We will undertake further analysis of how this can best be accomplished, which we will include in the final report. Joint agreement from Ministers of the UK Government and the devolved administrations concerned would be essential with regard to both (i) the process by which needs were assessed and (ii) the way in which the outcome of the joint assessment of needs was reflected in the budget setting process. **(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. This simple arithmetic adjustment to the current formula would place a floor under the funding provided to Wales, and would prevent any further convergence, pending wider reform. **(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. Such a facility would provide a smoother profile to the capital budget allocated to Wales and would permit capital investment in excess of the arbitrarily-determined capital budget allocated to Wales via Barnett. **(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. This would make it easier for the Assembly Government to undertake spending decisions that are aligned with Welsh needs. The only case for this facility to be temporarily suspended would be in the unlikely event that draw down of accumulated EYF by the Assembly Government would cause the UK Government to breach its overarching fiscal rules. **(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. In the event that the Assembly Government were granted this facility and was also given the power to draw forward future capital budgets, 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. **(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 Treasury and the Assembly Government. Such a body would have the following key responsibilities:

i)   assessment of whether spending programmes should have consequentials, and if so what these consequentials should be;

ii) calculation of amounts to be transferred as a result of transfers of additional responsibilities to the devolved administrations (so-called "machinery of government" changes);

iii) publication of an annual report on the financing of devolved administrations, giving an explanation for all its decisions over the previous year; and

iv) in the event that a needs-based component is incorporated in the funding mechanism in future, responsibility for technical aspects of the operation of this formula. (Chapter 5)

The UK Government and the Assembly Government should jointly agree a new Ministerial concordat on the detailed funding arrangements for Wales. Ideally, all of the topics covered in the Statement of Funding Policy should be transferred to a new concordat that would be subject to the joint approval of UK Government and the Assembly Government. The concordat should also retain a set of principles that both UK Government and Assembly Government Ministers would endeavour to uphold. The UK Government would retain the ultimate right to impose a solution in the absence of agreement and any imposed elements could be set out in a unilateral Treasury-owned Statement of Funding Policy. (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. The publication should also provide details of changes to the Assembly Government's budget arising from policy, transfer, and classification changes. (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)

Supplementary analysis

Overview

A2.1   This Annex provides additional information on the analysis in Chapters 2 and 4. It covers the following:

- i) analysis of Barnett and its impact on Wales, estimating comparable expenditure in England;

- ii) the impact of changes to the budgetary process: treatment of inflation;

- iii) the impact of changes to the budgetary process: European programmes;

- iv) explanation of the matching process used to compare Wales with the English Index of Multiple Deprivation;

- v) application of the English health formula to Wales;

- vi) application of the English local government formula to Wales;

- vii) application of the English Supporting People formula to Wales;

- viii) indirect application of the English Sure Start formula to Wales; and

- ix) other spending areas.

Analysis of Barnett and its impact on Wales: estimating comparable expenditure in England

A2.2   The Barnett Formula is described in Chapter 2, which also includes an illustrative example in Box 2.2. A more formal algebraic representation of how the Welsh block is calculated is:

$$B_W^t = B_W^{t-1} + \left[\frac{\left(B_E^t - B_E^{t-1}\right)}{Pop_E^t} \times Pop_W^t \right]$$

Where: B_w is Welsh Assembly Government DEL
B_E is comparable expenditure in England (expenditure on programmes devolved to Wales
Pop_w and Pop_E are the resident populations of Wales and England

Comparable English expenditure can be disaggregated to express the formula as:

$$\Delta B_W^t = \left[\frac{\sum_i w_i^t \left(B_{E,i}^t - B_{E,i}^{t-1} \right)}{Pop_E^t} \times Pop_W^t \right]$$

Where: B_w is Welsh Assembly Government DEL

$B_{E,i}$ is expenditure by UK Government department i

w_i is the proportion of department i's expenditure which is devolved to Wales (the comparability factor)

Pop_w and Pop_E are again the resident populations of Wales & England

A2.3   One of the first challenges in producing an analysis of the impact of the Barnett Formula on Wales is to identify an aggregate of expenditure in England which covers comparable functions to those covered by the formula in Wales, shown as B_E in the first equation above. The level of comparability for each UK Government department (w_i in the second equation) may vary over time; either because of shifts in funding between comparable and non-comparable programmes or because functions are transferred between departments. As noted in the main document, the UK Government does not publish figures for comparable expenditure in England, either for outturns or for the forward expenditure plans. This aggregate therefore has to be estimated from available information. The method used in this report involves applying the departmental level comparability factors published in the Statement of Funding Policy to each UK Government department, while taking account of any major transfers of functions.

A2.4   The latest set of comparability factors was published in the Statement of Funding Policy accompanying the 2007 spending review. These factors have been applied to each of the UK Government departments' DEL, as published in PESA. For example, Wales has a comparability factor of 68.3 per cent for the Department for Transport (DfT), so the comparable expenditure in England on transport is taken to be 68.3 per cent of the DfT's DEL. For PESA 2008, this provides outturn figures for comparable expenditure in England for 2002-03 to 2006-07, estimated outturn for 2007-08, and plans for 2008-09 to 2010-11.

A2.5   Estimates for earlier years have to be derived from earlier editions of PESA. For each edition of PESA the most recent comparability factors available at the time have been used. With a rolling 9 year window, there is substantial overlap in the years covered by successive editions of PESA. To compile time series going back before the first year of the current edition, we have taken the most recent available estimate for each year. There are frequently classification and transfer changes between editions of PESA which affect departmental outturns and plans. The overlap period has been used to adjust data from earlier editions to allow for this. For both Welsh expenditure and comparable expenditure in England, the ratio between estimates from successive editions of PESA in the earliest year of the overlap period has been used to adjust the earlier data. The results of this analysis are shown in Charts 2.5 to 2.8. There are many different ways that estimates from earlier editions of PESA could be incorporated into the time series of relative expenditure. Chart A2.1 illustrates how successive editions of PESA combined with the comparability factors available at the time give rise to varying estimates of relative expenditure. However, the broad pattern of convergence is apparent across these estimates and is robust to the method chosen to combine them into a single series.

Chart A2.1: Wales relative expenditure per head on programmes covered by the Barnett Formula (England=100)
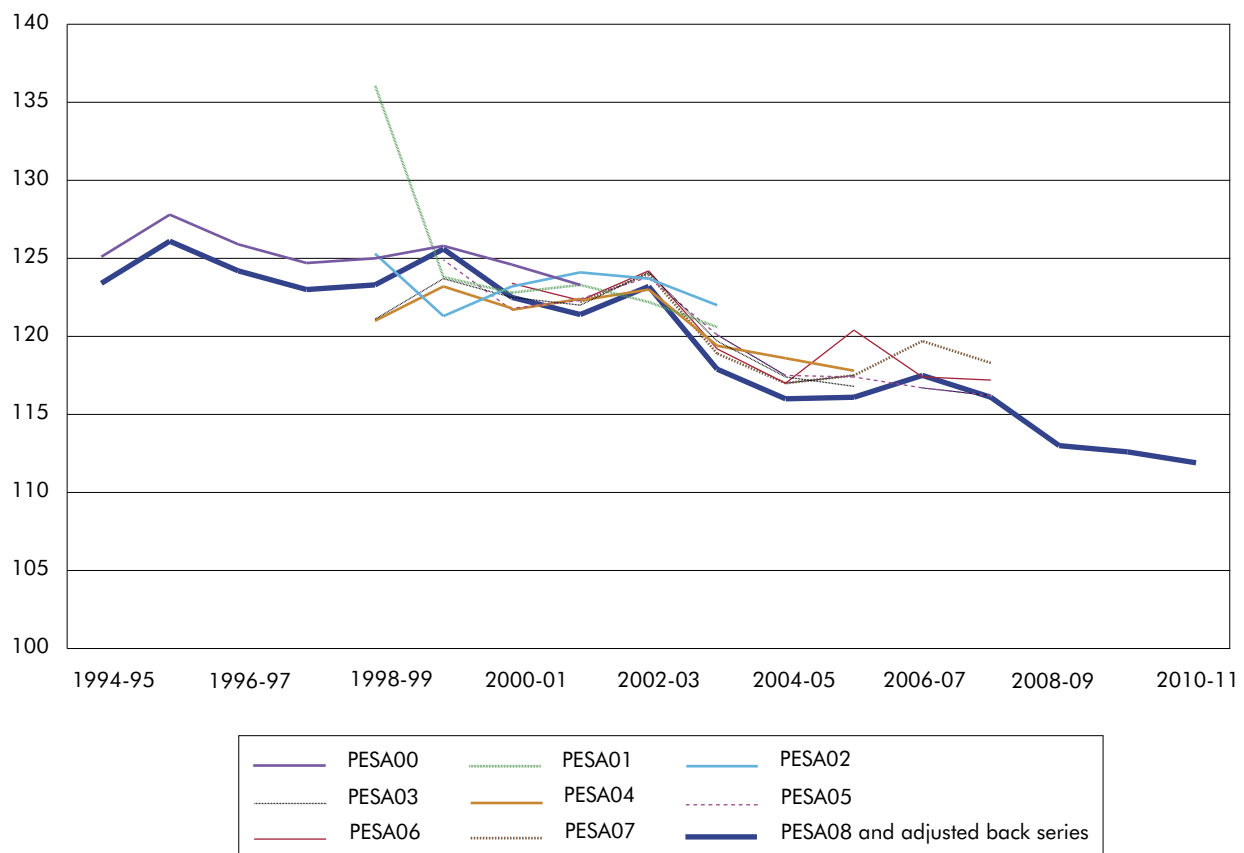
Source: HM Treasury PESA 2000-2008 and Commission calculations

The impact of changes to the budgetary process: treatment of inflation

A2.6   This section provides further details on the treatment of inflation in the budgetary process.

A2.7   Prior to the introduction of the spending review process in 1998, public expenditure planning was generally carried out on a rolling three year basis known as the Public Expenditure Survey, or PES, process. Under this system, in any one year there would be existing plans for two of the three forward years in the planning window. Prior to 1992-93, the third and final year was generally introduced to the system by rolling forward the departmental plans for Year 2 with a simple adjustment for inflation.[65] This adjustment was applied to the Wales, Scotland and Northern Ireland blocks as well as to Whitehall departments. In other words, a percentage increase was applied to the blocks themselves, not just to the Barnett consequentials of English expenditures. In effect, the baseline was set flat in real terms rather than nominal terms and Barnett allocations were calculated on real (that is inflation-adjusted) changes in English spending. An automatic, though partial, adjustment for inflation was therefore applied to the block grants.

A2.8   Under the current planning system, the budget for the current year for each devolved country is used as the baseline for all three planning years. Changes to the devolved budgets for future years are strictly limited to the Barnett consequentials of increases (or decreases) from the nominal flat baseline in comparable English programmes. Box A2.1 provides a simple illustration of how inflation adjustment mitigates the Barnett squeeze, using the same scenario as in Box 2.3.

---

[65]   House of Commons, 1997 Appendix 3, Annex 2, paragraph 16.

Box A2.1: An example of how Barnett was implemented with adjustments for inflation

	England		Wales		
Population	50 million		3 million		
	£ billion	£ per head	£ billion	£ per head	£ per head (English = 100)
Baseline	100.0	2,000	7.2	2,400	120
Real terms baseline for new period (assuming 10% inflation)	110.0	2,200	7.9	2,640	
Above inflation increase	*20.0*	*400*	*1.2*	*400*	
New budget	130.0	2,600	9.1	3,040	117

This hypothetical example uses the same overall increases in England as in Box 2.3. However, in this case, the baseline for the new budget is set flat in real terms (assuming 10 per cent inflation purely for illustrative purposes) before the Barnett Formula is applied to the additional, above inflation increment. The overall £600 nominal per head increase in England is split between the inflation adjusted baseline (£200) and the above inflation increment (£400). In Wales, the inflation adjusted baseline gives rise to a £240 per head increase and the Barnett-related above inflation increment of £400 per head is added on top of this. Overall spend per head in Wales relative to England falls from 120 to 117, rather than to115 as shown in Box 2.3 of the main text.

The higher baseline expenditure per head in Wales compared with England gives rise to a higher per head inflation adjustment. This mitigates the relative squeeze arising from the Barnett Formula and the rate of convergence is therefore slower.

A2.9   The impact of how this change would have affected recent years is illustrated in Chart A2.2.[66] It compares actual relative expenditure per head in Wales with what would have happened since 1999-00 had there been an adjustment for inflation prior to the application of the Barnett Formula. (The smoothness of the second line is purely an artefact of the method used to model this scenario. As described in paragraph 2.23, the method smoothes out relative End Year Flexibility movements). The stricter application of the Barnett Formula in the current planning system has led to faster convergence than would have happened if baselines had been set flat in real terms as they were before 1992-93.

---

[66]   Calculated from PESA data. The inflation adjusted line assumes Wales's Barnett-related increases calculated from outturn/planned increases in English comparable programmes after adjusting for GDP deflator increases in both England and Wales.

Chart A2.2: The impact of inflation adjustment on the budgetary process (England = 100)
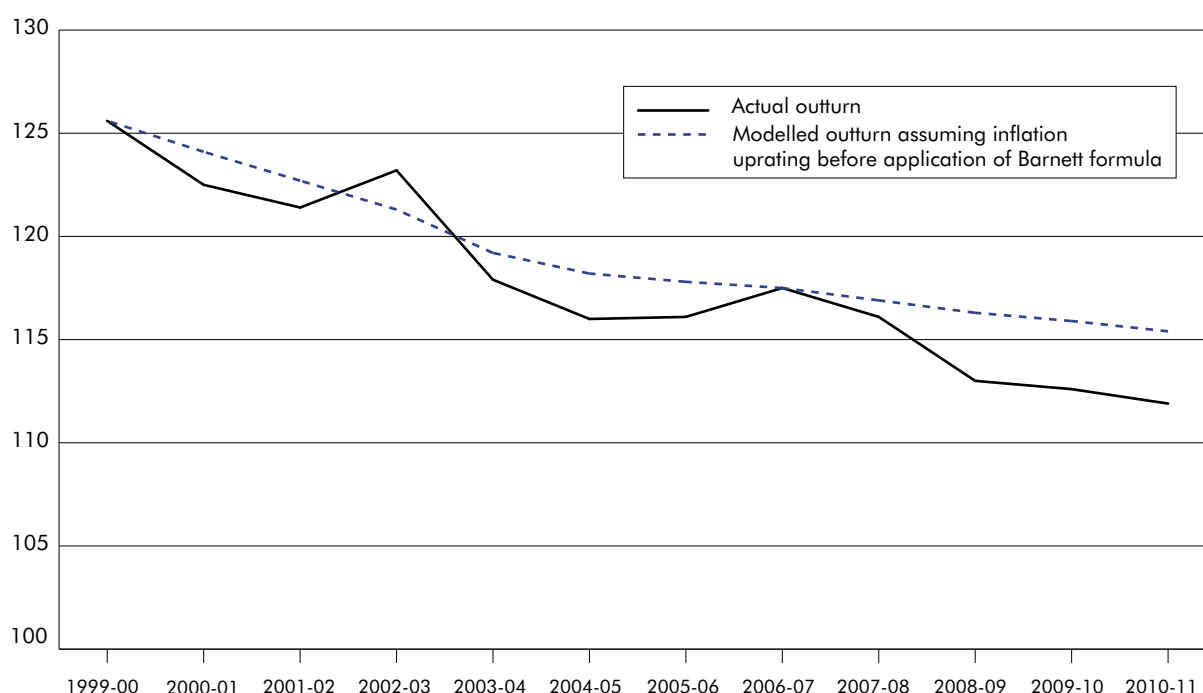
Source: Commission calculations

The impact of changes to the budgetary process: European programmes

A2.10   The funding of European programmes in Wales in recent years provides an example both of extra-Barnett adjustments (work-arounds) and accounting changes. West Wales and the Valleys qualified for the highest tier of European regional development funding for the 2000 to 2006 structural funds programme (and the 2007 to 2013 programme). In 2000, expenditure relating to European development programmes was included in the Barnett block, but the financing from the European Commission was not treated as additional but taken by the Treasury as part of general revenue. That implied the Assembly Government would have to offset increased spending on European programmes by reductions in other programmes.

A2.11   There was considerable debate about this issue shortly after the Assembly was founded in 1999. In the event, the Welsh budget was allocated an extra-Barnett increase and the European structural funds were, in effect, passed on. In the 2005 Pre-Budget Report the UK Government announced a change to the treatment of European expenditure programmes in the budgetary framework, whereby both the expenditure and the associated financing would score in the DEL. These programmes (including the Common Agricultural Policy) now have no overall impact on the size of the Assembly Government's DEL as the expenditure and the receipt from the European Commission cancel each other out.

A2.12   The change in treatment of European programmes in the expenditure system effectively removes them from the block grant process. They are regarded as direct transactions between the European Commission and the Assembly Government. They do of course constitute an additional resource for the provision of public services in Wales but are outside of the Barnett process and have therefore been excluded from our analysis in Chapter 2. However, even if gross structural funds expenditure were included in our comparisons between Wales and

England, there would be only a minor impact on the relative convergence illustrated in Chart 2.6. Relative expenditure per head in Wales in 2010-11 would be 13 per cent higher than in England, rather than 12 per cent higher under the net treatment of European programmes.

Explanation of the matching process used to apply the English Index of Multiple Deprivation to Wales

A2.13   This section provides further detail on the methodology used in the small-area matching exercise described in paragraphs 4.16-4.18 and illustrated in Chart 4.10.

A2.14   The ONS has produced a set of over 40 Census 2001-based socio-economic indicators to compare geographic areas in England and Wales. These indicators are used to group together geographic areas according to key characteristics common to the population in that grouping. They are also used to calculate corresponding areas or nearest neighbours; those places which most closely match the area of interest.

A2.15   This indicator set has been used to find small areas in England which most closely match each of nearly 2,000 small areas in Wales. These areas are called Lower Super Output Areas (LSOAs) and are the geographical units used in the English (and Welsh) Index of Multiple Deprivation. There are 32,500 such areas in England.

A2.16   For each LSOA in Wales, the matching process involves finding the LSOA in England with the most similar values across all the socio-economic indicators. The indicators are log-transformed to deal with outliers and then range standardised so that all indicator values lie between 0 and 1. This ensures that each indicator has an equal weight in the process. The matching area is identified by minimising the squared Euclidean distance across all indicators. Further details of the dataset and the methodology are available on the area classification part of the ONS website.

Application of the English health formula to Wales

A2.17   The Department of Health uses a weighted capitation formula to determine target shares of available revenue resources for NHS areas in England. The underlying principle is to distribute resources based on the relative needs of each area. This is to enable Primary Care Trusts (PCTs) to commission similar levels of healthcare for populations with similar healthcare needs and to help reduce avoidable health inequalities.[67]

A2.18   The weighted capitation formula calculates PCTs' target shares of available resources based on population adjusted for:

    a)   age distribution;

    b)   additional needs over and above that relating to age;

    c)   unavoidable geographical variations in the cost of providing services.

---

[67]   For a detailed description of the formula see: Department of Health, 2008.

A2.19   Given these target allocations, which may well differ from actual baseline allocations, a pace of change policy is established to link the two and so produce a set of allocations for years in the planning period. For our purposes, this damping mechanism has been ignored, as we are interested in the assessment of relative needs in Wales (as measured using the UK Government's formula for England) not how this interacts with historic allocations.

A2.20   The formula has three components relating to: hospital and community health services (HCHS) (around 75 per cent of the total), prescribing (the drugs bill), and primary medical services. HCHS in turn has separate needs formulae for acute services, maternity, mental health and HIV/AIDS. The needs formula for acute services includes 12 indicators covering death rates, illness rates, benefit rates and other socio-economic variables. The maternity formula includes low birth weight and house price indicators.

A2.21   To assess their relative importance, the needs variables are combined with supply variables in a regression analysis to explain variation in cost weighted utilisation or activity rates at small area level. The supply variables are included to allow for the fact that the supply of health services varies across the country and will affect utilisation. After estimation, the supply variables are neutralised to provide a needs formula which is independent of supply variations. The mental health formula works on a similar basis but has an additional variable designed to improve the estimation of unmet needs where certain societal groups do not receive healthcare services to the same level as others with similar health characteristics.

A2.22   In addition, there is a further formula to address the objective of reducing avoidable health inequalities. This is based on disability-free life expectancy, comparing each PCT's figure with a benchmark of 70 years. Finally, costs are taken into account via a market forces factor consisting of four elements: staff, medical and dental London weighting, buildings, and land. The staff element is the most important and is estimated using private-sector earnings data.

A2.23   The prescribing component works on much the same basis as the acute component, with a similar set of needs variables. It does not have a cost adjustment. The primary medical services component uses an age-sex workload index, based on estimated GP consultations per year for each age and sex group. Additional needs are based on regression analysis relating to survey-based GP utilisation information. The cost adjustment covers practice staff, buildings, land, and a GP pay factor to compensate deprived areas.

A2.24   In order to apply the formula to Wales the needs coefficients estimated in the regression analyses described above and the weights used in the inequalities formulae were applied to the equivalent needs variables for areas in Wales.

A2.25   The majority of needs, inequality and cost variables were available for Wales on a consistent basis and were used directly in this process. A few variables had to be created for areas in Wales by matching with data for English areas. These variables were created by one of two methods, either by regressing the standardised English area values on explanatory variables available for both England and Wales, or by matching values at area level. The matching process was as described in the previous section. Each area in Wales was assigned the value of the variable in the most closely matching English area. The variables where Welsh values had to be created were: children not staying in education; income deprivation affecting children; low income scheme - prescriptions not paid for; and the mental health index.

A2.26   Given the importance of health in the overall block grant, a further piece of analysis was carried out as a cross-check of the results obtained from the analysis described above. This involved the set of Census-based socio economic variables used in the matching process described in the previous section, but at PCT rather than small area level. The English PCT target allocations were regressed on this set of variables. The coefficients from the best specification found by this analysis were then applied to the same indicator set for local authority areas in Wales to derive Welsh target allocations. This analysis closely replicated the target allocations at English Strategic Health Authority (SHA) level and, as noted in Chapter 4, also closely matched the allocation for Wales derived from the direct application of the formula.

A2.27   Further supporting evidence is available from the health domain of the English index of multiple deprivation. Chart A2.3 uses the approach set out in paragraphs 4.17 and 4.18 and shows that the areas of England that most closely resemble areas in Wales are greatly over-represented in the most deprived deciles of the health and disability domain.

Chart A2.3: Distribution of English LSOAs most closely matched to Welsh LSOAs, health deprivation and disability domain, IMD 2004
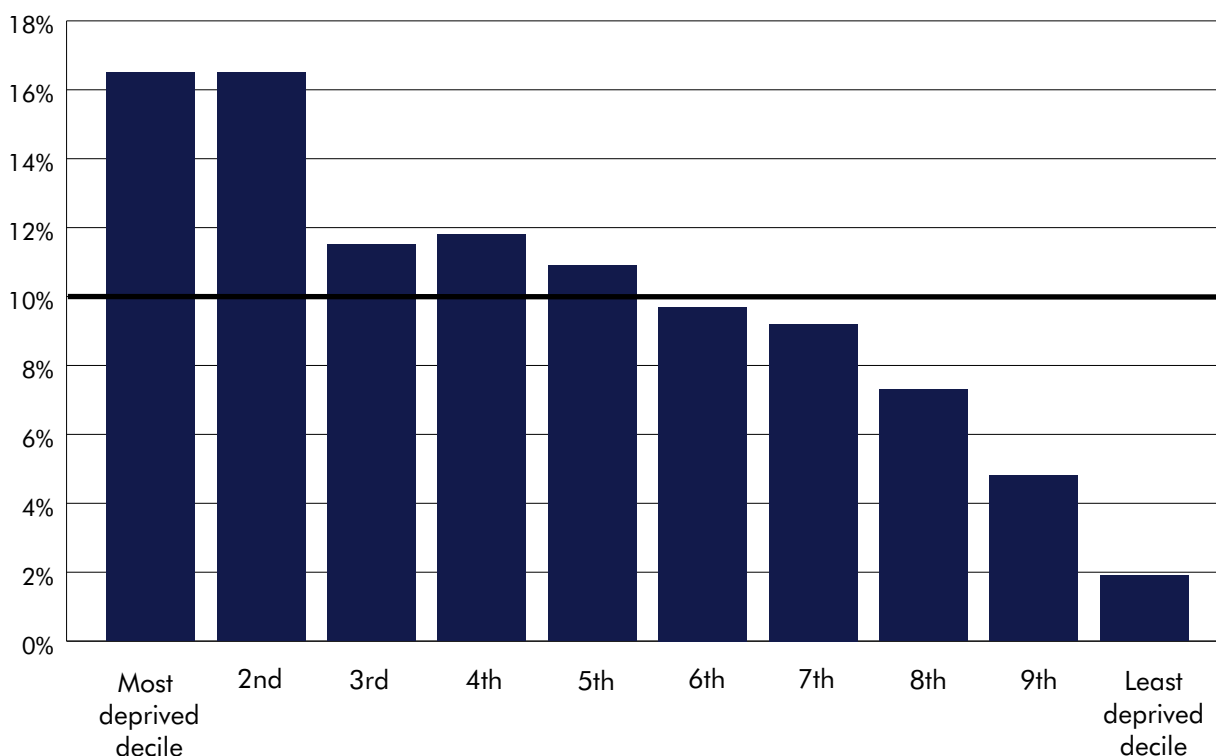
Source: Commission calculations

Application of the English local government formula to Wales

A2.28   English local government allocations are determined via the "four block model" formula grant distribution system, introduced in 2006-07. The four blocks of cash relate to:[68]

    a) relative needs;

    b) relative resources;

---

[68] For a detailed description of the formula see: Society of County Treasurers, 2008.

c) central allocations; and

d) damping.

The total of the four blocks is equal to the total Revenue Support Grant (RSG) and National Non-Domestic Rates (NDR) pool available. As with the health formula, we are not concerned with the damping mechanism (which nets out across authorities), only with the target allocations.

A2.29 The relative needs block uses formulae to determine resources to fund an authority's needs above a certain threshold. The relative resource block is a negative block and removes funding from those administrations with a larger tax base relative to their population. The central allocation block provides a basic level of funding per head of the population. The sizes of the blocks are set by Ministerial decision.

A2.30 The relative needs formulae use indicators that have been found to be statistically good indicators of expenditure on various services provided by local government. They are split into seven service groups, some of which contain smaller sub-groups. The groups are: children's services, adults' personal social services, police, fire and rescue, highway maintenance, environmental protection and cultural services, and capital financing. In general the formulae assign a fixed amount per member of the relevant client group for a service and then add top-ups for additional needs factors such as deprivation and sparsity. The result is then adjusted for service provision costs.

A2.31 Many of the indicators used in the relative needs formulae are from the 2001 Census, population estimates, or from social security benefit statistics. Welsh equivalents for these indicators have been relatively easy to compile. Where exact matches have not been possible, the available Welsh data have been adjusted by the difference between the English average from this dataset and the English average used in the formula. A few indicators are not readily available for Wales or are not well enough documented to identify an appropriate Welsh dataset. In these cases either the England average was applied across Welsh authorities or individual authorities were assigned the indicator level from English authorities thought to closely match them. The overall result of this exercise is robust to the exact methodology used in these instances.

A2.32 The only service area formula not directly applied to Wales was fire and rescue. A number of the indicators used in this formula are not available for Wales and, given the area's low weighting in the overall allocations, it was decided to apply the English average need per head of the population to areas in Wales.

A2.33 The relative resource block removes funding from authorities with a higher council tax base per head of the population. The tax base in this calculation is the number of Band D equivalent properties in each local authority. For historical reasons and following a recent revaluation exercise in Wales, the council tax bands do not match those in England. To allow for this the tax base in Welsh local authorities has been adjusted by the ratio of the average Band D council tax in Wales and the average Band D council tax in England. This assumes that the ratio of average Band D tax levels properly reflects equivalent tax raising effort in Wales compared to England. The Band D tax level as a proportion of house values in Wales is actually a little higher than in England, so there is no evidence that Council tax payers in Wales are undertaxed relative to those in England, given Welsh property values.

A2.34 The central allocation block simply allocates a standard per head amount to each local authority and presents no problem in extending the formula to cover Wales.

Application of the English Supporting People formula to Wales

A2.35   Supporting People is a programme designed to provide housing-related service to vulnerable individuals. In England funding to each local authority is allocated via a distribution formula. The formula is subdivided according to the main Supporting People client groups, with eight client groups in total. Each client group has a separate formula but a common approach is applied, consisting of three elements: the population of each client group relative to the total population of the area (termed the at risk population), deprivation and an adjustment for relative cost in delivering services.

A2.36   The population at risk element varies by each client group but is designed to measure relative demand for services. For example, for the older people client group the population at risk element is based on the proportion of the total population aged 60 and over, relative to the average for England as a whole. Many of the indicators used in the population at risk element are drawn from data collected by DCLG, UK National Statistics or other national sources. Welsh equivalents for these indicators are available in most instances or are relatively easy to compile on a comparable basis. The deprivation index is based on relative deprivation from the Index of Multiple Deprivation 2004 for England. To derive the appropriate data for local authorities in Wales we applied the matching of small areas of Wales to their closest English equivalent (see paragraphs 4.16-4.18 and A2.13-A2.16 for further details). Finally, the relative cost element reflects the local cost adjustment derived for the local government funding allocation formulae for England. The Welsh police authorities are included in the assessment for some local government allocations in England. Therefore, we have applied the relevant Welsh police authority data for Welsh local authority areas. Through this approach, we have been able to calculate the relative need for each of the eight client groups in Wales, which has an overall weighted score of 145.

Indirect application of the English Sure Start formula to Wales

A2.37   Sure Start is a programme that offers a broad range of services for children aged less than 5 years and their parents.

A2.38   Sure Start allocations to local areas in England were initially targeted based on relative deprivation. They also take account of the numbers of young children, sparsity and costs. We used a range of indicators to explain the variation in funding between areas in England, based on the local authority funding allocations for 2009-10. The indicators used cover demographics, deprivation and sparsity. There is also a dummy variable for inner London areas to account for cost variations.

A2.39   The indicators were brought together in a multiple regression analysis and were found to explain 90 per cent of the variation in funding per head across local authority areas in England. The regression analysis provides weights for each indicator which, in combination, best explain variations in funding. These same weights were applied to the indicator values for local authority areas in Wales to produce an estimate of the level of funding these areas would receive if they were covered by the English Sure Start programme. The results of this analysis indicate that, on average, areas in Wales would receive 14 per cent higher funding per head of the population than England. In other words, Wales' relative need per head is 114 compared to an English average of 100. As with health and local government funding, the estimate for Wales is close to the relative allocation per head in the North East of England (16 per cent above the England average).

Other spending areas

A2.40   In line with our stated methodology in Chapter 4, in each of the areas where no assessment of relative needs has proven possible, we have assumed that relative needs equal the weighted average of the relative needs in the areas for which we have been able to assign a score. In effect, this means that we have assumed relative needs in each of the areas discussed below equals 114. The total spending within this category accounts for 14 per cent of Wales's comparable DEL.

Transport

A2.41   The largest single area where no assessment of Welsh relative spending needs has been made relates to transport expenditure (accounting for 4 per cent of comparable DEL).

A2.42   Planned expenditure by the DfT in 2009-10 is estimated to be £13 billion. Wales's comparability factor is 68.3 per cent. The largest budgetary items for the DfT fall into three categories, namely the national road network, local transport provision and the rail franchise subsidy. In total, these three areas represent 60 per cent of the Department's budget.

National road network

A2.43   The Highways Agency is an Executive Agency of the Department for Transport, and is responsible for operating, maintaining and improving the strategic road network in England on behalf of the Secretary of State for Transport. The strategic network represents the motorways and major trunk roads in England. Motorways and trunk roads in Wales are the responsibility of the Assembly Government.

A2.44   Expenditure for constructing and maintaining the motorway and major trunk road network is not allocated on a sub-national level based on a distribution formula. Rather, expenditure is defined on a project basis that may well cover more than one administrative area.

A2.45   The most obvious measure of relative demand is the length of motorway and major trunk roads per head of population. On this measure Wales has a relative need of nearly 400 compared to an English average of 100. That is, Wales has almost four times more motorways and trunk roads per head of the population than the average for England. However, while the relative length of road network provides a useful proxy for need to spend, the intensity of use of the road network will also influence relative spending needs. The average number of journeys per kilometre of road network is lower in Wales than in England. Therefore, although Wales has a larger motorway and trunk road network per head of the population than England, average road use intensity is lower.[69] A precise assessment of the relative influences of these competing factors is a separate piece of research beyond the scope of this analysis.

Local Transport

A2.46   Local transport expenditure by the DfT is undertaken through the framework of local transport plans. Expenditure on local transport plans is divided into integrated transport and maintenance of the local authority managed road network. While formulae do exist for the distribution of funds to local authorities, these formulae are not published.

---

[69]   While it is clear that more intensive usage requires a greater need to spend on maintenance, it is also likely that the road network will require periodic maintenance almost irrespective of usage, due to weathering for example. Our analysis for local authority managed road networks suggests a strong correlation between road length and variations in local authority funding for maintenance.

A2.47   Integrated transport spending supports a wide range of activities, making a simple assessment of Welsh relative needs impossible.[70] For the maintenance elements of expenditure, one possible proxy for need could be derived from the length of the local authority road network, taking into account the average condition of the network. Based on a regression, the fit of this indicator in explaining the variation in English local authority budget allocations is strong.[71] The regression suggests that Welsh relative need in this area is 174 compared to an English average of 100. However, since no needs proxy for the other components of local transport plan expenditure was identified, the estimate was not incorporated into the analysis in Chapter 4.

Rail franchise

A2.48   Passenger rail services in the UK are provided by train operating companies under franchise agreements which generally run for seven to ten years. Part of the rail franchise includes a subsidy payment to contribute towards the cost of running rail services on routes that would not otherwise be financially viable.

A2.49   In 2006 the operation of the rail franchise was devolved to Wales. £141 million was allocated to the Assembly Government from the DfT at this time to cover the expected cost of operating the franchise in Wales. The budget for the rail franchise across England and Wales as a whole at that time was £1.74 billion. One possible way of assessing Wales's relative need to spend is to use the relative budgetary allocations to approximate Wales's relative spending needs in this area. Applying relevant population shares, this suggests that Wales's relative need to spend on the rail franchise is 142 compared to 100 for England.

A2.50   This analysis strongly suggests that Wales's relative need to spend on transport could be higher, and is very unlikely to be lower, than the value of 114 that was applied in Chapter 4.

Communities

A2.51   Communities expenditure mainly relates to housing and regeneration programmes. The Supporting People programme and Regional Development Agencies have already been covered. This leaves a residual amount dominated by capital housing programmes. A part of capital expenditure on housing in England called the Regional Housing Pot is distributed via a formula. We have not been able to find a full exposition of the formula but the description available shows that the formula uses indicators which are not available for Wales on a consistent basis. Because of this, and because the formula only relates to a portion of housing expenditure, we have not tried to apply it to Wales. Aggregate regional government expenditure data on these functions are available in PESA. These show that in 2007-08 relative capital expenditure per head on housing and community amenities was 116 in the North East of England, which is the area of England most similar to Wales. It was decided that the North East of England did not provide a robust enough proxy for this estimate of relative need to be applied to Wales.

Remaining spending areas

A2.52   The remaining expenditures for which no specific needs assessment has been made fall mainly within the categories of environment and rural affairs, culture, media and sport. In aggregate these account for 9 per cent of the comparable DEL. Expenditure in these categories covers a highly diverse range of activities. For example, environment spending includes funding for the Environment Agency, fuel poverty, waste, recycling and veterinary services. In each of these areas, we have been unable to proxy needs by applying a simple metric.

---

[70]   For example, schemes may include expenditure designed to improve public transport accessibility, safer cycling initiatives and walking initiatives.

[71]   The regression has a coefficient of determination, R^2 of 0.86.

Supplementary information

Overview

A3.1   This Annex provides additional information on the following:

i)   commissioned research;

ii)   the Assembly Government's current borrowing and tax powers;

iii) the philosophies of intergovernmental equalisation; and

iv)   international comparisons: an overview of funding systems in countries that share similarities with Wales.

Commissioned research

A3.2   Two research projects were commissioned under phase 1:

- "The Barnett Formula and its consequences for Wales: a literature review"

  This is an overview of the literature on the operation of the Barnett Formula as it relates to Wales, providing: a brief history of the Barnett Formula's operation in, and outcomes for, Wales; a detailed review of the evidence on the relative advantages and disadvantages of the formula in allocating funds to the devolved regions of the UK, with a particular emphasis on the implications for Wales; a review of the operation of the Barnett Formula in the international context by making comparisons to existing resource allocation methods in other countries.

- "The use of needs based formulae in the allocation of public resources: literature review"

  This reviews the literature on needs based formulae in operation in the UK and other developed countries, including an assessment of their operation and their relative advantages and disadvantages, drawing lessons for Wales.

A3.3   The completed research is published on the Commission's website.[72]

Borrowing and tax powers under the Government of Wales Act (2006)

Borrowing powers of the Assembly Government

A3.4   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.

---

[72] www.walesfundingreview.org. Hardcopies may be obtained by contacting: Holtham.Commission@wales.gsi.gov.uk

A3.5   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.

A3.6   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.

A3.7   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.

A3.8   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.[73]

Borrowing powers of other public sector organisations

A3.9   While the Assembly Government has only very limited powers to borrow, other public sector bodies have greater flexibility to borrow to fund public services.

A3.10   Local authorities in Wales have much greater freedom to borrow funds under the prudential borrowing system.[74] This system, detailed in the Local Government Act (2003), enables local authorities to determine their own levels of affordable capital investment and required borrowing providing they can demonstrate that borrowing can be supported within their existing resources. Specific Assembly Government consent for borrowing is no longer required under the prudential system.[75]

---

[73] 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.

[74] The current legislative framework replaces the previous scheme of credit approvals where a local authority in Wales would have to seek approval from the Welsh Assembly Government on a case by case basis. 'Credit approval' borrowing is also termed supported borrowing, as all local government borrowing covered under the previous scheme was funded by the RSG.

[75] Although there are no UK-wide limits imposed on prudential borrowing, beyond the local authorities' assessment of affordability, overall local authority borrowing levels are monitored by the Treasury to ensure that public sector borrowing does not exceed central government borrowing rules. If deemed appropriate by the Treasury, borrowing limits may be introduced.

A3.11   The prudential borrowing framework places great weight on the importance of sustainability, prudence and in particular affordability as the ultimate constraint on whether borrowing should take place and the amount that a local authority can spend or borrow. Affordability is determined by a judgement about acceptable council tax levels and in the case of borrowing to provide housing, acceptable rent levels. However, this decision is underpinned by a range of judgements such as likely levels of capital receipts, additional revenues raised from fees and charges in 'invest to save' schemes and treasury management considerations.

A3.12   NHS Trusts in Wales also have some limited power to borrow funds. While there are no restrictions on the source of borrowing, the aggregate of all sums borrowed must not exceed £300 million, or £600 million if the borrowing is guaranteed by Welsh Ministers. Trusts fall within HM Treasury budgetary controls and therefore such borrowing scores against the Assembly Government budget (see A3.6 above).

Taxation

A3.13   Most taxation in the UK is administered centrally. The two main exceptions comprise taxation for the provision of local services, namely NDR and council tax.

A3.14   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.

A3.15   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.

A3.16   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.

A3.17   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.

The philosophies of intergovernmental equalisation[76]

A3.18   Most countries, federal and unitary, aim at balancing the budgets of sub-national tiers of government so as to achieve a certain degree of inter-jurisdictional fairness, comparable economic development of regions, and hence political and social stability. This is usually effected through grants from the higher level (central) government. A given amount of funding *(closed fund)* is typically allocated to sub-national authorities on the basis of per-capita relativities.

A3.19   Three different views on calculating these per-capita relativities can be distinguished:

    i)   full budget equalisation (both from the revenue and expenditure sides);

    ii) fiscal capacity equalisation (from the revenue side);

    iii) expenditure needs equalisation (from the expenditure side);

         •   for recurrent outlays;

         •   for capital outlays.

i)   Full budget equalisation

A3.20   This approach is the most comprehensive of all, but also extremely rare in practice. The most prominent example of this philosophy is the allocation system for general sales tax to the Australian states; it is also the most developed and sophisticated in the world.

A3.21   The guiding line of the Commonwealth Grants Commission, which is in charge of deriving and proposing these grants relativities, reads as follows: "State governments should receive funding from the pool… such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard."[77]

A3.22   It is important to note that both sides of the state budget are considered in a standard fashion: the *same revenue effort* on the revenue side; the *same level of efficiency* and the *same standard for providing services* on the expenditure side. Standard efficiency hints at standard costs, and standard services hints at standard needs indicators.

A3.23   The grants distributed on the basis of these formulae are typically unconditional, i.e. although they may be calculated on the basis of cost and needs criteria, the recipient authorities are free to use the grant for whatever they deem fit.

ii)   Fiscal capacity equalisation

A3.24   This philosophy, found for instance in Canada or Germany, ignores the expenditure side, but attempts to even out regional inequalities resulting from differences in tax potential (with possible adjustments). Tax potential is a *standardised* tax base in order to eschew negative incentives, because compensating *effective* differences in tax collection would penalise those with a higher than standard tax effort and reward those with a lower effort on a given tax base. This can be avoided through standardisation (e.g. by using *average* instead of *effective* tax rates). The precondition for fiscal capacity equalisation is of course that lower tiers governments do in fact control their own resources within their respective jurisdictions.

---

[76] Written by Professor Paul Bernd Spahn.

[77] Australian Government Commonwealth Grants Commission, 2004 p.4.

A3.25   Differences in fiscal capacity reflect differences in the state of the economy. Obviously an affluent region benefits from a higher tax base to a greater extent than a poorer one. Taxable capacity may also be unevenly distributed due to statutory (tax is collected at firms' headquarters) or geographical reasons (local incidence of natural resource taxes).

A3.26   Fiscal capacity equalisation rests on the idea that public services should be reasonably comparable among regions irrespective of the state of their economy. So in some way this approach also equalises *private* incomes (respectively tax bases) indirectly through an equalisation of tax potentials, leaving the regions free to deliver public services once a financial level playing field is established. This type of grant is hence unconditional.

iii)   Expenditure needs equalisation

A3.27   Strictly speaking pure expenditure needs equalisation makes sense only if recipient authorities have no, or negligible, resources of their own. Otherwise a standard allocation of expenditures would benefit recipient governments that could co-finance these expenditures from their own resources compared to those that cannot. So normally this philosophy is rarely found in a pure form and some elements of fiscal capacity equalisation will typically sneak in. Nevertheless, a number of countries gear their equalisation systems predominantly toward the expenditure side in particular for providing resources to municipalities where these have few or small resources of their own.

A3.28   The assessment of expenditure needs must consider the legal framework of sub-national authorities' outlay responsibilities. As a rule these responsibilities are identical across governments at a given level (often excluding regions such as the capital district), which implies a symmetrical distribution rule of funding. Yet there are important exceptions to this rule where responsibilities are not uniformly assigned to regions: notably in the UK and in Spain. This makes a case for an asymmetrical distribution of funds. We shall dwell on the symmetrical case first.

Current outlays

A3.29   The principles guiding the Commonwealth Grants Commission of Australia are instructive. Their aim is to measure the effects of each recipient government's "disabilities" (reflecting their economic, geographic and demographic characteristics) on average expenses. The term "disability" is defined as "circumstances beyond the control of individual States that require a State to spend more (or allow it to spend less) per capita than other States to provide the average level of service".

A3.30   Disabilities can be broadly classified into two types - use disabilities and cost disabilities.

- *Use disabilities*. They are assessed by identifying particular users, for instance the number of students for schooling, the number of pensioners for old-age care, or the length of roads for road maintenance.

- *Cost disabilities*. They affect the cost per unit of service provided to particular groups of people or regions, for instance transportation costs might differ among urban and rural areas, or the costs of schooling might be higher for schools requiring smaller class size (diseconomies of small scale). Prices may also differ among regions, in particular the cost of wages and rentals.

A3.31   It is important to note that needs equalisation focuses on the provision of public services, not on private incomes. The latter is addressed only indirectly where lower tiers of government are responsible for social services and these services are reflected in the grants arrangements. Nevertheless, some countries attempt to include indicators relating to the state of the economy (such as the "degree of economic development",[78] e.g. unemployment or GDP/capita), which may not necessarily be consistent with a needs-based approach to equalisation where employment and regional development policies rest with the national government.

A3.32   In principle the same needs-based formulae can also be used in the asymmetrical case. Yet additional complexity derives from the fact that different expenditure responsibilities must be reflected in the grants. Of course, this could be effected by costing these services one by one, yet this may be difficult to measure and could lead to an exaggeration of costs. It could also risk open funding, which would bear on the budget of the donor government and could jeopardise macro economic stability.

A3.33   Two approaches can be identified to cope with asymmetries in expenditure responsibilities for equalisation: a segmentation of the resource pool by groups of recipients where members of a group have similar responsibilities; and closed funding by line items derived from the budget of the central government.[79] The Barnett Formula is of the latter type. However both strategies may fail, particularly over time, to provide adequate funding according to relative needs and cost criteria.

A3.34   Where grants are provided predominantly on the basis of expenditure needs criteria, the grants may be indeed be unconditional (as for the Barnett grants), but there could also be strings attached following a logic of equalisation by categories of needs. Often grants of this type are conditional, at least in part. This diminishes spending autonomy accordingly. Where outlay categories are broad and transfers are given in the form of block grants (such as for education or health, for instance) a certain degree of autonomy is preserved for micro-managing.

Capital outlays

A3.35   Where outlay responsibilities are recurrent (such as for education and health), it is relatively easy to design objective relative-needs indicators (such as number of standard students or patients). It is more difficult for capital spending and infrastructure development because of the often lumpy nature of these expenditures, which makes it difficult, if not impossible, to design a formula. Priority setting is highly political in this domain. Capital outlays might also entail the need for borrowing as a means of financing.

A3.36   The following classification is often useful in guiding discussion:

- *Centralised regional policy.* Where priorities for regional infrastructure development are set at the central level, there is generally no room for capital grants. Such grants may perhaps be suitable where the central government delegates the implementation of such investments to regional authorities. They then take the form of specific purpose capital grants.

---

[78] Some of these indicators also pose severe measurement problems, and they are controversial because they might entail moral hazard in the behaviour of regional governments.

[79] This is common practice when devolving new functions to lower tiers of government where these have previously been executed by the donor (funding) government. Yet it can only be used at a given point in time, and adjusting these grants to changing needs poses severe conceptual problems.

- *Cooperative forms of regional development.* Where decisions on regional infrastructure development are taken conjointly between the central and the regional governments, there may be a case for matching capital grants (co-financing). The European Structural Funds are a model in this instance. Priority setting may still be in the hands of the donor government, but potential recipient governments may also be involved.[80] This may require some institutional provisions for joint priority setting (such as the German Boards for the Joint Tasks).

- *Competitive bidding for funding.* The European Structural Funds (as all other potential donor governments) face a problem of competing claims for financing capital projects, given limited budget resources. This makes a case for competitive bids. Competitive bidding for funding capital projects is typically organised at the national level (usually within line ministries). Another prominent example is many of the so-called "categorical grants" of the United States Federal Government.

- Conversion into recurrent grants. Where investment projects are relatively small and/or tied to recurrent outlay functions (such as the construction of school buildings or hospitals), budget support can also be provided by converting the capital costs into a rental equivalent and include it in the general grant for recurrent outlay functions. This however generally entails the need to allow borrowing for financing new capital projects, and hence some fiscal autonomy. The revenue stream from the rental equivalent could then be used to service the corresponding debt. Few governments have adopted this solution although the Australian Commonwealth Grants Commission includes such types of investment in its grant assessments.

A3.37   Infrastructure development is obviously key to achieving a convergence of economic and social well-being in a country. This type of budget support is an important element in regional equalisation of economic opportunity.

International comparisons: overview of funding systems in countries that share similarities with Wales[81]

A3.38   The Barnett Formula has various characteristics to be compared with international practices: the formula (i) establishes a baseline for financing devolved functions; (ii) it determines the pace of development of the resources over time; and (iii) it has distributional consequences for the regions.

Establishment of a baseline

A3.39   Where central governments decide to devolve certain functions to regional or municipal governments, it is usual practice to start from budget lines of central spending ministries to determine the funding required for these functions. This is only possible where the local incidence of central expenditures is clear. Occasionally the devolution of funding is made through the transfer of payrolls (of teachers, say) plus some mark-up for additional costs, and, occasionally, through a full-fledged costing exercise. At its inception the Barnett Formula followed this universal approach in establishing a baseline. However in most other countries (except a few such as Spain or, where a phased approach is adopted, Serbia) devolution is symmetrical, so once the budget lines are

---

[80]   The need for matching resources at the regional level may also force national governments to step in, or even develop a national strategy for regional development, where own resources of regional authorities are wanting.

[81]   Written by Professor Paul Bernd Spahn.

transferred, any reference point for funding devolved functions is lost at the central level unlike in the UK where a substantial part of equivalent spending for England remains at the central level.

Evolution over time

A3.40   Usually the connection between devolved spending and the central budget is broken, unlike the case of the UK. So an attempt is made to match the baseline for outlays with the revenue side at sub-national levels. First it is examined what taxation powers can be transferred to regional or local tiers as own resources to partially fund devolved functions in order to enhance accountability. Typically property taxes, local business taxes, property transfer taxes, motor vehicle taxes, levies on water or electricity consumption, local regulatory charges and concessions (such as on construction, the use of local resources, including the environment), tourist taxes and user charges qualify for devolution because of their local character. Second any shortfall of revenue may then be addressed through revenue sharing on taxes, preferably those with a clear local incidence (such as income taxes or piggyback taxes on a national tax). Occasionally lower tiers of government are assigned such taxes in full, including policy and administration (e.g. Scandinavian countries). Such tax shares are fixed by legislation and are considered own revenue of devolved governments. Third instead, or in addition to, the aforementioned own resources, there are usually grants that mitigate remaining discrepancies between baseline expenditures and own resources. These grants come in two forms: unconditional revenue using an equalisation formula (based on standard needs and/or fiscal capacity) and hypothecated specific purpose payments (that may also follow appropriate needs indicators such as the number of pupils).

A3.41   The scale and growth of own revenue resources plus the residual grants then determines the financial envelope of regional governments over time, where the grants are typically tied to the buoyancy of resources at the central level in one way or another. So Barnett stands out in borrowing its dynamics on spending (per capita) from decisions at the central level, not from the development of own resources and grants received, which prevails in the fiscal arrangements of other countries.[82]

Distributional effects

A3.42   Barnett is also unusual in bringing resource allocations per capita to identical levels across the four countries of the UK over time, which is inconsistent even in the context of the UK itself because variations may persist among the regions in England. This "squeeze" is unusual in other decentralised countries where long-run relativities among regions are determined by the buoyancy and exploitation of their own resources, and by the equalisation formulae that operate through the tax sharing and grants arrangements.

---

[82]   An exception is perhaps Kosovo where the World Bank has insisted on a switch to tying grants to central expenditures in an effort to constrain total public spending at the national level.

Independent Commission on Funding and Finance for Wales

Overview

A4.1   This Annex provides additional information on the following:

   i)   the origins of the Commission;

   ii)   its terms of reference;

   iii) the relationship of the Commission to the Assembly Government;

   iv)   the Commission's reporting arrangements;

   v)   the membership of the Commission; and

   vi)   the appointment of the Commissioners.

Origins of the Commission

A4.2   The Commission was established by the Assembly Government in line with a commitment in "One Wales: a progressive agenda for the government of Wales". Specifically, One Wales states that:

> "There will be an independent Commission to review Assembly Funding and Finance, to include a study of the Barnett Formula, of tax-varying powers including borrowing powers and the feasibility of corporation tax rebates in the Convergence Fund region, including the implications of recent European Court of Justice Rulings in this area."[83]

Terms of reference

A4.3   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

A4.4   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.

---

[83] Welsh Assembly Government, 2007 p.6.

A4.5   The Commission is supported by a small secretariat of officials on secondment from the Assembly Government.

Reporting arrangements

A4.6   The Commission reports jointly to the First Minister, the Deputy First Minister and the Minister for Finance and Public Service Delivery.

A4.7   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

A4.8   **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.

A4.9   Mr Holtham's previous roles include:

- Director of the Institute for Public Policy Research, London;

- Head of General Economics Division at the Organisation for Economic Co-operation and Development, Paris;

- Fellow and Tutor at Magdalen College Oxford; and

- Visiting Fellow, Brookings Institution, Washington DC.

A4.10   **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.

A4.11   Professor Miles's previous positions include:

- Managing Director and Chief UK Economist at Morgan Stanley;

- Professor of Financial Economics at Imperial College;

- Chief UK Economist for Merrill Lynch;

- Department of Economics, Birkbeck College, London; and

- Bank of England.

A4.12   **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.

A4.13   Professor Spahn has worked with international organisations such as:

- International Monetary Fund;

- World Bank;

- United Nations;

- Organisation for Economic Co-operation and Development;

- Economic Commission for Latin America and the Caribbean;

- European Commission; and

- Council of Europe.

Appointment of the Commissioners

A4.14   The Chair of the Commission, Gerald Holtham, was appointed jointly by the three Ministers to whom the Commission reports. The other Commissioners, Professor David Miles and Professor Paul Bernd Spahn, were appointed by the three Ministers in consultation with the Chair.

A4.15   The Chair of the Commission was appointed in July 2008 and the other Commissioners were appointed in September 2008. The first meeting of the Commission was on 7 October.

From left to right:
David Miles, Gerald Holtham, Paul Bernd Spahn

Stakeholder Engagement

Overview

A5.1   In undertaking its work, the Commission has sought to engage with a wide range of experts and others with an interest in its activities. This Annex provides information on the following:

    i)   the Commission's website;

    ii)   the Commission's first call for evidence;

    iii)   engagement with the UK Government and the devolved administrations;

    iv)   engagement with other bodies reviewing the funding of the devolved administrations;

    v)   other contributors to the Commission's meetings.

The Commission's website

A5.2   The Commission has maintained a website at www.walesfundingreview.org where it has published:

- the submissions received in response to its call for evidence;

- answers to frequently asked questions;

- summary notes of its meetings;

- press releases referring to the Commission's work; and

- contact details for the Commission's secretariat.

The Commission's phase 1 call for evidence

A5.3   The Commission issued a call for evidence on 7th October 2008 and received responses from thirty-one individuals and organisations:

John Aldridge
Madoc Batcup
Bridgend County Borough Council
Dr. Gillian Bristow
Cardiff Council
Children's Commissioner for Wales
Martin Davies
Dyfed-Powys Police
Flintshire County Council
Professor James Foreman-Peck
Dr. Eurfyl ap Gwilym

Professor David Heald

Higher Education Wales

Institute of Revenues Rating & Valuation

Isle of Anglesey County Council

Professor Charlie Jeffery

Professor David King

Russell Mellett

Merthyr Tydfil County Borough Council

NAHT Cymru

NHS Trust Directors of Finance

Parliament for Wales Campaign

Dr. David Pickernell

Plaid Cymru

Society of Welsh Treasurers

Sustrans Cymru

Vale of Glamorgan Council

Wales TUC Cymru

Welsh Conservatives

Welsh Liberal Democrats

Welsh Local Government Association

In addition, Dr. John Ball submitted a copy of his monograph *"A strategy for the Welsh Economy"*[84] and Cymru Yfory - Tomorrow's Wales submitted a copy of its evidence to the House of Lords Barnett Formula Select Committee.[85]

A5.4   The responses were published on the Commission's website, from January 2009.

Engagement with the UK Government and the devolved administrations

Welsh Assembly Government

A5.5   The Commission has held a number of meetings with the First Minister, the Deputy First Minister and Minister for Economic Development and the Minister for Finance and Public Service Delivery, to whom it reports. The Commission has also met a range of officials from the Assembly Government.

UK Government

A5.6   The Commission met officials of HM Treasury in December 2008.

---

[84] Ball, 2008.

[85] Cymru Yfory - Tomorrow's Wales, 2009.

Scottish Government

A5.7   The Commission met the First Minister of Scotland, the Rt Hon Alex Salmond MSP, and officials of the Scottish Government, in February 2009.

Northern Ireland Executive

A5.8   The Commission met officials of the Northern Ireland Executive, in January 2009.

Engagement with other bodies reviewing the funding of the devolved administrations

Commission on Scottish Devolution

A5.9   The Commission met the Commission on Scottish Devolution, chaired by Sir Kenneth Calman, and also members of its Independent Expert Group, in February 2009.

House of Lords Ad Hoc Select Committee on the Barnett Formula

A5.10   The Chair had a private meeting with the Select Committee when the Committee visited Wales in March 2009. The parallel reporting timetables of the Select Committee and the Commission meant that it was not possible for the Commission to present formal evidence to the Select Committee.

Other contributors to the Commission's meetings

A5.11   The following experts were invited to meet the Commission to discuss aspects of the first phase of its work. Three round table sessions were held (in November and December 2008, and February 2009).

    John Aldridge, former Finance Director at the Scottish Executive.
    Professor Michael Artis, Swansea University.
    Professor David Bell, Professor of Economics, University of Stirling.
    Professor David Blackaby, Swansea University.
    Dr Gillian Bristow, Cardiff University.
    Professor James Foreman-Peck, Cardiff Business School.
    Paul Griffiths, Adviser to the Welsh Local Government Association.
    Dr Eurfyl ap Gwilym, Economic Adviser to Plaid Cymru.
    Professor David Heald, University of Aberdeen.
    Professor David King, Professor of Public Economics, University of Stirling.
    Guy Lodge, Institute for Public Policy Research.
    Professor Iain McLean, Nuffield College, University of Oxford.
    John Osmond, Institute of Welsh Affairs.
    Vanessa Phillips, Welsh Local Government Association.
    Alan Trench, Research Fellow, School of Law, University of Edinburgh.
    Professor David Ulph, School of Economics and Finance, University of St Andrews.

Priorities for phase 2

A6.1   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 in 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.

Abbreviations used in the report

AME	Annually Managed Expenditure
CSR	Comprehensive Spending Review
DCLG	Department of Communities and Local Government
DCSF	Department for Children, Schools and Families
DEL	Departmental Expenditure Limit
DfT	Department for Transport
EYF	End Year Flexibility
GVA	Gross Value Added
HCHS	Hospital and Community Health Services
IES	Identifiable Expenditure on Services
JMC	Joint Ministerial Committee
LSOA	Lower Super Output Area
NDR	Non Domestic Rates
NHS	National Health Service
ONS	Office for National Statistics
PCT	Primary Care Trust
PESA	Public Expenditure Statistical Analyses
PSNCR	Public Sector Net Cash Requirement
RDA	Regional Development Agency
RSG	Revenue Support Grant
SFP	Statement of Funding Policy
SHA	Strategic Health Authority

References and data sources

References

Australian Government Commonwealth Grants Commission (2004) "Report on state revenue sharing relativities, 2004 review"

Ball, J. (2008) "A strategy for the Welsh economy", Institute of Welsh Affairs

Bristow, G. (2009) "The Barnett Formula and its consequences for Wales: a literature review", report for the Independent Commission on Funding and Finance for Wales, Cardiff University

Commission on Scottish Devolution (2008) "The future of Scottish Devolution within the Union: a first report"

Cornwall Energy (2009) "The costs to consumers of electricity network charges: a comparison of the position at 1 April 2009 on 1 April 2008", grid charges 2009 paper for Consumer Focus, March 2009

Cymru Yfory - Tomorrow's Wales (2009) "Evidence from Cymru Yfory - Tomorrow's Wales to the House of Lords Barnett Formula Committee"

Department for Communities and Local Government (2008) "Statistical release: local authority revenue expenditure and financing"

Department of Health (2008) "Resource allocation: weighted capitation formula, sixth edition"

Heald, D. (1980) "Territorial equity and public finances: concepts and confusion", Studies in Public Policy number 75, Centre for the Study of Public Policy, University of Strathclyde, Glasgow

H M Treasury (1979) "Needs assessment study - report"

H M Treasury (1994) "Assessment of relative needs"

HM Treasury (2007a) "Funding the Scottish Parliament, National Assembly for Wales and Northern Ireland Assembly: Statement of Funding Policy"

HM Treasury (2007b) "Meeting the aspirations of the British people: 2007 Pre Budget Report and Comprehensive Spending Review"

HM Treasury and Welsh Assembly Government (2005) "Concordat between HM Treasury and the Welsh Assembly Government"

House of Commons Justice Committee (2009) "Devolution: a decade on"

House of Commons Treasury Committee (1997) "Session 1997-98 second report, the Barnett Formula"

House of Lords Liaison Committee (2008) "Second report of session 2007-08"

Hughes-Hallett, A., Peat, J., Scott, A., Sutton, L. and Zuleeg, F. (2008) "Options for Scotland's future - the economic dimension", The David Hume Institute, Occasional Paper No. 80

Independent Expert Group to the Commission on Scottish Devolution (2008) "First evidence from the Independent Expert Group to the Commission on Scottish Devolution", Heriot-Watt University

LE Wales (2009) "The use of needs based formulae in the allocation of public resources: literature review", report for the Independent Commission on Funding and Finance for Wales

McLean, I. (2002) "Fiscal federalism in Australia", Nuffield College Working Papers in Politics, 2002-W28

McLean, I., Lodge, G. and Schmuecker, K. (2008) "Fair Shares? Barnett and the politics of public expenditure", IPPR

OFWAT (2007) "Water and sewerage charges 2007-08 report"

Oxford Economics (2008) "Regional winners and losers in UK public finances"

Pickernell, D., Bristow, G., Kay, A. and Ryan, N. (2008) "The primacy of politics: intergovernmental fiscal relations in the UK and Australia", Public Money and Management, Volume 28, Issue 2, p.115-122

Scottish Government (2007) "Choosing Scotland's future: a national conversation: independence and responsibility in the modern world"

Scottish Government (2009) "Fiscal autonomy in Scotland: the case for change and options for reform: taking forward our national conversation"

Society of County Treasurers (2008) "SSI: a guide to the four block model 2008/09, 2009/10 and 2010/11"

Varney, D. (2007) "Review of tax policy in Northern Ireland", HM Treasury

Webb, D. (2007) "The Barnett Formula", House of Commons Library Research Paper 07/91

Welsh Assembly Government (2007) "One Wales: a progressive agenda for the government of Wales: an agreement between the Labour and Plaid Cymru Groups in the National Assembly"

Data sources

Department for Work and Pensions: Working age client group, Work and Pensions Longitudinal Study, via NOMIS

Department for Communities and Local Government: England Index of Multiple Deprivation 2004

Department of Health: Primary Care Trust Recurrent Revenue Allocation Exposition Book 2009-10 and 2010-11

HM Treasury: Public Expenditure Statistical Analyses (PESA) 2000/01 - 2008

Office for National Statistics: 2001 Area Classification of Super Output Areas: Standardised Census 2001 Source Data

Office for National Statistics: Annual Population Survey (APS)

Office for National Statistics: Annual Survey of Hours and Earnings (ASHE) 2008

Office for National Statistics: Census 2001

Office for National Statistics: Labour Force Survey (LFS)

Office for National Statistics: Mid-Year Population Estimates

Office for National Statistics: Regional accounts

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 6).

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.

By email:

Holtham.Commission@wales.gsi.gov.uk

By post:

Gareth Morgan
Secretary
Independent Commission on Funding and Finance for Wales
Room 2-017
Crown Buildings
Cathays Park
Cardiff CF10 3NQ

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.