

Wales in a Changing Union

First submission to the Silk Commission from the Changing Union Partnership Finance and Funding Working Group

1 Introduction

We very much welcome the establishment of the Silk Commission and are grateful for the opportunity to present evidence to the Commission. We hope that this first submission from our Working Group will contribute constructively to Commission's work, and that our project team will be able to collaborate productively with the Commission. At this stage many of the issues we have raised will require further research, analysis and debate but feel that our submission raises issues of general principle that will need to be urgently addressed by the work of the Silk Commission. We intend to make further submissions in the light of our own research and discussions and developments in the public debate throughout the UK.

2 The 'Changing Union' project

The 'Changing Union' project is a collaboration between three leading organisations in Wales with the aim of overcoming the disconnected nature of the debate on constitutional matters in the four countries of the UK. It is a large-scale initiative that we feel is both necessary and opportune at this point in the asymmetric development of the United Kingdom's constitutional landscape, and when even more momentous possibilities may emerge from developments in Scotland.

It is a three-year project funded by the Joseph Rowntree Charitable Trust. The three partner organizations are the Wales Governance Centre at Cardiff University, the Institute of Welsh Affairs and Tomorrow's Wales/Cymru Yfory, a cross party, cross sector group established in the wake of the 2004 Richard Commission to promote better governance arrangements for Wales.

The project will aim to overcome the disconnected nature of the debate on constitutional matters in the four countries of the UK - separate debates in which the implications of change in one place upon the other countries or upon the whole are rarely considered. It will provide an overview of the constitutional possibilities for the future of the Union, set against the backdrop of the promised referendum on Scottish independence, as well as a context in which to consider the future of the constitutional settlement in Wales, now being reviewed by the UK's government Commission on the same lines as the Calman Commission in Scotland.

We believe that Wales is well placed to moderate a debate amongst opinion-formers from all four countries, given its particular location on the devolution journey, and the fact that its distinct national identity and governance arrangements sit alongside an intense connectedness with England. Wales has a particular contribution to make to the re-imagining of relationships in these islands.

There are three work strands in the ‘Changing Union’ project:

- I. **Forum on the Changing Union:** Creation of a forum to be led by the Wales Governance Centre, tracking and informing the constitutional debate as it develops from 2011 to 2014, and identifying options for the UK’s constitutional future and their consequences. This will draw together a wide range of opinion-formers, including academics, politicians and other practitioners.
- II. **The Silk Commission:** Engaging with the Commission that is currently examining the fiscal powers of the National Assembly and Welsh Government, as well as the current constitutional settlement for Wales more generally, between September 2011 and March 2013. This will be done through three work groups on i) legal aspects and jurisdiction, ii) finance and funding, iii) accountability and scrutiny. These will generate outputs that will give Welsh civil society a solid information base to consider the questions that are before the commission, as well as supplying direct evidence to the commission itself.
- III. **Dissemination and debate:** As well as a planned programme of regular publications during the course of the project, we are engaging with wider civil society in Wales and the other nations of the UK in the debate. We are establishing partnerships with a national newspaper, with organisations involved in education in citizenship, as well as with organisations with common aims elsewhere in the UK. Throughout the process we are communicating with engaged elements in civil society and also extending this to the wider public and especially to young people through the extensive use of online techniques and the establishment of a Youth Forum.

3 Terms of reference of Silk Commission

We very much welcome the work of the Silk Commission and its remit, in undertaking part I, to:

“provide independent advice on the case for improving the financial accountability of the National Assembly for Wales consistent with the fiscal and constitutional framework of the United Kingdom;

consult widely on a package of fiscal powers which would improve the financial accountability of the National Assembly for Wales;

make recommendations on whether a package of fiscal powers could be devolved to the National Assembly for Wales which are likely to have a wide degree of support;

and consider and make recommendations on how best to

resolve the legal and practical implementation issues from devolving a package of fiscal powers, including consistency within the United Kingdom.”

We note however that the Commission will not be considering, in its work, *“the Holtham Commission's proposals for funding reform in Wales, including Welsh Ministers' existing borrowing powers, which are being dealt with through a separate bilateral process between the United Kingdom Government and the Welsh Government.”*

In our view this is a regrettable exclusion that will hinder the Commission in the necessary task of taking a holistic view of finance and funding. If the purpose of the Commission is to seek an improvement in accountability, it must be in a position to compare any new proposals with the status quo. It must, therefore, take a view of the status quo and known proposals for reforming it.

There is a second reason why the Commission needs to consider Barnett. You have been asked to identify, if possible, a package of fiscal powers “which are likely to have a wide degree of support”. We see no prospect of establishing a consensus in favour of tax-varying powers in Wales without a parallel reform of the Barnett formula. Some consideration of Barnett is, therefore, necessary for the Commission to discharge that particular consensus-seeking part of its remit.

We would, therefore, urge the Commission to consider the existing substantial body of evidence that the current system for funding the devolved administrations - the Barnett formula - is inequitable, particularly for Wales. In our view the current system does not fulfil the commonly agreed set of principles which underpin any equitable, transparent and accountable system for funding for sub-national, regional or provincial level of government.

This submission will restate some of this powerful evidence as well as the principles by which any level of sub-national or devolved government funding should be judged.

4 Principles of fiscal autonomy for funding devolved government

There is a widespread consensus that any system of fiscal autonomy for funding devolved government should be founded on clear principles.

The Calman Commission was established by the Scottish Parliament in 2008:

“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.”

The **Calman Commission** presented its final report in June 2009 and proposed six principles for funding devolved government. These principles

were subsequently endorsed by the Independent Commission on Funding and Finance for Wales, known as the **Holtham Commission**. The latter was set up by the then Welsh Assembly Government to look at the present Barnett formula and the distribution of public funding to the Welsh Government and to identify possible alternative funding mechanisms, including tax varying and increased borrowing powers. The Holtham Commission published its a final report: 'Fairness and accountability: a new funding settlement for Wales' in July 2010 and summarised the six principles as:

- I. **Stability/Predictability:** so that public spending can be managed properly
- II. **Simplicity/Transparency:** so that it is readily implemented and the justification is evident
- III. **Autonomy:** so that the sub-national government can decide how to allocate its resource
- IV. **Efficiency:** so that economic distortions created by incentivising movements of people and the factors of production simply to avoid taxes are avoided
- V. **Equity:** so that resources are allocated in a way that takes account of relative need, making it possible to provide a standard level of service in all parts of the UK
- VI. **Accountability:** so that 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.

These core principles were also supported by the **Steel Commission**, established by the Scottish Liberal Democrats and chaired by Lord Steel of Aikwood, former Presiding Officer of the Scottish Parliament, which reported in March 2006. The remit of the Steel Commission covered a wide range of issues regarding the future of the Scottish Parliament and developed proposals for "a new modern settlement for the United Kingdom," which included an examination of the fiscal principles they believed should underpin any new constitutional arrangement. The **House of Lords Select Committee** on the Barnett Formula also proposed a very similar set of principles. (para. 88)

We believe strongly that any fair, transparent and accountable system of funding for devolved government in the UK should seek to strike an appropriate and judicious balance of all these principles

5 Critique of the Barnett Formula

The current Barnett formula while fulfilling some of the above principles - for example, simplicity and respect for autonomy - fails to uphold others.

The current formula is not equitable because it is essentially a population-based system that does not take account of Wales' relative need. Neither does it fulfil the requirement for optimum accountability, as there is no link

between spending decisions made by devolved government and the revenue that is raised by the UK Government. Following this logic, both the Calman and Holtham Commissions were convinced that applying the principle of accountability justified tax-varying powers for devolved government on the basis that a body spending public money should be responsible for raising at least some of it.

In the case of Wales, however, we believe strongly that any change to the existing funding arrangements, including a grant of tax-varying powers to the Welsh Government, must necessarily include a reform of Barnett founded on a needs-based formula. Not to do so would, in our view, leave Wales with inadequate funding for its demonstrable needs, would not address the well-evidenced inequity in the current system and therefore fail to adhere to the principles that are commonly agreed.

Since the establishment of devolved government in Wales, Scotland and Northern Ireland in 1999, there have been several wide-ranging reviews of the existing constitutional settlement, including its fiscal arrangements. A great deal of background work on the issues being covered by the Silk Commission has been undertaken in this series of reports and commissions, including:

- The Richard Commission on the Powers and Electoral Arrangements of the National Assembly for Wales, appointed by the former First Minister in 2002, which reported in the Spring 2004
- The Steel Commission (March 2006.)
- The Calman Commission (June 2009)
- The House of Lords Committee on the Barnett Formula, Chaired by Lord Richard (July 2009)
- The Holtham Commission (Final report, July 2010)

The Richard Commission

Appointed by Rhodri Morgan, the former First Minister in 2002, and chaired by Lord Ivor Richard, the Commission reported in the Spring 2004. While examining the fiscal arrangements of the National Assembly was not the main focus of its work, Richard did recommend that, if the Assembly was to acquire primary legislative powers, it would be *“desirable, though not essential, to confer tax-varying powers.”* The Commission however stated that it was not in a position to evaluate *“alternative methodologies for calculating the devolved Budget”* or their implications for Wales.

House of Lords Committee on Barnett

The House of Lords Select Committee, also chaired by Lord Richard, while accepting that the Barnett formula had advantages of simplicity, stability and the absence of ring-fencing, described it as 'arbitrary and unfair' and his committee recommended it should be replaced by a system that recognised the differing economic needs of the devolved nations. The report said,

“We find the argument that devolution funding should be based on relative need to be a compelling one. Public

spending per head of population should be allocated across the United Kingdom on the basis of relative need, so that those parts of the United Kingdom which have a greater need receive more public funds to help them pay for the additional levels of public services they require as a result.” (para 81)

The committee also recommended that

“if the existing formula is to be replaced or reformed, any alternative must represent an improvement on the current system.” (para 51)

Calman Commission

The Calman Commission argued that, while the present funding system had got devolution “off to a good start”, it had major shortcomings. In particular, because so much of the budget derives by grant from the UK Parliament,

“the Scottish Government and Parliament were [not] accountable to the Scottish electorate for how revenue is raised in the same way that they are for how it is spent.” (Executive Summary, 24)

As a consequence, Calman proposed that part of the Scottish Parliament’s Budget

“should now be found from devolved taxation under its control rather than from grant from the UK Parliament. The main means of achieving this should be by the UK and Scottish Parliaments sharing the yield of income tax.” (Recommendation 3.1)

Nevertheless, Calman argued that even if the Scottish Government was to have tax-varying powers, there was an overwhelming case for the block grant from the UK Government to remain:

“supporting the social Union through pooled taxation makes it clear that need is the principle which must justify block grant funding. The present system of calculating block grant by the Barnett formula is not well related to need.” (para 3.86 Final report)

For the UK block grant to continue, Calman accepted that it should in future be calculated on an assessment of need,

“as the means of financing most associated with equity, (it) should continue to make up the remainder of the Scottish Parliament’s Budget but it should be justified by need. Until such times as a proper assessment of relative spending need across the UK is carried out, the Barnett formula, should continue to be used as the basis for calculating the proportionately reduced block grant.” (Recommendation 3.4)

Holtham Commission

Like Calman, the Holtham Commission also accepted the case for greater fiscal autonomy and accountability, and recommended that the Welsh

Government should acquire some revenue raising powers. Like the House of Lords report, Holtham also argued persuasively that the Barnett formula was flawed. In its first report, the Holtham Commission concluded that the way the Barnett formula had operated in Wales had not fulfilled all the principles of fiscal autonomy for devolved government. In particular, it been inequitable and Wales had experienced a degree of under funding as a result.

The Commission proposed that

“the Barnett Formula lacked any objective justification.... (and) as a direct result of the formula, the relative funding per capita for devolved activities in Wales has converged markedly towards the average level of funding in England over the past decade for reasons that have nothing to do with the relative needs of Wales. We found that this process of relative decline (the so-called “Barnett squeeze”) has caused the funding of devolved activities in Wales to fall below what Wales would receive were its budget determined by the various formulae that the UK Government uses to allocate resources to comparable functions in England. If the Barnett Formula remains in place, this convergence will continue over the medium term, with the funding of devolved public services in Wales moving ever closer to the average English level of funding per capita, irrespective of higher Welsh relative needs.” (Final Report 1.12)

As a result of the operation of the ‘Barnett squeeze’ one of Holtham’s main recommendations was that

“in order to establish a fair and rational basis for determining the size of the Welsh block grant, the Commission recommended that in the medium term the funding arrangements for Wales should be based on relative needs. However, we also acknowledged that this could take time.”

The Holtham Commission reported in 2010, using 2008 figures, but nevertheless found that using the ‘English’ needs-based formula, Wales should get between 114% and 117% of the English per capita expenditure, compared with a then-current 112%. Wales therefore received about £400 million per annum less than from an equitable needs-based formula.

The Commission, using the same needs-based formula, calculated that Scotland should get about 105% of the ‘English’ level but was actually receiving 120% of ‘English’ expenditure. Consequently, Scotland currently receives about £4 billion a year more under Barnett than it would from a needs-based formula.

The Holtham Commission argued persuasively that a needs-based analysis based on a small number of objective indicators or ‘need proxies’ was *“able to explain over 95% of the variation in funding across sub-regions of Wales, England and Scotland.”* (3.21 Final Report)

These were

- i) number of children under 16

- ii) number of retired people
- iii) percentage of the population claiming benefits
- iv) percentage of the population with long-term illness
- v) population sparsity
- vi) London weighting.

Recognising the political difficulties of getting agreement amongst the four governments in the UK, as an interim measure, the Commission recommended

“a simple modification to the existing formula that would place a “floor” under the block grant at a level indicated by English needs formulae and would prevent any further convergence, pending wider reform.” (Final Report 1.13)

Steel Commission

Holtham, Calman and the House of Lords reports were all written from an explicitly unionist perspective. The Steel Commission, established by the Scottish Liberal Democrat party, was also unionist in its assumptions and beliefs but also explicitly federalist. Like the Calman Commission, Steel proposed that Scotland should have greater revenue raising powers, although it recognised that under any new system of what they termed fiscal federalism, the people of Scotland would continue to pay taxes which are set and collected by the UK Government. The Commission believed this was to the benefit of all areas of the United Kingdom.

Like other commissions, the Steel Commission proposed that one of the principles of fiscal autonomy should be equalisation on the basis of need. The Commission therefore argued strongly for the view that equalisation of need is an important part of the Union and that a new needs-based system would benefit the whole of the UK in the long term. As a consequence the Commission recommended that

“fiscal federalism should be based on an equitable distribution of resources between different parts of the country based on their respective needs.”

The Steel Commission also proposed that any needs-based formula should take a similar range of objective indicators into account. The House of Lords Committee on Barnett formula also found compelling the argument that funding devolved government should be based on relative need and recommended that *“Public spending per head of population should be allocated across the United Kingdom on the basis of relative need, so that those parts of the United Kingdom which have a greater need receive more public funds to help them pay for the additional levels of public services they require as a result.”* (para 81)

Independent adjudication of the operation of Barnett

One of the most consistent recommendations of the various commissions that

have reviewed the fiscal arrangements in a devolved UK is that some form of arms-length body be set up to oversee the funding arrangements. This would be to ensure greater transparency in the administration of any devolved fiscal system, its funding formula and the allocation of revenues.

The Calman Commission recommended that a Finance Commission of the Nations and Regions should be established between the United Kingdom and the devolved administrations. Holtham made a similar recommendation which, it said, would also reduce 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 HM Treasury and the Assembly Government.” (A2.7, page 126 Final Report)

The House of Lords Committee on Barnett criticised what it saw as the opacity of the present system in which:

“on every funding decision the Treasury is judge in its own cause, including whether to bypass or include any expenditure within the application of the Barnett Formula.”

Consequently, the Committee, like the Calman and Holtham Commissions strongly recommended the establishment of

“an independent body, similar to the Commonwealth Grants Commission in Australia should be established in the United Kingdom. It should be the role of such a body to recommend the allocation of public monies based on population and through a new needs-based formula.” (Para 73)

6 Implications of changes deriving from a Scottish referendum

As Carwyn Jones, First Minister of Wales has pointed out recently, the holding of a referendum and the prospects of Scotland seceding from the Union has transformed the political landscape across the UK, not least in Wales. The current context is now very different from the one that faced the Calman, Steel and Holtham Commissions and the House of Lords Committee report.

Wales now has to address the implications of events beyond its boundary and beyond its control. The Commission’s task of assessing the merits of fiscal devolution to Wales in terms of improved accountability now seems unnecessarily narrow. There is now a pressing need to assess the wider constitutional and fiscal implications for Wales of the different scenarios that could arise in the wake of the Scottish referendum. The Commission should evaluate these implications in detail.

In considering these issues there are, of course, significant uncertainties deriving from the possibility that the Scottish referendum may, in addition to the question on independence, also ask another question on the electorate’s views on full fiscal autonomy or, as it has been called, devolution-max. The uncertainty arises, first, because the UK Government and other political parties have not agreed to this suggestion by the Scottish Government and, second, because terms such as ‘full fiscal autonomy’ and ‘devo-max’ have not been clearly defined.

Fiscal autonomy will vary according to the balance between devolved and reserved revenue raising powers and funding sources. As the Steel Commission pointed out, *“in its academic sense, fiscal autonomy is essentially a sliding scale ranging from full fiscal autonomy to the current position (in Scotland) of limited autonomy through limited tax varying powers.”* The Steel Commission further argued for *“the artificial debate on fiscal powers to move forward into the real world”*.

a. Full fiscal autonomy

There appears to be little or no clarity on what is meant by full fiscal autonomy and how it differs from independence. As the Steel Commission pointed out, there was a great deal of public confusion in the debate on fiscal autonomy in 2006. There is little evidence that public understanding of this crucial issue has improved and we feel strongly that the work of the Commission and of our own ‘Changing Union project’ have a crucial role to play in increasing the level of public awareness and debate.

Under full fiscal autonomy a devolved government would raise and retain all the taxation it raised. In the case of Scotland, it would then be for the Scottish Parliament to agree with the UK Government what services, if any, should be shared and to agree to remit an amount to Westminster to pay Scotland’s share of these services.

The confusion that arises about the meaning of full fiscal autonomy and ‘devomax’ arises partly because the Scottish Government has not defined what it means by the latter. In its submission to the Calman Commission, ‘Fiscal Autonomy in Scotland: the case for change and options for reform’ (Scottish Government, 2009) the Scottish Government proposed the following:

*“**Devolution max** - full fiscal autonomy within the UK - would make the Scottish Parliament and Scottish Government responsible for raising, collecting and administering all (or the vast majority of) revenues in Scotland and the vast majority of spending for Scotland.”* (para 4.22)

*“**Independence** - Independence - full fiscal autonomy - would see Scotland with the same responsibility for fiscal and economic policy as other, similar countries.”* (para 4.26)

While full fiscal autonomy therefore may appear on the surface to offer a straightforward and apparently easily understood proposition, the Steel Commission rejected full fiscal autonomy in this form.

“Rather than being a simple concept, it is a simplistic concept. Time and again academic studies on fiscal autonomy have concluded that full fiscal autonomy does not operate in any industrialised country.”

The Commission, taking a federalist position, opposed the proposition on the grounds that that such a system of full fiscal autonomy effectively rejects any real role for a wider UK state. Steel also quoted evidence that such a system of full fiscal freedom falls foul of the problems of equity, and furthermore risks problems of tax exportation and movement of production if it fails to take place within an agreed UK framework. As a consequence, Steel believed it did

not fulfil the principles that should govern fiscal autonomy for devolved government

As could be expected from a Commission adopting a unionist and federalist position, Steel made a trenchant criticism of the concept of full fiscal autonomy, saying it is supported:

“by those who want to make the case for independence and the destruction of the United Kingdom - but who want to wrap it up in comfortable-sounding language. Full fiscal autonomy (also known as fiscal freedom) is, in fact, no more and no less than a Trojan horse for independence.”

In a recent article for the Institute of Welsh Affairs, Gerald Holtham made some estimates of the impact of fiscal autonomy for Scotland. In it he looked at various scenarios, depending on the share of any oil revenues Scotland might receive from the UK Treasury, and also the state of the economy.

He suggested that, based on pre-recession figures from the Government Expenditure and Revenue in Scotland statistics (GERS) for 2007-8, and if Scotland received its geographical share of North Sea oil in a good year with high oil prices, Scotland would have a net deficit of £3.7 billion (2.6% of GDP). With estimated revenue equalization grant of between £2-3 from UK Treasury, its position would be little different from its current position under the Barnett formula. This estimate is based on high oil prices and buoyant economic conditions. With North Sea oil production and consequent revenues set to decline, current estimates might not be a reliable guide to future tax income for the Scottish Government and Holtham argues that if recession is prolonged and the oil price declines, Scotland could be a great deal worse off.

Holtham suggests that figures for Wales comparable to Scotland's GERS do not exist, and therefore any estimates for Wales are much less dependable. But in his commission's own estimate Wales would lose out compared with the current situation.

The Holtham Commission estimated that in 2007-08 total identifiable expenditure in Wales was about £25 billion, exceeding Welsh tax receipts by £6 billion. This represented a fiscal deficit of 10% of Welsh GDP, although he suggests this gap would have more than been made up with a possible revenue equalisation grant of £27.5 billion from the Treasury based on 5% of UK population share. However, he also points out that under full fiscal autonomy Wales would presumably have also had to pay extra contributions towards UK-wide expenditures, on defence, foreign policy and debt service.

b. Taxation

As pointed out previously the Calman and Holtham Commissions both supported the argument that proper accountability required governments to be responsible for raising at least a proportion of the money that they spent.

In applying this principle, the Holtham Commission suggested that in Wales only three taxes raise significant revenues: VAT, National Insurance and Income Tax, two of which are problematic in terms of devolution.

With VAT, it is against EU law for single nation states to have to have different rates within their borders. Variable VAT rates would also lead to cross-border

smuggling.

National Insurance is seen by most of the population as part of the welfare system, with people making National Insurance contributions to earn future benefits of some kind. Consequently, as the benefit system is not devolved it would not make sense to devolve the National Insurance system as well.

This would leave Income Tax as the most significant source of potential revenue although, as the Holtham Commission suggested, there are other minor taxes that could be devolved to give the Welsh government some more policy levers.

But what is clear and uncontested, is that Wales would be worse off under any combination of devolved taxation powers, unless it were also buttressed by the retention of a needs-based expenditure equalization system - i.e. a reformed Barnett formula. Without this the situation would not conform with the principle of equity. Nevertheless, we accept that responsibility for raising revenue as well as spending it will improve accountability because it is likely to change the mindsets of governments and individual ministers by making them aware of the tax base that they are dealing with. This awareness is likely to be even more acute at the Welsh level than at the UK level.

We believe that discussion of the devolution of taxation powers to Wales has tended to be avoided because of a consciousness of Wales's low taxation base. But the relative poverty of Wales should not preclude some devolution of revenue raising powers. After all, at local council level even the poorest local authority or community council still levy rates.

We would therefore argue that the issue for Wales is one of securing revenue resources sufficient to meet its needs. Given the current state of its economy this cannot come solely from taxes within Wales, neither is it likely to be met from a system of revenue equalisation only.

Consequently, for the foreseeable future Wales will require a combination of self-generated taxation revenues plus sufficient other additional fiscal transfers to achieve an equalisation of expenditure based on a calculation of need. Without this any funding arrangement is likely to fail the test of equity.

As we have proposed strongly earlier in this paper, expenditure equalisation should be on the evidenced basis of need - as is currently practised in the allocation of public expenditure across England - and therefore must be extended into the working of the Barnett formula. We have therefore concluded that a combination of taxation powers and a reformed Barnett formula would be the best available path both to improved accountability and achieving consensus in Wales.

c. Borrowing powers

The Holtham Commission makes a persuasive case for the Welsh Government to have borrowing powers to finance capital expenditure.

At present the Welsh budget is divided into separate capital and revenue budgets. The capital stream is determined on the basis of capital expenditure in England. Spending in England on capital projects generates capital

consequentials for Wales, just as revenue spending by UK Government departments in England leads to revenue consequentials for the Welsh Government.

Welsh Ministers are allowed to transfer funds from revenue to capital but cannot move funds from capital into revenue without the consent of the UK Treasury. As the Welsh Government's budgets are set within the three-year time horizon of the UK Government Spending Reviews, Welsh Ministers have certainty about funding the Welsh Government's capital programme for only a limited period. Yet these capital programmes are planned over much longer periods than three years, typically over a 10-20 period. As Holtham points out:

“this lack of forward visibility, combined with the occasional need to contemplate projects that are large relative to the annual budget, can complicate investment planning.”

The main argument for borrowing powers is that at any one time there will be desirable capital projects of a very large scale, but where the investment profile over a relatively short period effectively makes them unaffordable for Welsh Government. Holtham cites the example of a new stretch of the M4 south of Newport where planning started in the late 1990s, the project was given the go-ahead by Welsh Ministers in December 2004, but was cancelled in 2009 because it was deemed unaffordable. The project's cost in 2006 prices was £670 million, compared with the Welsh Government's annual capital budget in 2010-11 of £1.7billion.

As Holtham pointed out, at present similar rules apply in Scotland. The Calman Commission recommended providing Scottish Ministers with the ability to borrow up to a certain limit to fund capital expenditure. Under these proposals, Scottish Government borrowing would be undertaken via the Debt Management Office (DMO). The former UK Government accepted the case for Scotland to be given limited borrowing powers along with an enhanced ability to vary taxes, with the proviso that any borrowing would have to be self-financed by setting Scottish taxes above those of the UK.

The situation in Northern Ireland is different, with the Executive carrying out functions that are undertaken by local councils elsewhere in the UK. As such it already has limited borrowing powers, which were acquired under the 2002 Reinvestment and Reform Initiative. Under this arrangement, the Executive gained access to additional capital expenditure funded by borrowing from the DMO. Borrowing was limited to £125 million in 2003-04 and £200 million per annum thereafter.

As a consequence of the limitations faced by the Welsh Government and the precedent set by Scotland and Northern Ireland the Holtham Commission believed the present restrictions on the Welsh capital budget are unjustifiable. (Final Report 8.25) The Commission therefore recommended limited powers to borrow in order to finance capital expenditure should be devolved to Welsh Ministers: (Final Report A1.15)

Holtham suggested that borrowing should be undertaken via the Debt Management Office (DMO), and that a borrowing framework should be agreed between the Welsh Government and HM Treasury, and a ceiling should be placed on the total amount of debt that the Welsh Government

should be able to carry. (Final Report A1.16)

Lastly, the Commission recommended that the current overdraft facility of £500 million available to the Welsh Government, combined with a rollover facility enabling deficits to persist beyond the financial year-end, would be sufficient to deal with the additional volatility arising from its preferred approach to income tax devolution. (Final Report A1.17)

In the final report the Commission argued that the case for borrowing powers was stronger once tax-varying powers are devolved to the Welsh Government. If that happened then Welsh Government would have its own source of revenue that would provide additional reassurance about its ability to repay borrowed funds. (Final report 8.24) We believe that this adds to the argument we have made previously in this paper that if the Welsh Government was to acquire tax-varying powers, subject to reform to the Barnett formula along a needs-based system, then a source of revenue to secure repayment of any borrowing would then exist. This ability to borrow should also extend to the issuing of bonds.

d. Government debt

Given the current economic situation, especially in the Eurozone, the recent banking crisis and the subsequent ballooning of Government debt in the UK and more widely, there has been increasing debate about the impact this debt might have on a post-referendum Scotland, and indeed Wales.

As Martin Wolf in a recent Financial Times article has pointed out, an independent Scotland would very likely inherit its population share of UK net public debt, forecast by the UK Treasury to peak at 71% of GDP in 2013-14. Wolf argued thus:

“A newly independent small country with sizeable fiscal deficits, high public debt and reliance on a declining resource for 12% of its fiscal revenue, could not enjoy a triple A rating. Its costs of borrowing might be far higher than those of the UK. To avoid the risk, it would need to lower its debts quite rapidly. This would require even greater austerity than in the UK as a whole.” (Financial Times, 20.1.12)

It is likely that the burden of this extra austerity would fall on public spending. As the Scottish economy is heavily integrated with that of the rest of the UK, it would be extremely difficult for Scotland to have higher tax rates than the rest of the UK. The risks that Wolf cites are clearly present but no-one at this stage can be sure how severe these might be.

e. Monetary policy

Another key factor affecting the outcome of the referendum in Scotland would be the implications for monetary policy. Recent economic history in the European Union has shown the challenges for independent states of being within a single monetary union. The Scottish Government suggests that Scotland would want to remain within the sterling area. However, this would also have to be decision for the UK Government and not be one the Scottish

Government could take on its own. Scotland could adopt sterling as its currency, however it could not ensure that the Bank of England, the currency's central bank, takes responsibility for its financial stability by acting as lender of last resort. In this instance the usual mechanism is that a currency board pegs domestic currency (i.e. Scottish Pounds) to the anchor currency (i.e. Sterling) by issuing domestic currency only for the anchor currency reserves it has in its vaults. There are about 16 states around the world that do this.

Without access to the Bank of England, neither the Scottish Government nor its banks would have the Bank of England as a lender of last resort. As has been seen in the Eurozone recently this has had toxic effects on the ability of governments to manage their finances and economies.

If, on the other hand, Scotland were to use the Bank of England as its central bank, the Bank would impose conditions on its fiscal policy, i.e. the UK Government would be overseeing Scottish Government's fiscal management. In effect, the Scots would be using a 'foreign' currency without a central bank, in which case Scottish independence would be severely constrained.

It has to be said that we should not underestimate the pressures there would be on both Scotland and the remainder of the UK to collaborate for mutual benefit.

7 Recommendations

In conclusion, we once again welcome the opportunity to engage with the Silk Commission in its very important work. We are aware that many of the issues we have raised will require further consideration but offer this paper as a constructive contribution to the crucially important debate on the future of the Union, and in particular the future for Wales. This paper covers what we consider to be issues of general principle and we would therefore welcome the opportunity to make a further, more detailed submission to the Commission. In summary therefore, we make the following initial recommendations:

1. That retention of an unreformed Barnett formula system of funding the Welsh Government is not an option, whatever the outcome of a Scottish referendum.
2. That pending a full reform of Barnett, the Government should place a floor under the Welsh block grant to ensure that the convergence mechanism does not reduce expenditure in Wales below that of the poorest English region.
3. That the Commission should consider the case for reform of Barnett, along lines recommended by the Holtham Commission, as an essential ingredient in establishing a consensus on fiscal powers in Wales.
4. That the Commission should demand the creation of a Welsh version of GERS/Revenue and expenditure to give a firm basis to its recommendations.
5. That the Welsh Government be given borrowing powers, that are not confined to loans from the DMO, but also include a capacity to issue bonds within an agreed overall framework of borrowing.

6. That cash management of the Welsh Government's funds should be devolved in order to encourage the efficient use of public funds, and avoiding unnecessary repeated friction around year-end adjustments.
7. That the Commission should liaise with Scottish Government and others to obtain a clearer understanding of what is meant by full fiscal autonomy or devo-max.
8. That the Commission should explore the implications for Wales of the possible outcomes of the referendum in Scotland, as outlined in this paper.