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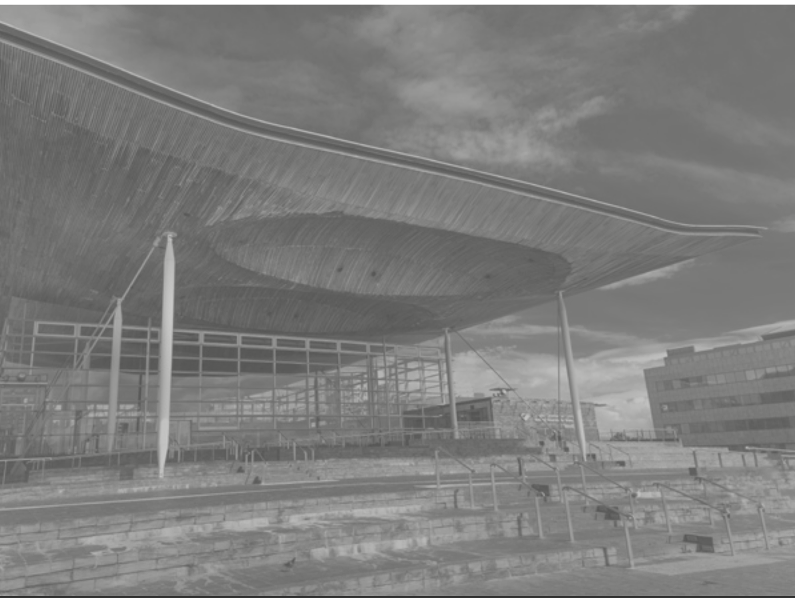

Fiscal Firepower: Effective Policy-Making in Wales

An assessment of the Welsh Government Fiscal Framework's impact on policy making with a focus on borrowing powers

About the author

Harry Thompson is the IWA's Economic Policy Lead, with his work aiming to contribute to the IWA's mission of a successful, clean, green and fair economy for Wales. Prior to joining the IWA he worked in a variety of political and policy roles at local authority, Westminster and Senedd level.

About the IWA

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IWA – Institute of Welsh Affairs, Room 6.01,
sbarc | spark, Maindy Road, Cardiff CF24 4HQ
tel: 029 2048 4387
email: info@iwa.org.uk
www.iwa.wales

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Contents

Executive Summary & Recommendations

Wales faces urgent challenges including climate change, a cost-of-living crisis, dealing with the fallout of the Covid-19 pandemic, a broken housing 'market', and more.

The IWA is concerned that despite the Welsh Government having fairly sweeping powers and a budget in the tens of billions, this belies a lack of 'fiscal firepower', with much of its budget essentially being pre-committed to public service delivery, and little available finance over-and-above that needed for public service delivery to effectively deliver major projects that could set the Welsh economy and society on the different path it clearly needs.

The correct way to assess the fiscal framework is the scale of the challenges at hand and the ability of government to deal with them. Wales has had not only power devolved to it but responsibility, too. The comparison should therefore not only be with other nations or sub-state governments, but rather with the ability of the Welsh Government to address these challenges. We find in this report that the Welsh Government is restricted in its ability to do so. This paper addresses reform to borrowing powers, a fairly simple mechanism that could mitigate this issue, but not the end of the journey.

The IWA has undertaken desk-based research and interviews with experts in order to examine how Wales' fiscal framework was developed, its impact on devolved policy-making, and the potential for borrowing powers to give the Welsh Government more 'fiscal firepower' in a way that is fair to the rest of the UK by making all repayments out of its own future budgets.

We have found that a lack of 'fiscal firepower' makes it difficult for the Welsh Government to fully execute its devolved responsibilities – with the Covid-19 furlough scheme and its impact on the ability of the Welsh Government to execute public health policy a high-profile example. We also argue that the removal of around £300m of European funding from the Welsh Government (now controlled instead at a Westminster level with Local Authorities submitting bids), which represented funding twice that of the Welsh Government's annual borrowing limit, has made this situation more urgent.

We have found that there are legitimate reasons for the UK Government to have some reticence in granting the Welsh Government unlimited borrowing powers to rectify this issue, particularly the 'moral hazard' of an implicit bailout guarantee by the UK Government should any future Welsh Government over-leverage itself.

However, we also find that this 'moral hazard' needs to be counterbalanced with the need to allow the Welsh Government to effectively conduct policy in the devolved areas to any scale Welsh citizens should democratically decide, negotiated by decision-makers in a mature way against the fiscal constraints and realities that all governments face. There has been too little consideration of this democratic right of Welsh citizens in this debate, and of the fiscal framework's limiting impact on policy-making in Wales.

This democratic right to vote for policy within normal fiscal constraints is available to voters within most countries with the freedom to borrow as they wish. It is also available to voters in England, with the UK Government and its freedom to borrow when acting in essence as the English government in areas devolved to Wales, Scotland and Northern Ireland.

The fiscal constraint on the Welsh Government enacting policy measures voted for by people in Wales in devolved areas is clearly a cause of unfairness. However, the Welsh Government itself could be argued to benefit in some ways from a system wherein the difficult decisions over many fiscal trade-offs still reside at Westminster, with the Welsh Government able to (legitimately) point the finger of blame at London when it does not have the finances to support certain projects. Giving Cardiff Bay the fiscal firepower to properly implement policy decisions would increase accountability and fairness to all involved.

Although this paper primarily addresses frameworks for effective governance, in this debate it is also important to remember that Wales is a significant beneficiary of fiscal transfers from other areas of the UK, with public sector spending in Wales considerably higher than taxes raised.

This paper only focuses on borrowing powers as a potential solution to the problem of undue fiscal restraints on policy-making in Wales. Those with a wider remit may therefore examine the replacement of the UK's fiscal framework and the Barnett Formula entirely. Within the context of the fiscal firepower of the Welsh Government, its impact on policy-making, and borrowing powers, we make the following recommendations:

1. The IWA supports the Welsh Government's calls for it to have prudential borrowing powers and it should continue to explore the case for this. It should publish its up-to-date case for having these powers in response to this report in order to push this important issue more fully onto the political agenda.

2. The UK Government should accept the insufficiencies of the Welsh Government's fiscal framework and accept the Welsh Government's case for prudential borrowing powers via the National Loans Fund, if it is able to protect its own position from the 'moral hazard' of implicit bailouts by means such as further tax devolution or strong repayment guarantees. An increased borrowing cap would provide an improvement on the current system, but is less preferable to prudential borrowing powers for the Welsh Government.

3. Any future amends to the fiscal framework should seek to maximise flexibility for the Welsh Government in the use of reserves and borrowing, and between resource and capital. For example, greater flexibility within borrowing powers should be explored, including allowing borrowing for revenue as well as capital expenditure in order to increase the number of policy options available to the Welsh Government.

4. The lack of fiscal firepower for the Welsh Government should be a core consideration for all policy-makers, academics, and the Constitutional Commission.

Introduction

Wales currently operates under a 'reserved powers' model of devolved government. This entails all power being devolved from Westminster to Welsh Government outside of a specific and lengthy list of powers reserved to Westminster. The responsibilities of the Welsh Government for public services in Wales are therefore wide-ranging, and encompass areas such as Wales' National Health Service, education systems, local government, housing, and other vital public services. In 2022-23, the Welsh Government has allocated over 90% of its budget in these areas alone.[1 2]

In 2016, the Welsh and UK Governments jointly published the agreement for the Welsh Government's new fiscal framework.[3] This was intended to set out a new framework for the funding and fiscal powers of the Welsh Government. The primary driver of this move was the Wales Act 2014 providing the legislative framework to devolve tax and borrowing powers to Wales, following the recommendations of the Commission on Devolution in Wales (also known as the Silk Commission).

At the time of the agreement, the predominant focus for government and academics in Wales was on both block grant funding for the Welsh Government and its partial replacement for the first time with devolved taxation. Particular focus was given to mending perceived unfairness to Wales built into the Barnett Formula, and ensuring that tax devolution did not result in perpetually lower funding for Wales as a result of slower population growth than in England. This focus on the devolution of taxation powers led to some wins for Wales, including agreeing to make separate block grant adjustments for each of the three bands of income tax and modifying the Barnett Formula to cement Wales' receipt of 115% of spending per person in England in recognition of Wales' higher spending needs.[4]

Given the major challenges that the devolution of some taxation powers presented, combined with the numerous issues surrounding how the Barnett Formula worked in practice with regards to Welsh funding, a focus on these topics was understandable. However, it may have led to less focus on the Welsh Government's borrowing powers that also form a part of the fiscal framework.

The IWA has been an important voice throughout the key moments in Wales' recent economic history, both pre- and post-establishment of devolution, and afterwards. Our work has been instrumental to the development of distinctive approaches to economic development, including the potential for smart technologies, the formulation of the South Wales Metro, the exploration of the opportunities of green energy as an economic sector and the long-term value of strengthening the foundational economy.

1 Final Budget 2022 to 2023 - Welsh Government

2 Welsh Government Budget Analysis - Deryn Consulting

3 The agreement between the Welsh Government and the United Kingdom Government on the Welsh Government's fiscal framework - Welsh Government, UK Government

4 Welsh funding: Assessing the fiscal framework deal - BBC

With this paper we are aiming to kick-start another contribution to the evolution of Wales as a nation, and as a distinct political entity with a successful, green, and fair economy.

Supported by core funding from the Friends Provident Foundation, we asked ourselves what the major barriers were to Wales' major modern economic problems: an economy that has successfully lowered its historic high rates of unemployment but with a fundamentally broken and unequal low-wage, low-rights model; an economy that has been too slow to transition to the necessity of a new green future and to get first-mover advantages from transitioning to that future; a weak public sphere, a housing 'market' in crisis, and now a cost of living crisis in Wales that will predominantly be tackled at a Westminster level. Again and again, a key component that has held Wales back in addressing these issues is the Welsh Government's lack of fiscal firepower.

When deciding on a topic of study, we considered options such as examining the possibility for transforming our transport systems with generational investment in public transport, modal shift and place-making. However, on this and many other topics, it was clear that a lack of fiscal firepower reduced this to a purely theoretical possibility.

Of course, all governments have fiscal constraints – no state has an unlimited budget. But as a nation, Wales is in the relatively uncommon position of having little control over its budget, with limited taxation powers, next to no influence over its block grant from Westminster, and exceptionally limited borrowing powers.

The hypothesis of this paper is that this situation has a chilling effect on Welsh policy, with the England-led nature of the fiscal framework preventing Wales from embarking on true policy divergence. At present, changes to Wales' funding are largely led by the Barnett Formula, with the decision by the UK Government to cut or increase spending for a UK Government department in England resulting in a 'Barnettised' change for Wales. We suspect that if Wales wanted to embark on transformative policy divergence it is essentially fiscally unable to do so despite ostensibly having devolved competency.

This paper seeks to start a conversation on Wales' fiscal framework with a particular focus on borrowing powers, and whether transformative policy under the current framework is actually possible in practice. We want to spark a debate about whether Wales' fiscal framework needs reform, and whether small-scale thinking is baked into the very structures that underpin the governance of our country. The paper particularly examines borrowing powers, which thus far have flown under the radar with regards to Wales' fiscal framework and could potentially alleviate the lack of fiscal firepower available to the Welsh Government in a way that is fair to the other constituent nations of the UK.

In writing this paper we have undertaken desk-based research and spoken to a range of experts in the field about the history of the fiscal framework in Wales, the way it operates in practice in the modern context, and the limitations it sets on policy-making in Wales.

We have found severe limitations in Wales' fiscal framework and its borrowing powers, including a lack of fiscal firepower, a lack of control by the Welsh Government over its own spending programme, a system that embeds expensive borrowing and essentially bans cheaper forms of borrowing above a certain level, and a disincentive against more innovative projects. Ultimately, this all combines to form a system that potentially locks Wales into lower levels of development than wealthier areas of the UK.

However, we have also found that many of these problems can be addressed by increasing the Welsh Government's fiscal firepower and reforming the controls currently in place on its ability to borrow. We hope that this paper contributes to a more mature discussion on the role of the state in Wales, and that it ultimately allows devolution to more fully live up to its initial promises to the people of Wales.

What is Wales' Fiscal Framework?

The Route to Wales' Current Fiscal Framework

The 'Fiscal Framework' is the term used to describe the Welsh Government's funding and finance power arrangements as set out initially in *The agreement between the Welsh Government and the United Kingdom Government on the Welsh Government's fiscal framework*.[5] It contains devolved taxation, a block grant from Westminster, capital borrowing powers with a cap of £1bn, and some other smaller measures such as resource borrowing powers in certain narrow circumstances. We outline below the current fiscal framework, the route to its development, and the context in which it was created, with a particular focus on borrowing powers.

One Wales Coalition Agreement 2007

The road to Wales' current fiscal framework began in June 2007, when Welsh Labour and Plaid Cymru published their One Wales Coalition Agreement, which stated the following:

> *"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."*[6]

The Holtham Commission: The Independent Commission on Funding and Finance for Wales (2008-2010)

As a result of the One Wales Coalition Agreement, the Independent Commission on Funding and Finance for Wales[7] – otherwise known as the Holtham Commission – was created, running from 2008-2010. The final report of this Commission gave recommendations on fiscal devolution, the replacement of the Barnett Formula with a needs-based formula, tax devolution and tax varying powers, as well as, latterly, borrowing powers.

The most pertinent recommendations and findings to the subject of this report were as follows:

— The Assembly Government should pursue the introduction of a simple needs-based formula as the means of determining the Welsh block grant.

— The Assembly Government should acquire limited powers to vary income tax rates in Wales.

5 The agreement between the Welsh Government and the United Kingdom Government on the Welsh Government's fiscal framework - Welsh Government

6 One Wales Coalition Agreement - Deryn Consulting

7 Independent Commission on Funding and Finance for Wales (Holtham Commission) Final Report - Welsh Government

— The Assembly Government should seek discussions with the UK Government and the other devolved administrations about the feasibility of devolving corporation tax.

— Stamp duty land tax should be devolved to Wales, provided a fair offset to the block grant can be negotiated.

— The administrative costs of devolving capital gains tax on property and land should be explored with HMRC. If administrative costs are not prohibitive, then it should be devolved to Wales, provided a fair offset to the block grant can be negotiated.

— The Assembly Government should consider the reform of council tax by investigating the introduction of additional bands covering high value properties and (ii) the scope to undertake more frequent revaluations of the housing stock.

— Local authorities should be given discretion to levy a higher council tax on second homes.

— The Assembly Government should undertake an assessment of the usefulness of landfill tax, air passenger duty and aggregates levy as policy instruments, in the light of Ministerial objectives in those matters. If it is concluded that the taxes would provide Ministers with useful policy levers then they should be devolved to Wales, assuming a reasonable deduction from the block grant can be agreed.

— A procedure should be confirmed to enable the UK Parliament to confer power on the National Assembly to introduce new taxes in Wales, where the Assembly requests that power.

— The Assembly Government should seek agreement with the UK Government for an arrangement to invest End Year Flexibility (EYF) funds in government securities under the auspices of the Commissioners for the Reduction of the National Debt.

— Limited powers to borrow in order to finance capital expenditure should be devolved to Welsh Ministers.

— Borrowing should be undertaken via the Debt Management Office (DMO). A borrowing framework should be agreed between the Assembly Government and HM Treasury, and a ceiling should be placed on the total amount of debt that the Assembly Government should be able to carry.

— The current overdraft facility of £500 million available to the Assembly 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 the preferred approach to income tax devolution. The maximum allowable overdraft would need to be kept under review and may have to be adjusted over time to take account of inflation and economic growth.

The first report also recommended that the Assembly Government should be able to draw forward its capital budget across the period of a spending review, that it should have a free hand in accessing the EYF funds that it has accumulated in prior years, without the requirement for discussion with, and agreement from, HM Treasury, and that it 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.

It is important to note the context of this Commission. The One Wales Coalition agreement in 2007 came just ten years after a comparatively limited version of devolution was approved by the 1997 referendum in Wales, with a majority of less than 1% of voters. Then-First Minister Rhodri Morgan responded to the final recommendations of the Holtham Commission in 2010 with strong opposition, stating that there was 'no mandate' for taxation powers.[8]

The drafting of the Commission's report was therefore written in a different context to today. Seminal events in the history of devolution were yet to happen – such as Welsh voters offering an 'emphatic yes'[9] on primary law-making powers, parties supportive of devolved taxation winning a Senedd super-majority in two consecutive elections, and the Covid-19 pandemic raising the profile of the office of the First Minister and devolved governance as a whole.

The political context in which the report was drafted is worth taking into consideration. Rhodri Morgan's comments indicate that there was clearly considerable concern about the legitimacy of a democratic mandate for taxation powers. This does not exist in the wake of the 2022 Senedd election, the first election post-tax devolution wherein all of the parties elected to the Senedd backed taxation powers either implicitly (via the lack of a commitment to remove them) or explicitly.

The cautiousness surrounding the devolution of some taxation powers contrasts strongly with the position we now find ourselves in, with a First Minister who has called for the UK Government to 'recognise that sovereignty is now dispersed across four parliaments in which we choose to pool it for common purposes'.[10]

The Holtham Commission's recommendations were seen as relatively radical at the time, with the cautiousness surrounding taxation powers for Wales – and the subsequent recommendation of their devolution – likely to have reduced the practical ability of the Commission to also recommend large-scale borrowing powers. This is both a matter of politics and practicality. Devolution of taxation powers engendered not just political anxiety but also practical barriers, with little prior UK precedent. The importance of ensuring that recommendations to reform the Barnett Formula and tax devolution did not negatively impact the public finances of the Welsh Government is likely to have reduced the appetite of policy-makers of all persuasions to bring in reforms that would create further uncertainty in the public finances of a government with limited fiscal experience.

8 Rhodri Morgan opposes tax-varying powers for assembly - BBC Wales News

9 Welsh referendum: Voters give emphatic Yes on powers - BBC Wales News

10 First minister Mark Drakeford promises radical plans for Wales - The Guardian

Our research has indicated that this understandable focus on the Barnett Formula and the devolution of taxation led to borrowing powers for the Welsh Government being de-prioritised in focus. This comes through to some extent in the Commission's report, with the Commission Chair stating in the preface that borrowing 'is to some extent a subsidiary issue. Once spending responsibilities are set and the arrangements for financing them, including any taxation powers, are established, the consequences for sensible borrowing powers tend to follow'.

The final Holtham report also outlines the way in which the UK Government borrows from capital markets in order to finance public expenditure. UK Government borrowing is undertaken by the DMO. The DMO is an executive agency of the UK Treasury. It is legally and constitutionally part of the Treasury, but operates at arm's length from Ministers. The DMO has a remit to minimise financing costs over the long term.

The report also lays out the borrowing powers that existed both for local authorities and for the Welsh Government pre-2016 fiscal framework. The Welsh Government could borrow in practice from the Secretary of State for Wales to meet a temporary excess in expenditure over income, or to provide a working balance. This was capped at £500m.

The report also outlined local authority borrowing powers in the UK. Local authorities are able to borrow to fund capital expenditure either through the Public Works Loan Board (PWLB), a statutory body within the DMO, via commercial banks, or issuing their own debt. In practice, the report outlines that nearly all local authority borrowing is via the PWLB. The PWLB allows local authorities to borrow at gilt rates, over any period of maturity. The PWLB's funds are drawn from the National Loans Fund (NLF), which is the account that brings together all the UK Government's lending and borrowing. In practice, borrowing via the PWLB offers lower rates, making it the most attractive option.

The final pertinent point in relation to this report is the short assessment the final Holtham Commission report makes with regards to borrowing powers internationally and in economics literature. It states that sub-central government borrowing exists in many developed nations, and that it is both feasible and desirable. However, it also explains that there is widespread concern about the 'moral hazard' of sub-central governments exploiting explicit or implicit guarantees from central government by acting imprudently and creating unplanned fiscal liabilities for central government. It points to debt crises among sub-national governments in Brazil and city level bankruptcies in the USA as practical examples of this. It therefore states that limits on sub-central government borrowing through the central government are needed.

The Silk Commission: The Commission on Devolution in Wales (2011-2014)

As a result of the coalition agreement between the UK Conservatives and Liberal Democrats in 2010, the Silk Commission – or the Commission on Devolution in Wales – was established. This resulted in two reports: one on financial powers and one on other powers. It is this first report – '*Empowerment and Responsibility: Financial Powers to Strengthen Wales*'[11], published in November 2012 – that is of key interest to this paper.

This report found that the then-funding arrangements for the Welsh Government did not meet the requirements of a mature democracy and were anomalous in an international context. It made 33 recommendations, including:

— That part of the budget for the Welsh Government should be funded from devolved taxation under its control.

— Devolution of business rates, stamp duty, landfill tax, and Air Passenger Duty for direct long haul flights.

— UK and Welsh Governments should share the yield of income tax. The Welsh Government should have responsibility for setting income tax rates in Wales via a Welsh rate of income tax (subject to a referendum).

— Welsh Ministers should be given an additional power to borrow to increase capital investment above the Welsh Government Departmental Expenditure Limit (DEL) budget. There should be an overall limit to such borrowing, at least proportionate to that in Scotland, whilst taking into consideration the relative lack of exposure to Private Finance Initiative (PFI) in Wales. The agreed annual profile should provide some flexibility and be subject to review in each spending review.

— Borrowing should be from the National Loans Fund and commercial sources and the Welsh Government should be able to issue its own bonds.

— The Welsh Government should be allowed to switch spending from capital to resource spending within the terms of a concordat agreed with HM Treasury, in the light of the Welsh Government's record on budget management and provided the UK Government's fiscal targets are not put at risk.

— A new Wales Bill should be introduced to devolve tax and borrowing powers.

With regards to borrowing powers, the Fiscal Powers to Strengthen Wales report stated that it had received a substantial amount of evidence supporting the Welsh Government gaining powers to borrow for capital purposes, which it said would allow the Welsh Government to pursue larger capital projects more flexibly. It also pointed towards a 2012 ICM poll that demonstrated 80% support amongst the Welsh public for the Welsh Government to have borrowing powers for transport and other infrastructure projects[12].

11 Empowerment and Responsibility: Financial Powers to Strengthen Wales - Silk Commission

12 Cautious support for Welsh tax-raising powers - ITV Wales

On revenue borrowing, the Silk Commission recommended that Welsh Ministers should be provided with powers to borrow to finance current expenditure up to the Welsh proportionate equivalent (which might be about £100 million) of the Scottish £200 million in any one year, with an overall limit of £500 million. It also recommended that the borrowing limit should be reviewed at each UK spending review and revised if necessary to reflect economic conditions.

On capital borrowing, the Commission noted that the Welsh Government had a lower exposure to PFI projects (about 10% of the Scottish exposure, and 1% of the UK total). It also noted that evidence from the *Wales in a Changing Union* project suggested that the Welsh Government might be able to service higher debt prudently, proposing that a limit could be set on the proportion of the Welsh budget that could be devoted to servicing debt. This report stated that a limit set at 5% of the block grant would have meant Wales could carry a total debt of £3 billion at the time – something it said was 'trivial in relation to UK Government debt of around £1,000 billion'[13]. However, the Commission made no ultimate recommendation on upper borrowing limits other than that the annual and stock borrowing limits be reviewed at each UK spending review.

The Silk Commission also found that there was no reason in principle to prevent the Welsh Government from being able to issue its own bonds in addition to borrowing from the NLF and other sources such as commercial banks, which although likely to be more expensive, would give the Welsh Government experience in this area, with the expense of borrowing for the Welsh Government potentially reducing in the future.

The UK Government stated in its response to the report[14] that it had already accepted in principle the need for the case for Welsh Government capital borrowing powers for infrastructure investment,[15] subject to the availability of an appropriate independent stream of revenue to support borrowing costs such as tax devolution. It stated that its support was limited to borrowing from the National Loans Fund and commercial sources.

13 Wales in a Changing Union - Institute of Welsh Affairs, Wales Governance Centre, Tomorrow's Wales

14 Empowerment and responsibility: devolving financial powers to Wales - UK Government

15 Speech by Chief Secretary to the Treasury, Rt Hon Danny Alexander MP; Welsh Funding announcement, Cardiff - UK Government

The Wales Act 2014

The Wales Act 2014 implemented some of the measures proposed by the Holtham and Silk Commissions. On borrowing, it specifically gave the Welsh Government limited powers to borrow to manage in-year volatility of receipts, to provide a working balance to the Welsh Consolidated Fund (WCF) in order to manage cash-flow, to deal with differences between the full year forecast and outturn receipts for devolved taxes, and to fund capital expenditure.[16]

The Act continued to allow the Welsh Government to borrow temporarily from the Secretary of State for Wales to provide a working balance to the WCF and to manage in-year volatility of receipts (which was allowed in the 2006 Act) and extended this to allow the Welsh Government to use the borrowing across years to fund deviations between forecasts and actual receipts of devolved taxes. In total, borrowing in this way was capped at £500m. The Act stated that the Secretary of State for Wales, with the consent of the UK Treasury, could revise this up or down but never below £500m. This was to allow the total amount to be adjusted from time-to-time to keep pace with inflation or in exceptional circumstances.

The Act also allowed for an additional £500m of borrowing to finance capital. This has many of the same stipulations as the initial £500m. It can be amended up or down by the Secretary of State for Wales with the consent of the UK Treasury, but never below £500m. The Act stated that borrowing to fund capital expenditure was subject to the UK Treasury's approval, and had to be in the form of a loan either from the National Loans Fund (through the Secretary of State for Wales) or from another lender, such as a commercial bank. The Act explicitly stated that the Welsh Government was not permitted to issue Welsh gilts or bonds.

In sum, the Wales Act 2014 therefore continued to allow temporary borrowing from the Secretary of State for Wales for specific technical reasons rather than direct policy-making, and £500m for capital expenditure to a total of £1bn, although this could be altered upwards by the UK Government.

16 Wales Act 2014, Borrowing by the Welsh Ministers with Explanatory Notes - The National Archives

The St David's Day Agreement, 2015.

Powers for a Purpose: Towards a Lasting Devolution Settlement for Wales

The UK's Conservative-Liberal Democrat coalition government responded to the Silk Commission's second report by announcing the St David's Day Agreement, the key content of which was contained within a 2015 command paper entitled *Powers for a Purpose: Towards a Lasting Devolution Settlement for Wales*[17]. Although this predominantly focused on devolving powers, it did contain a commitment to extend the borrowing powers of the Wales Act 2014 to enable the Welsh Government to issue bonds to borrow for capital expenditure. It also committed to establishing a funding floor for Wales.

Fiscal Framework Agreement 2016

The Wales Act 2014 provided a legislative framework to devolve tax and borrowing powers to the Senedd and Welsh Government. The 2016 Fiscal Framework Agreement[18] between the Welsh and UK Governments then enabled the powers in the Wales Act 2014 and 2017 (a Bill at the time of publication) to be implemented. This included supporting the devolution of stamp duty and landfill tax, and the creation of Welsh rates of income tax. It also built on the joint funding announcement in 2012 and the funding floor (implemented at the 2015 Spending Review), and created a new Wales Reserve.

Of particular interest to this paper are the Fiscal Framework Agreement's announcement of an increase in capital borrowing powers. It raised the cap from £500m to £1bn, and raised the yearly spend from £125m to £150m (15% of the overall cap) from April 2019. As per the St David's Day Agreement announcement, it also reiterated the commitment to allow the Welsh Government to issue its own bonds. The Agreement stated that resource borrowing powers set out in the Wales Act 2014 remained unchanged.

The Fiscal Framework Agreement also announced the creation of a new Wales Reserve, held within the UK Government and capped in aggregate at £350m. It announced that there were no annual limits for payments into the Wales Reserve, with annual drawdowns limited to £125m for resource and £50m for capital.

Wales Act 2017

The Wales Act 2017 predominantly focused on devolved powers, but in the wake of the Fiscal Framework Agreement it contained a provision to increase the borrowing limit for capital expenditure to £1bn (retaining the structures and provisions of the 2014 Act for all else).

17 Powers for a Purpose: Towards a Lasting Devolution Settlement for Wales - UK Government

18 The agreement between the Welsh Government and the United Kingdom Government on the Welsh Government's fiscal framework - Welsh Government and UK Government

The Welsh Government's Current Borrowing Powers

As the result of the long process detailed in the previous section – started by the One Wales Coalition Agreement in 2007 and ending in the passing of the Wales Act 2017 – the Welsh Government acquired £1bn of capital borrowing powers in April 2019, with a maximum annual spend of £150m. It also has £500m of revenue borrowing powers, although these are intended for more technical reasons such as allowing the Welsh Government to provide working balances to the WCF and to protect against any volatility in tax receipts, rather than for active policy-making.

The bulk of the Welsh Government's ability to increase its 'fiscal firepower' is therefore contained in the £1bn of capital borrowing, as well as the ability of the Welsh Government to issue its own bonds. However, the issuing of bonds counts towards the Welsh Government's borrowing cap[19], meaning they do not represent an additional source of borrowing potential.

The Welsh Government can also borrow towards the £1bn total from the NLF. The NLF is essentially the UK's main borrowing and lending account (as opposed to the Consolidated Fund, which could be considered the UK's current account).[20] Most of the NLF's borrowing needs are now met indirectly through borrowing on its behalf by the DMO, an executive agency of the UK Treasury. Professor Gerald Holtham, former Chair of the Independent Commission on Funding and Finance for Wales, has stated that borrowing via the DMO is 'by far the cheapest means of borrowing' available to the Welsh Government[21]. This fact, combined with a strict cap, reduces the likelihood the Welsh Government would issue its own bonds in practice. It also raises the question of whether the fiscal framework's strict cap on borrowing via the DMO unnecessarily increases the cost of Welsh Government borrowing by essentially mandating that it use more expensive forms of private borrowing.

Finance Minister Rebecca Evans stated in 2019[22] that the Welsh Government had requested an increase in its borrowing powers from the UK Government, and that while the Welsh Government had developed the Mutual Investment Model (MIM) to provide £1 billion-worth of investment, it would not have done so if it had access to other forms of borrowing.

This request for increased borrowing powers was reiterated in May 2020[23]. However, Secretary of State for Wales Simon Hart stated that the Welsh Government had to make a 'compelling case' for this, and did not commit to increasing the limit.[24]

19 Inquiry into the Welsh Government's capital funding sources, p22 - Senedd Finance Committee
20 National Loans Fund Account 2015-16 - UK Government
21 Finance Committee - Fifth Senedd - 01/05/2019 - Senedd Cymru
22 Inquiry into the Welsh Government's capital funding sources: Evidence session 7 - Senedd Cymru
23 Welsh Government seeking bigger borrowing powers and more flexibility on how it spends its budget - Business Live
24 If Welsh Government wants greater borrowing powers it needs to make a compelling case says Simon Hart

On the topic of issuing Welsh Government bonds, then-Finance Minister, now-First Minister Mark Drakeford stated that the Welsh Government did not intend to issue its own bonds directly, but rather used the power as a tool to 'keep the UK Government honest' so that the Welsh Government had alternative options if the UK Government decided to increase the interest rate charged on loans acquired by the Welsh Government through the NLF. When the power for the Welsh Government to issue its own bonds was officially announced, he stated that the principle underpinning the Welsh Government's approach to capital was to always exhaust the use of the least expensive forms of capital before using other sources of repayable capital[25].

Finance Minister Rebecca Evans is on record that the Welsh Government's position is that the borrowing cap should be set by the Senedd and the Welsh Government, within the context of prudential borrowing,[26] a proposal that is explored later in this report.

25 Written Statement: Welsh Government Bonds - Welsh Government

26 Finance Committee 17/07/2019 - Senedd

Welsh Government Funding Sources

The Welsh Government gets its funding from two main sources: the Welsh block grant from the UK Government (£17.7bn, 82% in 2022-23) and devolved taxation (£3.9bn, 18%)[27]. It can also marginally increase this total with borrowing of up to £150m a year for capital investment with a total cap of £1bn as outlined earlier in the report.

Welsh Block Grant (£17.7bn, 82%)

The Barnett Formula

Changes to the Welsh Block Grant are calculated by the Barnett Formula. If the UK Government makes spending changes in England to a department budget that is fully or partially devolved, the Welsh Block Grant is changed via the Barnett Formula, with additional spending as a result of spending rises in England being commonly known as 'Barnett consequentials'.[28]

The 'Barnett Formula' as it applies to Wales is as follows:
Change in UK Government spending x Comparability Percentage x Welsh population share x Needs-based factor.[29]

The Comparability Percentage refers to the extent to which a department's functions have been devolved. If a UK Government department's spend is fully devolved (and therefore applies only to England) the Comparability Percentage is 100%, such as in Education.[30] However, whereas around 20% of the Department of Work and Pensions is deemed to be devolved to Scotland, the figure is 0% for Wales, reflecting the devolved powers settlement.

There are flaws to the Comparability Percentage process. For example, Transport is considered to be around 92% devolved in Scotland and 95% devolved in Northern Ireland. In Wales it is considered to be around 36% devolved. However, this does not mean that the Department for Transport is then bound to give Wales any guaranteed amount of funding. Wales does not receive a population share of rail funding, receiving at most £2.2bn between 2001-2029 when a population share total would be around £5.1bn or, based on rail route lengths, £10.2bn.[31]

27 Fiscal devolution in Wales - Senedd Research Service
28 What is the Barnett Formula? - Senedd Research Service
29 What is the Barnett Formula? - Senedd Research Service
30 The Barnett Formula - House of Commons Library
31 Historical investment in rail infrastructure enhancements - Welsh Government

The Welsh population share refers to Wales' population as a percentage of England (around 5.6%). It is worth noting that as England's population tends to grow faster than Wales', this figure is likely to decline in the long term, and Barnett consequentials will decline with it. However, a slower growing population relative to England's can be good news for relative spending per head in Wales. Barnett consequentials would fall in this situation, but the bulk of the block grant would require spread between fewer people.

The Holtham Commission identified a potential gap in funding for the Welsh Government compared with equivalent funding for English regions. It recommended introducing a funding floor to recognise Wales' additional needs (such as an older, less healthy population requiring more health spend).

The Commission estimated that Wales' needs were between 114% and 117% of England's, and the UK and Welsh Governments agreed to add a needs-based factor to the Barnett Formula when applied to Wales. This needs-based factor is currently set at 105%, but it has been agreed that it will be set at 115% in the long run. It is currently lower due to Wales' relative block grant spending being around 120%, with the needs-based factor being set to 115% when relative block grant funding reaches this level. This is intended to ensure that the Welsh Block Grant does not fall below the needs-based calculation of 115% of spending in Wales in relation to spending in England.

In essence, the Welsh Block Grant is therefore essentially decided by spending on behalf of the UK Government in England, adjusted for population and for Wales' differing demographic and social profile.

It is worth noting that Lord Barnett, the former Chief Secretary to the Treasury who devised the Barnett Formula in 1978, has stated his belief that the Barnett Formula should be replaced with a statutory body charged with distributing government spending in a way that the most money goes to areas that need it most, with his Barnett Formula only originally intended as a temporary measure for one or two years[32].

32 I demand that the shamefully unfair Barnett Formula is scrapped, by LORD BARNETT, the architect of the hated subsidy to Scotland - Daily Mail

Devolved Taxation

Welsh rates of income tax (£2.5bn, 11%)

Parts of the income tax paid by Welsh taxpayers is devolved to the Welsh Government. The devolution process saw the UK Government reduce the three rates of income tax (Basic, Higher, Additional) paid by the Welsh population by 10p in every pound. The Welsh Government then introduced its own rates of 10p in every pound, meaning that 10p in every £1 of taxable income in each of the three income tax bands goes to the Welsh Government.[33]

It is worth noting therefore that most income tax in Wales still goes to the UK Treasury. It then receives the Welsh Block Grant from the UK Treasury although, as outlined above, this is not directly related to Welsh income tax take.

Non-domestic rates (£1bn, 5%)

Non-domestic rates – or business rates – are charged on most non-domestic properties, including shops, offices, pubs, and factories.[34] In Wales they are calculated by taking the Rateable Value of the property and multiplying it by the current non domestic rates 'multiplier'. Business rates relief is available for certain kinds of properties such as agricultural buildings or those used for the welfare of disabled people.[35]

Land transaction tax (£366m) and Landfill disposals tax (£36m) (Combined 2%)

The Welsh Government introduced the Land Transaction Tax to replace Stamp Duty when it was devolved. It is paid when buying a property. Landfill Disposals Tax is the smallest of the devolved taxes, and is paid based on the weight of items disposed at landfill.

Borrowing Powers

The Welsh Government's borrowing powers are outlined in detail earlier in this report. The £150m annual capital borrowing figure is equivalent to around 0.7% of the Welsh Government's budget.

33 Fiscal devolution in Wales - Senedd Research Service

34 Business Rates - Welsh Government

35 Business Rates - Business Wales

Current Context

Replacement of European Funding

Between 2014-20, as part of a wider £400m annual European Structural and Investment Funds (ESIF) investment, the Welsh Government received around £300m per year through the two main European economic development funds: the European Regional Development Fund (ERDF) and the European Social Fund (ESF)[36]. This total funding of £1.5bn per Senedd term amounted to more than the Welsh Government's entire £1bn capital borrowing cap, with the £300m a year accounting for double the Welsh Government's £150m annual capital borrowing limit. This amount received by the EU therefore represented a huge proportion of the Welsh Government's additional fiscal firepower. This funding gave the Welsh Government the potential to do things over and above its block grant and devolved taxation income which, due to being overwhelmingly decided by changes in public services spending in England, largely amount to the total needed to run public services in Wales.

In the wake of the UK leaving the European Union, the UK Government created a number of replacement schemes, including the Levelling Up Fund and the UK Shared Prosperity Fund, which Wales benefits from significantly. However, these schemes are predicated on local authorities constructing bids which are then put forward to the UK Government for approval. This moves decision-making from the Welsh Government to the UK Government, with around £300m of European funding removed from the Welsh Government, a large blow to its fiscal firepower over and above its obligations to public services.

Economic development was a specifically devolved power as far back as the Government of Wales Act 2006. However, due to these funding changes, practical responsibility for economic development has now significantly shifted towards the UK Government's Department for Levelling Up, Housing, and Communities. This is particularly significant as large parts of pre-devolution economic development objectives were held by the Cardiff-based Welsh Development Agency (WDA) since its creation in 1976, albeit with that body ultimately being accountable to the UK Government.

The UK's exit from the European Union and the removal of EU funding from the Welsh Government therefore makes the subject of the Welsh Government's additional fiscal firepower – over and above what is needed to run public services – more pressing than ever. It also gives impetus to the case for re-examining Wales' fiscal framework agreement in this light.

Impact of Welsh and UK Government Relations

There has been a significant deterioration in relations between the Welsh and UK Governments in recent years. Relations between Welsh and UK Governments were at times awkward[37] even when run by the same political party. However post-2010 the additional tension of the Welsh and UK Governments being run by competing parties has led to a further deterioration in relations. The IWA has previously highlighted the importance of mature inter-parliamentary[38] and inter-governmental relations. Unfortunately, since our 2020 recommendation to strengthen the role of devolved parliaments in legislative consent the situation in this area has worsened with the denial of legislative consent by the Senedd ignored by the UK Government on a number of occasions.[39]

The Welsh Government's economic powers have also been limited by the Internal Market Act, which operates under the market access principles of mutual recognition and non-discrimination across the United Kingdom[40]. In practice, this means that the Senedd and Welsh Government regulations on goods and services in Wales are dis-applied when these goods and services meet market standards in England, Scotland or Northern Ireland. This means that the minimum regulatory standard in either Wales, England, Scotland or Northern Ireland becomes the de facto standard across the UK. Clearly, this limits the Welsh Government's ability to regulate markets above the level of regulation elsewhere in the UK.

Relations between the Welsh and UK Governments have continued to deteriorate during the Boris Johnson premiership. Despite the two governments being run by opposing parties during the David Cameron and Theresa May eras, the respect agenda[41] outlined by these governments was at least mostly upheld. However, relationships effectively broke down during the Boris Johnson government, with some commentators in Wales viewing the UK Government as antagonistic towards devolution[42], and Johnson himself describing devolution as a 'disaster'.[43]

The breakdown of the respect agenda between the UK and Welsh Governments outlined by David Cameron has exposed fault lines in the devolution settlement. The Welsh Government's ability to conduct policy in a transformative way has few fail-safes if the UK Government wishes to limit its ambitions or policy goals, due its strong hold on Wales' public finances.

This section has described the impact of the loss of European economic development funding and of the Internal Market Act on the Welsh Government's ability to achieve its economic goals. Another way in which this can be limited is through the reduction of Barnett consequentials.

37 Power struggles revealed in Rhodri Morgan's memoirs - ITV Wales
38 Missing Links: Past, present and future inter-parliamentary relations in the devolved UK - Institute of Welsh Affairs
39 Sewel Convention - Institute for Government
40 An Introduction to the Internal Market Act - UK Government
41 Cameron talks tough on cuts while he cosies up to Carwyn - WalesOnline
42 'Good riddance to Boris Johnson': The Prime Minister who saw Welsh devolution as a troublesome inconvenience - WalesOnline
43 Boris Johnson 'called Scottish devolution disaster' - BBC News

The case of High Speed 2 (HS2) has become symbolic of this issue. The UK Government chose not to classify the high speed Manchester to London line as an 'England only' project, choosing instead to classify it as an England and Wales project despite the line being entirely in England. This meant that, unlike the Scottish and Northern Irish governments, the Welsh Government is receiving no Barnett consequentials as a result of this major infrastructure project[44], which is estimated to cost around £74bn[45] (down from £98bn as a result of the decision not to build the route to Leeds). As a result of this single decision, the Welsh Government has lost billions of pounds in Barnett consequentials. Although the total amount lost will only become clear when the final spend of HS2 is known, it would certainly be in the realms of billions and therefore have a potentially transformative impact when viewed in the context of a total capital borrowing budget of £1bn. This once in a generation opportunity to upgrade Wales' infrastructure is likely to be lost, with Wales' economic development continuing to suffer as a result. The HS2 example is not merely a symbolic example, but a major issue in and of itself.

It is worth noting the weakness of the case for classifying HS2 as a project that benefits both England and Wales. The line itself is entirely within England, and HS2-commissioned research by KPMG found Wales to be one of the biggest losers from the HS2 project. As noted at the time[46], the landmark report which was intended to make the economic case for HS2 actually found that Wales would suffer economically from its construction. This was not published in the initial report, but published as a result of a Freedom of Information request from Newsnight[47]. The research found areas across Wales such as Bridgend, Cardiff, Conwy, Swansea, Powys and more were set to lose out as a result of HS2, with some potential marginal increases in areas in north east Wales. HS2's own research has therefore found that the project is of economic benefit to England, but of economic detriment to Wales. It also found Scotland was a net beneficiary of the project, despite its receipt of Barnett consequentials.

The UK Government also recently set a new precedent by taking £30m from the Welsh Government's devolved capital budget to contribute towards the non-devolved area of military aid for Ukraine, with the Welsh Government Finance Minister stating that they were told they could contribute the funds up-front or via a reduction in Barnett consequentials later[48]. The Welsh Government stated it accepted the use of the funds but described the situation as 'novel, worrying, and potentially divisive'[49] due to its potential to set a precedent. In fact a precedent has certainly been set. It is now proven to be possible for the UK Government to reduce its liability for certain reserved projects by using already-limited Welsh capital budgets intended for devolved areas such as schools and hospitals, when the project's nature is politically impossible to reject, as with military aid for Ukraine.

44 Transport funding for Wales and HS2 - House of Commons Library

45 High Speed Rail 2 – an overview - House of Commons Library

46 High speed link could leave Wales stranded - Eurfyl ap Gwilym via IWA

47 Newsnight FOI to KPMG regarding HS2 - BBC

48 Row over £30m for Ukraine taken from Welsh government funds - BBC Wales News

49 Written Statement: Funding for Military Support for Ukraine - Welsh Government

A combination of a loss of European funding, limits placed on economic governance in practice such as the Internal Market Act, denial of significant capital spend enjoyed by the other UK nations via HS2, and a number of precedents set regarding the UK Government interfering in Welsh governance and spending has created a significantly challenging context for Welsh economic governance. It has become clear in recent years that despite being a devolved area, it is still challenging for the Welsh Government to significantly reform the Welsh economy without the implicit consent of the UK Governnment. This wider context contributes to the challenges of spending – which underpins all policy-making in a significant way – being driven by London decision-making rather than Wales. Ultimately, despite significant devolved powers, Wales will struggle to achieve any true desired policy divergence without a more significant degree of fiscal independence to match constitutional powers.

Limitations of the Fiscal Framework

Lack of Fiscal Firepower

As noted in more detail earlier this paper, changes to the Welsh Government's block grant which make up 80% of its budget are predicated on departmental spending changes in England on areas devolved to Wales. Access to finance clearly provides a framework within which policy is created. Policy ambition that has a monetary cost can grow only to the size of the finance available, no matter where devolved responsibility technically rests.

The Covid-19 pandemic and the use of furlough gave a key example of this. With the UK-wide furlough scheme set to end on 31 October 2021, in light of rising Covid-19 cases the Welsh Government took the decision to introduce a new firebreak lockdown from 23 October - 9 November 2021[50]. However, the UK Government refused to extend the furlough scheme, potentially leaving Welsh workers without this support when the furlough scheme ended. In contrast, when the UK Government made the decision soon after to take England into a firebreak lockdown, the furlough scheme was extended to 2 December 2021, causing an angry reaction from some in Wales,[51] with a perception that the UK Government acting on behalf of England with regards to health was using its greater fiscal firepower for the benefit of England, in a way that the Welsh Government is not able to do so for Wales.

This is a clear example of how although the Senedd and Welsh Government may theoretically have broad powers over health, the economy, housing, transport, and more, these are hugely limited in practice by a lack of financial firepower. During the worst of the pandemic, Wales was limited in its practical ability to make life-saving interventions such as firebreak lockdowns in the way the UK Government did on behalf of England. Equally, large-scale investment in Wales' housing, transport, and civic infrastructure that could transform the basis of Wales' economy and society, as well as give greater returns in the future, require a level of fiscal firepower that is available to most governments – including the UK Government on behalf of England – but not to the Welsh Government.

The UK Government is therefore able to dictate the scope of Welsh policy-making in devolved areas by setting the limits of the Welsh Government's budget (as noted earlier, around 80% of its financing is from the Welsh block grant). In this sense, it is hard to say that the Welsh Government has 'full' devolved powers in any policy area.

Political realities surrounding expectations of public service delivery also means there is very little budget flexibility in practice for the Welsh Government. Research found that[52] the 2022-23 Welsh Government draft budget dedicated 47% of the budget to the health and social services department, 22% to finance and local government, 13% to climate change (with the majority of this

50 National coronavirus firebreak to be introduced in Wales on Friday - Welsh Government

51 Criticism of furlough extension now England set for lockdown after requests denied for Wales fire-break

52 Welsh Government Budget Analysis - Deryn Consulting

being housing retrofit), 12% to education and the Welsh language, and 2% for economy, 2% for rural affairs, 2% for central services and administration, and 1% for social justice. These numbers tell a story. It is nearly politically impossible for the Welsh Government in practice to significantly reduce funding for the NHS or education. This means that there is exceptionally limited fiscal leeway for the Welsh Government to pursue policy that is truly dial-moving.

There is a central problem that the Welsh Government, unlike other governments, has an inflexible, finite budget, with the same demands from public services as other governments. Short of a decision that would likely reduce the quality of public services, the Welsh Government largely acts as a middle man between the UK Government and those responsible for public services, passing on the funding whilst having no role in setting its overall budget, and very little role in direct delivery on-the-ground.

In practice, this leaves public service reform as one of the only full powers the Welsh Government has. More ambitious or transformative policy proposals that would require high additional spending (but which may contribute more tax intake or other benefits in the long-run) are severely constrained in Wales. Public service reform should not be underestimated as a policy tool, but equally it should not be overestimated.

It is important to note that the Welsh Government is not entirely powerless in this area. It does have some flexibility in its fiscal toolbox. Options such as varying and raising some taxes are available to it. It is able to, for example, shift more of the burden of local government on to council tax, reform council tax, or raise income tax rates. However, it is limited in these areas too. For example it is not able to adjust income tax bands or create new ones, which were formulated on a UK basis and are therefore less suitable to Wales' income levels, with Wales having very few individuals earning above the additional rate of £150,000.

The Senedd Research Service and Wales Fiscal Analysis team at Cardiff University's Wales Governance Centre's work has been combined into a Welsh income tax tool which demonstrates the inflexibility of the Welsh Government's tax-varying powers[53]. Their tool estimates that increasing the additional rate of tax in Wales by 1p in the pound (prior to the announcement of its abolition by the UK Government) would only raise between £5m and £8m. Conversely, raising the basic rate of income tax by 1p in the pound would raise £227m. The tool estimates that a radical rise of 5p in the pound across the three tax bands would bring in around £1.3bn, with nearly £1.1bn of this coming from the rise in the basic rate. The structure of the bands in Wales and the inability of the Welsh Government to alter them makes spending predicated on progressive tax rises more difficult than in the case of the UK Government. This 5p rise would cost a taxpayer on a salary of £30,000 an additional £1,500 a year, making it politically difficult, if not impossible in practice.

53 Welsh Government Revenue Calculator - Senedd Research Service

The Welsh Government is constrained both by fairly limited taxation powers and a UK Government that is reluctant to devolve new powers. The Welsh Government has stated that its experience of moving through the agreed process to seek new tax powers has been protracted and challenging, and that given its struggles to make a case for the devolution of powers for a Vacant Land Tax, it is difficult to envision a scenario whereby the case for further tax devolution could successfully be made under existing arrangements[54].

The Covid-19 pandemic firebreak example works well in illustrating the central issue at hand: the UK Government acts on behalf of England in areas that have been devolved to Wales. The Welsh Government acts on behalf of Wales in these areas. However, the UK Government has near-unlimited borrowing powers and far greater influence over the UK's central bank. This therefore creates a situation where the UK Government, on behalf of England, is able to invest in transformative policy whenever it wishes and whenever England needs or votes for this action. The Welsh Government, however, must wait and hope that the UK Government on behalf of England increases spending so that it can benefit from a Barnett Consequential.

This has a wide impact. In practice, England, via the UK Government, can embark on major infrastructure spending such as the HS2 rail scheme. The UK Government simply uses the fiscal firepower available to it – including practically limitless borrowing powers at until recently extremely low rates of interest – to finance the scheme. Wales, however, is in the unenviable position of having a largely pre-spent budget that is almost almost wholly earmarked for public services before it is even received, and must hope that the UK Government acting on behalf of England embarks on a major infrastructure project before it can do so itself. Further to this, it must also hope that the UK Government then gives the consequential at all: as noted earlier in this report, in the case of HS2, the UK Government simply deemed it an England and Wales project despite the entire line being located in England, thus removing the need to give Wales its considerable consequential that could have been used for large infrastructure projects.

It is difficult to see how a proportionate project such as HS2 could occur in Wales. As has been outlined, much of the Welsh Government's budget is committed in practice before it is received, and it has little excess fiscal capacity, with borrowing powers constrained and European funding removed. Despite this, responsibility for much economic development and most infrastructure projects is held at a Welsh level. This contributes to a state of stasis in economic development in Wales, with the UK Government not obliged to contribute to economic development in Wales and the Welsh Government fiscally unable to do so to the same scale as the UK Government is able to do in England. Funding for a very large infrastructure project (such as HS2 in England) in Wales could potentially be met from the Welsh Government's existing capital budgets over a large number of years, but would likely exhaust these at the expense of nearly all other projects. These strict trade-offs demonstrate the central issue at hand: that the Welsh Government, whilst not entirely fiscally powerless, suffers from full governmental responsibilities in devolved areas but tight fiscal rules not suffered by independent nations or the UK Government acting on behalf of England. This limits its thinking to smaller projects.

54 Welsh Tax Policy Report 2021 - Welsh Government (Page 16)

Wales has huge problems to solve, such as pandemic recovery, climate change, educational inequality, child poverty and more. Progressive economist Mariana Mazzucato, in works such as *The Entrepreneurial State* and *Mission Economy* has encouraged governments and policy-makers to apply high levels of boldness and experimentation to these 'wicked problems' of our time. She encourages governments and policy-makers to challenge conventional wisdom that portrays government as a clunky bureaucratic machine that cannot innovate: at best, its role being to fix, regulate, redistribute; and to correct markets when they go wrong. Moreover, she states that we cannot tackle the key challenges facing our economies until civil servants are treated as creative and risk-taking, rather than relying on government simply levelling the playing field and getting out of the way of private business[55].

The Welsh Government is particularly constrained in its ability to be a creative and activist state, creating value for the public good and challenging the 'wicked problems' as outlined above. It is notable that these 'wicked problems' are related to health, environment and education, all of which are devolved. However, with the Welsh Government's fiscal framework constraining policy in Wales, this limits ambition across the board and limits the ability of Welsh Government to act in a transformative manner. The power and (in particular) fiscal constraints placed on the Welsh Government act as a disincentive to transformative, cutting-edge thinking on a major scale.

The current system of the Welsh Government needing to wait for departmental spending changes in England in order to embark on major projects is not a mature or sensible way of financing an entire nation. Part of the initial justification for devolution was that Wales as a nation has different needs to the rest of the UK. As we have laid out publicly[56], the IWA has concerns that the lack of fiscal firepower for the Welsh Government severely limits the scope of policy-making in Wales. In the face of a climate emergency, a broken economic model, and the need to rebuild public services strained to breaking point by an ageing population and the Covid-19 pandemic, policy responses even in fully devolved areas are systemically limited in scale by the fiscal framework.

The Fiscal Framework and 'Levelling Up'

There is also an important point to make regarding the current debate on 'Levelling Up' in nations and regions of the UK to create a more geographically equitable United Kingdom, as opposed to the current situation where Gross Value Added (GVA) per capita is far higher in London and the south east than other areas of the UK.

Wales is in some ways the poorest nation of the UK. GDP per capita is £24,586, whereas across the border in England it is £33,809 per capita. In Scotland it is £30,560, and in Northern Ireland it is £25,656. The GDP per capita in England is therefore 37.5% higher than in Wales, with Wales having a lower GDP per capita than every English region except the North East. There

55 Misson Economy: A Moonshot Guide to Changing Capitalism - Mariana Mazzucato

56 IWA Analysis: Can Wales truly be radical? - Institute of Welsh Affairs

is considerable inequality within England, with the London figure being £56,199 and the north east figure being £24,068.[57] GDP per capita is also an imperfect measure, as it does not take into account wealth distribution. There is also considerable poverty within London.

However, the Welsh Government is funded based on the Barnett Formula, of which only departmental spending in England as a whole by the UK Government matters. It is therefore reasonable to question whether Wales is best served by a system wherein it can only fund infrastructure enhancements based on whether England is also undertaking them. England (as a whole) appears to be starting from a higher base of development than Wales, as the GDP per capita figures demonstrate. This assertion is further demonstrated by the First Minister's claim that 41% of English railway lines are electrified, compared to 25% in Scotland and only 2% in Wales[58].

The fundamental principles underpinning the Barnett Formula are predicated on the Welsh Government being funded based on a population share of UK Government spending in devolved areas in England, along with an additional needs-based formula to ensure that spending in Wales does not fall below 115% of levels in England. This additional funding is therefore a reflection of greater levels of need in Wales, such as an older population placing more strain on the NHS. Although the 115% figure is a rudimentary tool, the underlying point is that this top-up simply allows Wales to keep pace, rather than funding any increased outcomes in comparison to England or other areas of the UK. However, it is worth noting that relative spending is currently above estimated levels of relative need in Wales.

On the topic of infrastructure, it is prudent to question whether a system of funding Wales to keep pace with spending decisions in an already more-developed nation truly allows Wales to 'level up' to the UK or English average. There is very little mechanism for Wales to match the historically high levels of funding[59] and wealth in highly developed areas such as the south east of England (inclusive of London) within the current framework of a block grant based on English departmental spending changes, inflexible taxation powers, and extremely limited borrowing powers. Although the UK Government's replacement scheme for European regional economic development funding provides an additional spend to the Barnett Formula, there is scant evidence that this matches the historically higher levels of funding in the south east of England (inclusive of London), or comes close to evening out the additional private sector investment that these areas attract, with private spending being particularly crucial in funding London's new Elizabeth Line[60].

It is therefore reasonable to state that the current fiscal framework may have the impact of 'locking in' Wales to a lower level of infrastructure development than England as a whole, with current fiscal systems not providing either the funding for Wales to 'catch up', or the means for the Welsh Government to attempt to provide this 'catch up' funding itself. If England as a whole

57 Regional economic activity by gross domestic product, UK: 1998 to 2019 - ONS
58 Plenary Transcript 21/09/2021 - Senedd Cymru
59 More than half UK investment in transport is in London, says study - The Guardian
60 Funding - Crossrail

is starting a few developmental steps ahead of Wales, a funding system that only allows both nations to take one step ahead together will never produce overall equality. It is of course worth noting that, despite this fact, comparisons with England as a whole should be caveated with the knowledge that there is significant regional inequality within England itself.

One potential partial solution to this problem may be allowing more flexibility in Wales' borrowing powers. Raising the current cap of £1bn in total to a level that allows major projects to begin at the behest of the Welsh Government and Wales' priorities and needs may remove this developmental straightjacket. This could mitigate the issue of spending currently being driven by departmental spending changes in England and reliance on the willingness of the UK Government of the day to deliver major Barnett consequentials that Wales is owed.

It is important to separate criticism of strict restrictions on the Welsh Government to practically launch its own large-scale projects and economic reforms from any grievance surrounding Wales as a whole being under-funded by the UK Government. Wales is a considerable beneficiary of UK public spending redistribution, as is every area outside of London and the south east. In 2019-20 Wales had a public sector expenditure deficit of around £14.4bn with total receipts from Wales of around £31bn and total public sector expenditure of around £45.5bn[61].

There is considerable debate around the interpretation of these numbers. That Wales is a net beneficiary of public expenditure is predominantly due to its low tax receipts rather than higher net spend, with total public expenditure per capita in Wales almost 8 per cent higher than the UK average but revenue per head being 25% lower[62]. Higher tax receipts from London and the south east, which are then redistributed to other areas of the UK, are the result of the greater wealth that this corner of the United Kingdom benefits from. It could be argued that the public spending deficit of Wales and much of the rest of the UK is a symptom of neglect by various UK Governments rather than a symbol of its virtue. What is less debatable, however, is that the current situation is as it stands: Wales is a considerable net beneficiary of funding from other areas of the UK, and different public policy choices by the UK Government could reduce or eliminate this if desired.

UK Government spending in Wales is unsurprisingly considerable. UK Government departmental spending equates to about 43% of identifiable public expenditure in Wales, with Welsh Government spending making up around 35% and local government spending equating to around 22%. The UK Government therefore plays a more active role in spending in Wales than in Scotland (36%) and Northern Ireland (16%), a reflection of the more limited nature of devolution to Wales.

The way the UK Government spends is worthy of further consideration. In 2019 Wales received only 0.9% of government and research councils' research and development spend in the UK, despite making up nearly 5% of the population. Total expenditure (including higher education, business, and nonprofits) on research and development in Wales was 2% of the UK total[63]. The Institute of Fiscal Studies has found that investment spending per head is £1,456 per head in

61 Country and regional public sector finances net fiscal balance tables (Financial Year ending 2020 of this dataset) - Office for National Statistics

62 Twenty years on from devolution, the UK's fiscal and economic model is still broken - OpenDemocracy

63 Latest research and development expenditure by area and expenditure type - StatsWales

London, versus an average of £891 in the rest of the UK, with transport spending being 2.5 times higher in London than the rest of the UK[64]. The focus of this paper is on the potential for reform of the fiscal framework in order to allow the Welsh Government to more effectively conduct its devolved responsibilities, rather than litigating the fairness or unfairness of total spend in Wales. However, further study on the effectiveness of UK Government spending in Wales, and whether it is predicated towards mitigating symptoms of an underperforming economy, rather than creating a strong and fair economy, is clearly needed.

Borrowing and Inflation

As outlined earlier in this report, the Welsh Government has a total cap on its capital borrowing powers via the NLF of £1bn in perpetuity, with a cap of £150m of annual spend.

One limitation of this borrowing settlement that has become more urgent in recent months is the lack of an automatic provision to increase these caps on annual and total borrowing with inflation. The Wales Act 2014 allows this cap to be raised by the Secretary of State for Wales via the affirmative procedure in the House of Commons in order to keep the cap at the same level in real terms in response to inflation.

However, despite provisions in the Act aimed at explicitly preventing the Secretary of State for Wales from reducing the borrowing cap, in real terms they are able to do so via simply failing to uprate the annual and total caps for inflation. With inflation forecast by the Bank of England to hit 11%[65], the Welsh Government's borrowing powers are set to drop significantly in real terms unless the UK Government intervenes. This further demonstrates the restrictions faced by the Welsh Government on its fiscal settlement and the need for fiscal devolution to match power devolution.

Expense of Borrowing

The Welsh Government currently has the powers to borrow £1bn of capital funding via the NLF. It can also theoretically issue its own bonds, which also count towards its total borrowing cap.

As stated above, the Welsh Government's Finance Minister stated that they would not have developed the Mutual Investment Model (MIM) in order to access capital funding over and above its existing capital budget and borrowing powers if they had access to other forms of borrowing[66]. The Senedd's Finance Committee found that it is hard to establish a significant difference between the MIM and Private Finance Initiatives (PFI), specifically as to how MIM offers greater value for money. PFI schemes have been criticised for their high cost to the taxpayer, with the National Audit Office (NAO) finding in 2018 that from £60bn of total capital value of schemes

64 Levelling up: what might it mean for public spending? - Institute for Fiscal Studies

65 Bank of England says inflation will hit 11% after raising interest rates to 13-year high - The Guardian

66 Finance Committee, Record of Proceedings, 17 July 2019, paragraph 88 - Senedd Cymru

entered into by that point, there would be a total cost of £199bn to the UK taxpayer[67], with private finance costing as much as 40% more than using public money[68].

Of the borrowing options available to the Welsh Government, it is borrowing through the NLF that appears to be the most cost-effective. Professor Gerald Holtham told the Senedd's Finance Committee that borrowing via the NLF was by far the cheapest source, that the costs were fixed-rate and predictable, and that there were no negatives when compared with other forms of borrowing available to the Welsh Government[69].

This raises the clear concern that the Welsh Government has a cap on the most cost-effective form of borrowing available to it, but has developed a model outside of this cap that appears to be far more expensive. The fiscal framework's low cap on borrowing via the NLF therefore almost certainly raises the cost of the Welsh Government financing capital projects in Wales, delivering lower value to the taxpayer and constraining the amount of finance available to spend on projects rather than enabling the effective financing of them.

There is therefore a clear case to maximise the amount of borrowing available to the Welsh Government via the NLF in order to move as much financing as possible away from costly private finance and towards cheaper forms of borrowing. The current system wherein the Welsh Government is structurally incentivised to move its borrowing towards more expensive forms of finance does not appear to have any logical consistency. The Senedd, Welsh Government and UK Government should consider whether this system as a whole pushes the cost of financing capital projects to greater levels in Wales than in England.

Non-Traditional Project Disincentives

The cap on borrowing via the NLF may have other consequences than forcing the Welsh Government to use more expensive forms of finance. Holtham told the Senedd's Finance Committee that private finance expense is calculated based on risk, with private finance providers preferring to lend to projects that they are used to doing and more comfortable with,[70] which provides a lower cost of borrowing than for innovative projects they have not financed before, and which may therefore be deemed to have a higher risk for lenders.

This means that borrowing via the NLF is more suited to innovative or radical projects, and borrowing via the private sector is best used for more conservative and traditional projects. With the Welsh Government's borrowing via the NLF being subject to a strict and low cap there is therefore a clear financial incentive for projects undertaken in Wales to be more conservative and traditional, in order to appeal to private finance lenders. This paper does not take a position

67 PFI and PFI2 - National Audit Office

68 Taxpayers to foot £200bn bill for PFI contracts – audit office - The Guardian

69 Finance Committee - Fifth Senedd - 01/05/2019 - Senedd Cymru

70 Finance Committee - Fifth Senedd - 01/05/2019 - Senedd Cymru

on which form of project is preferable. However, there would appear to be a 'radicalism tax' on projects that are both large-scale enough to be untenable for the Welsh Government's strict £1bn cap, and non-traditional in the sense that the private sector does not usually finance them. This is likely to constrain innovative policy-making with regards to capital projects in Wales.

Lack of Control

As discussed, a lack of budgetary control is a core issue with the Welsh Government's fiscal framework. Around 80% of the Welsh Government's funding comes from the block grant, which is ultimately driven by spending decisions taken by the UK Government on behalf of England. If the Welsh Government wishes to undertake a project above a certain scale, it must either take this money from public services, borrow it privately via the Mutual Investment Model, or hope that the UK Government decides to undertake a project of a similar scale in England, and that it delivers on Barnett consequentials.

A more mature system of financing a government would allow the Welsh Government to fire the starting gun on major projects itself, as long as this was possible within the Welsh Government's long-term fiscal reality.

Conclusions and Potential Solutions

This paper has identified issues within the Welsh Government's current fiscal framework that limit its ability to deliver on its devolved responsibilities. It is in an unenviable situation as a government that it is largely unable to borrow to deliver larger-scale spending projects, despite having the responsibility to deliver in areas that other governments would commonly use these borrowing powers in, such as economic development, transport, skills, and education.

Welsh Government borrowing via the NLF or through issuing its own bonds is capped at £1bn. It is funded via the Barnett Formula, with changes to spending predicated on decisions made by the UK Government on behalf of England with consideration to England's needs. The Welsh Government is therefore severely limited in its ability to undertake large capital spending projects through running a deficit, as is common to many governments. It has virtually no resource borrowing powers at all. Previously, European Regional Development Funding of around £300m a year provided a significant sticking plaster to this, providing the Welsh Government with funding powers over and above the 'Barnettised' amount which is largely earmarked for the day-to-day running of public services.

The IWA believes that there is an urgent need to unlock the Welsh Government's fiscal ability to address the responsibilities devolved to it in a practical manner. This has become more urgent in the wake of a huge proportion of the Welsh Government's economic development funding being moved from Cardiff Bay to Westminster. The devolution of responsibilities without the full devolution of the fiscal tools needed to deliver against these responsibilities has too often been absent from debate around the constitution, and this is ultimately of huge consequence to delivery on the bread-and-butter outcomes that matter to citizens of Wales. Powers without finance often become merely theoretical powers, and this fact should be more widely acknowledged in debates surrounding Wales' constitutional situation.

This report has also highlighted that the current fiscal framework emerged in a different time with the process to our current settlement beginning in 2007, prior to the Welsh public voting for full law-making powers, the Covid-19 pandemic raising the profile of devolution and the Welsh Government, or implicitly signing off on tax-raising powers in Senedd elections.

A 2020 YouGov poll asking if a range of powers including tax and welfare should be fully devolved to the Welsh Parliament found 40% of Welsh voters in favour and 28% against, with those saying they didn't know or wouldn't vote making a combined 30%. Of those expressing an opinion, 59% were in favour[71]. Institute for Government analysis shows that support for full independence has risen from 20% to 30-35%[72], with YouGov finding support for abolishing the Senedd at 28%[73]. Although there is a range of opinion, attitudes towards devolved powers in the Wales of 2022 are

71 'Devo-Max Poll' - YouGov

72 Percentage of people who would vote yes in a Welsh independence referendum - Institute for Government

73 Who supports abolishing the devolved parliaments, and why? - YouGov

clearly very different from the context in which Rhodri Morgan said there was 'no mandate' for any taxation powers in 2010. A strong devolution settlement with fiscal powers included appears to be very much the settled will of at least a large plurality of Welsh voters.

This paper aims to contribute towards a discussion about what the role of the state is in Wales. The economic model of past decades has contributed to surging inequality and a contemporary cost of living crisis, and has proved unable to mitigate negative externalities such as carbon emissions, instead simply outsourcing them elsewhere. This has led to a resurgence of interest in a more creative and interventionist state, shaping markets towards the common good and contributing to the success of private enterprise, as the state has always done, via education, research and development, and strategic infrastructure developments. The UK Government's furlough scheme was an example of a creative, interventionist state measure contributing to the public good. It was also a clear example of how fiscal firepower allows these policies to happen at a UK level, but not a Wales level.

In Wales this debate often appears to be constrained to technocratic arguments about the fairest and most efficient way to deliver public services that are under increasing strain, with a thin offering of genuinely innovative, yet small-scale projects and pilots[74] at the fringes that make a difference to individual lives but which do not improve the fundamental structures of our society or economy. Strong consideration should be given to the idea that the fiscal framework, which provides very little excess capacity to launch projects over and above public service delivery, at the very least provides an incentive for decision-makers to act in this way.

There is still debate about the very concept of devolution in some quarters, and the thought of the Welsh Government acting as 'the state' and attempting to fundamentally reform society and economy, rather than simply hand over money for the delivery of public services, will no doubt be met with surprise or challenge in those quarters. However, the Welsh Government has the clear responsibilities of a state and a clear democratic mandate to act in this way. It should therefore be confident in arguing for it to be empowered to act in this way, and to ask itself the bigger questions about what its role is, and what it wants the Welsh economy and society to look like. With responsibilities as important to people's lives as housing, healthcare and education devolved to it, thinking of itself as anything less than a state would be an abdication of duty on the part of the Welsh Government.

Another finding of this report is the illogical way in which the Welsh Government's borrowing powers are organised. Borrowing of the cheapest forms are subject to strict limits, incentivising more expensive forms of borrowing, which themselves are a disincentive to innovative thinking.

There is a strong case for reform to the Welsh Government's fiscal framework in order to allow major investment decisions to begin as a result of democratic decision-making within Wales, rather than UK Government investment in England and subsequent consequentials. This should also encompass reforms to allow the Welsh Government access to the cheapest forms of borrowing.

74 Wales pilots Basic Income scheme - Welsh Government

There are a number of options available that could rectify some, or all, of these issues. The Australian Government utilises the independent Commonwealth Grants Commission[75], which makes recommendations on distribution of their Goods and Services Tax Pool based on need. A system such as this, if taking into account historic differential levels of investment in infrastructure and the private sector wealth and investment that has followed it, could provide an equitable alternative to the current system whilst still allowing constituent nations of the UK freedom to choose how they spend the funds. However, this would require a full overhaul of funding mechanisms, and the advantages and disadvantages of such a move are beyond the scope of this report but nonetheless worthy of consideration by those with a wider remit. The extent to which such a commission can be wholly independent, if ultimately funded by the UK Government, should also be considered.

Another consideration is how non-devolved departments of the UK Government are funded. UK Government departmental settlements are based on departmental statements of need, and the extent to which the UK Treasury agrees with this need and builds it into wider spending plans. The Barnett Formula and Welsh Government block grant which constitutes 80% of funding is far more of a 'take what you're given' system. During our research for this report, one interviewee raised the option of direct negotiations between Welsh and UK Governments over the block grant based on Welsh need. However, this option would rely on a constructive relationship of respect and goodwill on the part of the UK Government in making the decisions, something that cannot be guaranteed, as this report and experience has demonstrated.

The most obvious decision that would increase the fiscal firepower of the Welsh Government to levels over and above public service delivery, whilst delivering fairness to the rest of the UK, is by an increased ability to borrow via the NLF. On the face of it, this would allow the Welsh Government to borrow money to finance its own priorities, constrained only by the fiscal realities that all governments face. This would also rectify the illogical situation wherein private financing is encouraged in Wales, with the cheapest forms of borrowing strictly limited.

The Welsh Government has not yet fully utilised its existing borrowing powers, having only borrowed £65m of its total £1bn cap in 2021[76]. This has been pointed to by some, including the UK Government[77], as a reason against extending the current borrowing limit. The Welsh Government itself has said that it begins every financial year with the intention to borrow £150m for capital investment, but late capital Barnett consequential receipts mean that this need is satisfied. It therefore places the blame on the inflexibility of the current system, with its total capital budget for the year being impossible to predict due to the nature of the fiscal framework.

This paper does not enter into the debate around blame for the current under-utilisation of borrowing powers, but does reject the notion that it should have a large bearing on any decision to raise the cap. Debates amongst political parties about the extent to which deficits should be utilised and to what scale are healthy and common in democracies. There is also the question of what the response would have been if the Welsh Government had 'maxed out' its permanent borrowing capacity in a few short years and then asked to extend its limit.

75 Commonwealth Grants Commission - Australian Government

76 The Welsh Government is significantly under-utilising its borrowing powers - Business Live

77 If Welsh Government wants greater borrowing powers it needs to make a compelling case says Simon Hart - Business Live

As referenced earlier in this report, the Welsh Government has stated that it would not have developed the Mutual Investment Model had more affordable forms of borrowing been more readily available. It has called for an appropriate borrowing limit within the context of prudential borrowing, with the limit set by the Welsh Government in discussion with the Senedd[78]. This call is based on the prudential system for local authority capital finance introduced by the UK Government in 2004, allowing local authorities to determine their own levels of affordable borrowing for capital expenditure.

The Welsh Government's own guidance to local authorities on prudential borrowing states that prior to the introduction of this system there were perverse incentives to look for forms of finance which did not count against capital finance controls, with value for money from financing taking a poor second place to finding a form of finance which would deliver an asset without using up credit approvals[79]. The parallels with the Welsh Government's use of the Mutual Investment Model are clear. The Welsh Government's guidance also states that under the prudential system, local authorities can decide for themselves how much they can afford to borrow based on a prudent assessment of their capital expenditure requirements.

This call for a prudential borrowing framework for the Welsh Government was supported by the Fifth Senedd's Finance Committee in 2019. The committee stated that the Welsh Government had given evidence that it was seeking prudential borrowing powers to support its capital infrastructure programme, with the majority of Committee Members agreeing this should be a priority and that the Welsh Government should continue to petition for these powers[80].

This paper has identified issues in the current fiscal framework surrounding a lack of control by the Welsh Government over its ability to launch major projects, a disincentive to borrowing to fund innovative policy, a fiscal framework that embeds Wales' place as one of the least-developed areas of the UK, and a systemic narrowing of this situation by means of inflation. The introduction of prudential borrowing would appear to address all of these issues, with borrowing limited by the Welsh Government's ability to pay rather than an arbitrary £1bn cap. A substantially raised cap, although not as preferable as prudential borrowing powers, would also be preferable to the current system.

A prudential borrowing framework for the Welsh Government, allowing it to borrow unlimited amounts via the NLF, also has the benefit of being tried and tested within a UK context by local authorities.

There is some risk associated with a prudential borrowing framework for the Welsh Government, as identified by the Holtham Commission's warning of the 'moral hazard' of overspending by sub-central government. The issue is summarised well by Jonathan Rodden, who states that:

> *'The central argument starts with a basic dynamic commitment problem facing the centre in all decentralised systems of government… when the centre dominates the power to tax and*

78 Finance Committee 17/07/2019 - Senedd Cymru (Paragraph 80)

79 Guide to the Prudential Framework for Capital Finance for Local Authorities in Wales - Welsh Government

80 Inquiry into the Welsh Government's capital funding sources - Fifth Senedd Finance Committee

takes on heavy obligations to fund subnational governments, it cannot credibly commit to withhold bailouts in the event of a local fiscal crisis. Knowing this, subnational officials face weak incentives ex ante for fiscal discipline… credit rating agencies perceive implicit federal guarantees of subnational debt in the vast majority of the world's decentralised systems – even the majority of formal federations… Thus decentralised finance poses a moral hazard problem for countries – federal and unitary alike – in which subnational governments are funded primarily through revenue-sharing and grants. Knowing that creditors and voters have relatively weak incentives to discipline local governments, it is in the central government's interest to place firm limits on their borrowing.'[81]

This moral hazard is partially mitigated by the fact that a stable and extensive sub-national borrowing power framework currently exists in the UK in the form of prudential borrowing powers for local authorities. Viewed from a policy-making perspective, it appears strange that strong borrowing powers are granted at a UK level and the local level, but not to a national Welsh level, despite notionally extensive devolved responsibilities.

Rodden does state that the 'real fiscal danger' is a 'murky semi-sovereignty' that comes about when a politically constrained centre dominates taxation but not spending and borrowing, pointing towards Canada, Switzerland, and the United States as pre-eminent examples of federations that he believes have constituent units that are viewed by creditors essentially as sovereign, in large part due to primary funding coming via broad-based taxes over which they have considerable autonomy, rather than grants from the centre.[82] This would appear to strengthen the case for the further devolution of taxation towards the Welsh Government in order to decrease the 'moral hazard' outlined by Rodden, and to increase fairness to the UK Government. It is worth noting that prudential borrowing powers would almost certainly allow the Welsh Government to borrow through the NLF as well as by issuing its own debt, reducing the potential for creditors to look at the Welsh Government as a fiscal sovereign and making a theoretical bailout by the UK Government more explicit than implicit. It is likely that NLF borrowing would always take precedence over Welsh Government borrowing, due to its probable lower cost.

There are therefore two opposing needs for reform to the Welsh Government's fiscal settlement. The first is that policy divergence and the effective execution of responsibilities and democratic mandates are limited by a narrow fiscal settlement. The second is a fiscal reliance by the Welsh Government on the UK Government, not only for its considerable financial subsidy but also for the low cost of its borrowing, due to the likelihood of it taking place via the NLF.

81 Hamilton's Paradox: The Promise and Peril of Fiscal Federalism - MIT (p326 - 327)

82 Hamilton's Paradox: The Promise and Peril of Fiscal Federalism - MIT (p329)

Strengthened borrowing powers would ultimately contribute to increasing the empowerment and accountability of the Welsh Government. Reforming its ability to borrow would empower the Welsh Government by giving it a greater fiscal firepower to undertake the democratic duties devolved to it, as well as enable it to finance its own policy initiatives, rather than calling for the UK Government to announce measures in order to release the funding via Barnett consequentials to Wales. Allowing the Welsh Government more fiscal leeway via borrowing powers to fund policies such as mass house-building programmes, transport infrastructure, income tax cuts, public sector pay rises and more would move the final say on these measures, as well as the accountability for them, further towards Cardiff Bay, rather than Westminster. We are in favour of this.

Recommendation 1:

The IWA supports the Welsh Government's calls for it to have prudential borrowing powers and it should continue to explore the case for this. It should publish its up-to-date case for having these powers in response to this report in order to push this important issue more fully onto the political agenda.

However, any concerns from the UK Government surrounding levels of borrowing by the Welsh Government are legitimate. Greater borrowing powers, whilst needed to allow the Welsh Government to effectively executive its responsibilities and democratic mandate, do carry some risk for the UK Government. A greatly increased borrowing cap may reduce this hazard, but the risk of a large cap could be that it becomes implicitly seen as a 'safe' level of borrowing by the Welsh Government, whereas this may not be the case.

The concerns over the 'moral hazard' of explicit or implicit bailout guarantees for the Welsh Government by the UK Government need to be counterbalanced by the ability of the Welsh Government to conduct policy that is voted for by people living in Wales. The low £1bn cap veers too far in favour of the UK Government's concerns and ignores the need to allow the Welsh Government to be able to fully execute devolved powers and live up to its devolved responsibilities.

Prudential borrowing powers with strong mechanisms for reclamation of debt repayments may be a more appropriate system to counter-balance these opposing needs. For example, a new and explicit agreement between the Welsh and UK Governments that debt repayments are removed from the Welsh Government's block grant before it is received may go some way to removing any implicit bailout guarantee on the part of the UK Government. Leaning on Rodden's work, the further or full devolution of income tax to the Welsh Government would give the fullest level of security surrounding debt repayments by reducing the assumption that the UK Government, as the main recipient of Welsh taxes, should bail out a Welsh Government that may have overleveraged itself. It is worth pointing out that there is no practical restriction on the UK Government that compels it to bail out any theoretical Welsh Government in this position: it would be the UK Government's decision to do so.

Recommendation 2:
The UK Government should accept the insufficiencies of the Welsh Government's fiscal framework and accept the Welsh Government's case for prudential borrowing powers via the National Loans Fund, if it is able to protect its own position from the 'moral hazard' of implicit bailouts by means such as further tax devolution or strong repayment guarantees. An increased borrowing cap would provide an improvement on the current system, but is less preferable to prudential borrowing powers for the Welsh Government.

There is also the question of capital versus revenue borrowing powers. Allowing the Welsh Government the flexibility to borrow for both capital and revenue purposes would open up a greater range of policy options. If a future Welsh Government were ideologically so inclined, borrowing for revenue purposes might help to finance some tax cuts, theoretically giving Wales a competitive advantage.

Recommendation 3:
Any future amends to the fiscal framework should seek to maximise flexibility for the Welsh Government in the use of reserves and borrowing, and between resource and capital. For example, greater flexibility within borrowing powers should be explored, including allowing borrowing for revenue as well as capital expenditure in order to increase the number of policy options available to the Welsh Government.

Fixing the Welsh Government's borrowing powers would not be the end of reforms to the Welsh Government's fiscal framework. Any long-term and substantial fiscal divergence in Wales from the rest of the UK – if desired and voted for by Welsh voters in Senedd elections – would also likely require a change in taxation levels. Narrow control over income tax (without control over bands) and few other taxes is also likely to constrain the Welsh Government's ability to fulfil democratic mandates for reform, and reform of the Welsh Government's taxation powers also merits further study, both by academics and by decision-makers seeking to reform the UK and Welsh constitutions.

Recommendation 4:
The lack of fiscal firepower for the Welsh Government should be a core consideration for all policy-makers, academics, and the Constitutional Commission.[83]

Self-governance in Wales was ultimately decided on, implemented and consistently strengthened on the premise that Wales as a nation has its own strong identity, and differing needs to the other nations in the UK. The very existence of this self-governance is predicated on the notion that Wales via its own government should be able to vote for and implement differing policies to other constituent nations. The Welsh Government's fiscal powers should reflect this, and be reformed to allow divergence to take place when desired and voted on by the citizens of Wales.

83 The Independent Commission on the Constitutional Future of Wales

IWA ECONOMY