



Northern Ireland
Assembly

Research and Information Service Research Paper

17 January 2013

Gareth Brown, Bob Harper and Colin Pidgeon

Update on Fiscal Devolution and Devolved Funding

NIAR 903-12

This Research Paper provides an up-to-date review of developments across the United Kingdom (UK) in relation to fiscal devolution and funding arrangements for the devolved administrations. The paper suggests some issues arising from the review that the Committee for Finance and Personnel may wish to consider as part of its future inquiry into the Barnett formula.

Executive Summary

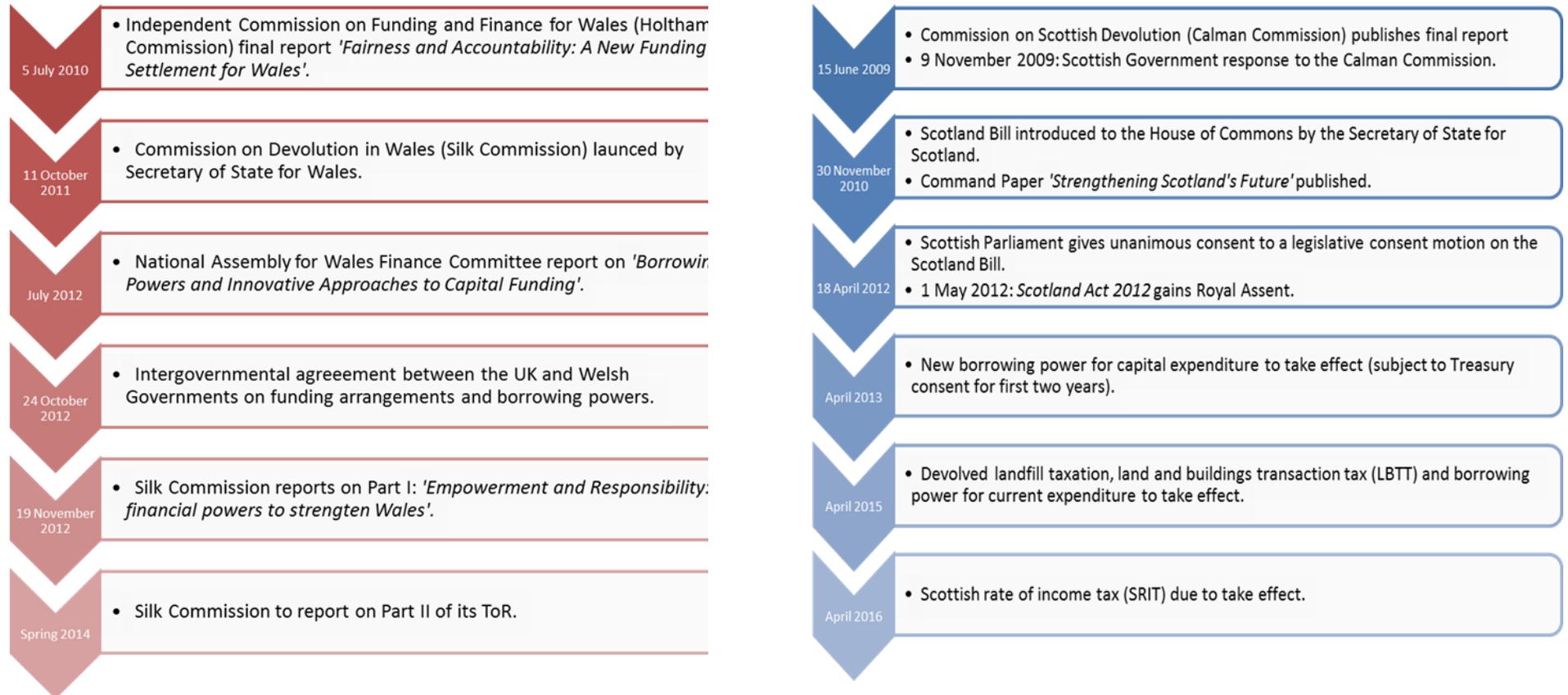
The research presented in this paper demonstrates that the debate around fiscal and financial devolution has moved some distance in relation to the UK's other devolved administrations since the Committee for Finance and Personnel last considered these issues.

In particular, there has been a noticeable shift in the UK Government's position on the operation of the Barnett formula. In an intergovernmental agreement with the Welsh Government, the UK has agreed to consider the impact of 'convergence' at the time of the next spending review. Further, there is an apparent commitment to act to mitigate the impact of any such convergence.

In relation to other issues, there have been a number of recommendations made in relation to Wales and to Scotland (on borrowing powers, partial devolution of income tax, and in relation to new 'own territory' devolved tax powers) which may – if fully implemented – leave Northern Ireland out of step with the other devolved administrations.

Timelines of the developments in Scotland and Wales are presented below at Figure 1.

Figure 1: Timelines of major events associated with fiscal devolution in Wales and Scotland



Contents

- Introduction7
- 1. Scotland8
 - 1.1. The Calman Recommendations9
 - 1.2. Scotland Act 2012: Provisions and Analysis10
 - 1.2.3. *Bonds*13
 - 1.3. Observations on developments in Scotland15
- 2. Wales17
 - 2.1 Intergovernmental talks on funding reform.....17
 - 2.1.1. *Devolved funding*17
 - 2.1.2. *Borrowing powers*.....18
 - 2.2. The Silk Commission19
 - 2.2.1. *Taxation powers*20
 - 2.2.2. *Borrowing powers*23
 - 2.2.3. *Improving the availability of information*.....23
 - 2.3 The Finance Committee report on other capital funding options24
 - 2.4. Observations on developments in Wales24
- 3. Northern Ireland26
- Appendix 1: the Silk Commission’s recommendation in relation to corporation tax28

Introduction

Since the Committee for Finance and Personnel (CFP) was last briefed substantively on the subject,¹ there have been some developments in the debate surrounding fiscal devolution and the application of the Barnett formula in the UK. This Research Paper examines the issues arising from these developments.

In particular, this paper highlights specific points that CFP may wish to bear in mind when formulating the terms of reference for its forthcoming inquiry into the operation of the Barnett formula in Northern Ireland.

The paper is structured as follows:

- Section 1 looks at developments in Scotland;
- Section 2 looks at developments in Wales; and,
- Section 3 draws out relevant points for consideration in relation to Northern Ireland.

¹ On 8 February 2012 the Committee heard from expert witnesses (Mr Gerald Holtham, Prof. Iain McLean and Mr Alan Trench) [[Official Report 8 February 2012 Committee for Finance and Personnel](#)] and was briefed by the Northern Ireland Assembly Research and Information Service (RaISe) on the Barnett formula. See RaISe (2012) [Pros and Cons of the Barnett Formula for Northern Ireland \[NIA 29/12\]](#) and [Barnett Consequentials \[NIA 04/12\]](#).

1. Scotland

The debates around the nature of fiscal devolution and devolved funding arrangements for Scotland have continued to evolve in recent times. Notable landmarks include: the Calman Commission - which published its final report in 2009 - entitled *Serving Scotland Better: Scotland and the United Kingdom in the 21st Century*;² a commitment from the UK government to implement the proposals; and, the subsequent Scotland Act 2012 that legislated for several of the recommendations. Moreover, discussions around fiscal devolution have intensified in light of the Scottish independence debate.

This section contains:

- an outline of the Calman recommendations (see section 1.1 below);
- the subsequent relevant provisions of the *Scotland Act 2012* (see section 1.2); and,
- a more detailed discussion of these legislative provisions (see section 1.3).

²Commission on Scottish Devolution (Calman Commission) (2009) [*Serving Scotland Better: Scotland and the United Kingdom in the 21st Century*](#)

1.1. The Calman Recommendations

The Calman Commission, which delivered its final report in 2009, made a number of recommendations with regards to taxation, borrowing and devolved funding arrangements in Scotland. Key recommendations are outlined below in subsections 1.1.1-1.1.3:³

1.1.1. Taxation

The Calman Commission's recommendations on taxation are presented in Box 1.

Box 1: The Calman Commission's recommendations on tax devolution⁴

∞ **Part of the Budget of the Scottish Parliament should now be found from devolved taxation under its control rather than from the grant from the UK Parliament. The main means of achieving this should be by the UK and Scottish Parliaments sharing the yield of income tax.**

Therefore the Scottish Variable Rate of income tax should be replaced by a new Scottish rate of income tax, collected by HMRC, which should apply to the basic and higher rates of income tax.

To make this possible, the basic and higher rates of income tax levied by the UK government in Scotland should be reduced by 10 pence in the pound and the block grant from the UK to the Scottish Parliament should be reduced

Income tax on savings and distributions should not be devolved to the Scottish Parliament, but half of the yield should be assigned to the Scottish Parliament Budget, with a corresponding reduction in the block grant.

The structure of the income tax system, including the bands, allowances and thresholds should remain entirely the responsibility of the UK Parliament.

∞ **Stamp Duty Land Tax, Aggregates Levy, Landfill tax and Air Passenger Duty should be devolved to the Scottish Parliament, again with a corresponding reduction in the block grant.**

∞ **The Scottish Parliament should be given a power to legislate with the agreement of the UK parliament to introduce specified new taxes that apply across Scotland. The new procedure Calman recommends in Part 4 of its Report for the Scottish Parliament to legislate on reserved issues with the agreement of the UK Parliament could be used for this.**

1.1.2. Borrowing

The Calman Commission also advanced proposals for the devolution of greater powers to borrow to Scotland. These are presented in Box 2.

³ Calman Report, Part 3, para 3.206, p. 111-112

⁴ Commission on Scottish Devolution (Calman Commission) (2009) [Serving Scotland Better: Scotland and the United Kingdom in the 21st Century](#) (recommendations 3.1, 3.2 and 3.3)

Box 2: The Calman Commission's recommendations on borrowing⁵**The Scottish Ministers should be given additional borrowing powers:**

The existing power for Scottish Ministers to borrow for short term purposes should be used to manage cash flow when devolved taxes are used. Consideration should be given to using the power in the Scotland Act to increase the limit on it if need be.

Scottish Ministers should be given an additional power to borrow to increase capital investment in any one year. There should be an overall limit to such borrowing, similar to the Prudential regime for local authorities. The amount allowed should take account of capacity to repay debt based on future tax and other receipts. Borrowing should be from the National Loans Fund or Public Works Loans Board.

1.1.3. Devolved Funding

Finally, the Calman Commission also made a recommendation relevant to the operation of the Barnett formula.

Box 3: The Calman Commission's recommendations on funding⁶

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

1.2. Scotland Act 2012: Provisions and Analysis

The *Scotland Act 2012* (the *2012 Act*) was enacted by the UK Parliament, receiving Royal Assent on 1 May 2012.⁷ The *2012 Act* makes many amendments to the *Scotland Act 1998* (the *1998 Act*). These include changes to the Scottish devolution settlement and implementation of many of the recommendations set out by the Calman Commission. As well as making changes to the functioning of the Scottish Parliament and the powers of the Scottish Government, the *2012 Act* strengthens many fiscal and financial powers available to the Scottish administration. Specifically, the new taxation and borrowing powers. Box 4 below highlights these changes.

Once the *2012 Act* is fully implemented from 2016 onwards, the Scottish Government will be responsible for raising around 35% of its revenue. This doubles the current amount of approximately 14% raised locally (mainly under council tax and non-domestic rates).⁸

⁵ Commission on Scottish Devolution (Calman Commission) (2009) [Serving Scotland Better: Scotland and the United Kingdom in the 21st Century](#) (recommendations 3.7)

⁶ Commission on Scottish Devolution (Calman Commission) (2009) [Serving Scotland Better: Scotland and the United Kingdom in the 21st Century](#) (recommendations 3.4)

⁷ Scotland Act 2012, <http://www.legislation.gov.uk/ukpga/2012/11/contents/enacted>

⁸ HM Government (2010b) [Strengthening Scotland's Future \(Cm 7973\)](#) p 23.

Box 4: Key provisions of the Scotland Act 2012⁹

- ∞ A Scottish rate of income tax, to replace part of the UK income tax;
- ∞ Devolved landfill and land (stamp duty) taxes;
- ∞ Powers to devolve further taxes and of the Scottish Parliament to create its own taxes;
- ∞ New borrowing powers;
- ∞ A Scottish cash reserve to manage budget fluctuations; and,
- ∞ A seat for Scottish Ministers on a new UK-Scotland tax committee.

1.2.1 Taxation Powers

Part 3 of the *2012 Act* contains taxation provisions and amends the *1998 Act* (bringing these powers within the legislative competence of the Scottish Parliament).¹⁰ It concerns:

- omitting Part 4 of the *1998 Act*, which deals with the powers of the Scottish Parliament to fix the basic rate of income tax (known as the ‘Scottish variable rate’ or SVR).¹¹ It also introduces changes in income tax for Scottish taxpayers, by decreasing the rate of UK income tax paid by Scottish taxpayers by 10 percentage points and adding a Scottish rate of income tax (SRIT). It provides associated powers to the Scottish Parliament to set the SRIT.¹²
- disapplying UK stamp duty land tax and devolving powers for Scottish Government and Scottish Parliament to set any tax on transactions involving land and buildings in Scotland;¹³ and,
- disapplying UK landfill tax and devolving powers to the Scottish Government and Scottish Parliament to set taxes on disposals to landfill made in Scotland.¹⁴

The SRIT effectively alters the UK rate on all income tax bands (basic, higher and additional rates). The Scottish Government does not refer to the SRIT as a ‘devolved tax’, as it operates within the current UK income tax framework.¹⁵ For example, the Scottish Government will not have the power to change the level of personal allowances or higher rate thresholds – this was labelled the ‘lockstep’ system by the Silk Commission (see 2.2.1) because the ‘gaps’ between bands cannot be altered by the Scottish Government.

⁹ <http://www.legislation.gov.uk/ukpga/2012/11/contents>

¹⁰ *1998 Act* ss 28-30

¹¹ This was a power available to the Scottish Parliament to vary the UK rate of basic income tax by 3 pence in the pound, with any extra revenue collected being due to the Scottish Consolidated Fund (SCF), and any reduced revenue due to the UK Consolidated Fund from the SCF. However, this power has never been utilised since its 1999 introduction.

<http://www.scotland.gov.uk/Topics/Government/Finance/scottishvariabletrate>

¹² *2012 Act* ss 25-7. This also alters the UK *Income Tax Act 2007*.

¹³ *Ibid* ss 28-9.

¹⁴ *Ibid* ss 30-1.

¹⁵ Scottish Government (2012b) *Fiscal responsibility*.

Under the new tax system, Scottish taxpayers¹⁶ are levied a Scottish rate of non-savings income tax, which is additional to any UK income tax they may be subject to (but at a rate of 10 percentage points lower). The effect on Scottish taxpayers is shown in Table 1.

Table 1: Example of income tax rates for Scottish taxpayers under an SRIT of 11.5%.

Income tax band	UK income tax rate ¹⁷	UK income tax rate for Scottish taxpayers	Scottish rate of income tax (SRIT) ¹⁸	Income tax rate paid by Scottish taxpayers
Basic	20%	10%	11.5%	21.5%
Higher	40%	30%	11.5%	41.5%
Additional	45%	35%	11.5%	46.5%

Her Majesty's Revenue and Customs (HMRC) will still collect the taxes due from Scottish taxpayers under SRIT; however, Scotland's block grant will be reduced to reflect the 10 percentage point decrease in the UK rate of income tax, with any additional tax raised through the SRIT to be paid to the Scottish Government.

The Scottish Government must pay any administration costs associated with the SRIT, as was the case with the SVR. Previously, HMRC kept the administrative and technical systems in place for the use of SVR. However, these were eventually suspended in light of Scottish commitments not to use the varying power. HMRC estimated in 2012 that to update the system would cost £7m.¹⁹

For the purposes of the new devolved taxes, a new body (Revenue Scotland) will be established by statute some time in 2015 to run the administration and computer systems.²⁰

Issue for consideration: what are the arguments for and against the partial devolution of income tax to Northern Ireland? Should the issue be considered alone, or together with consideration of reform of the Barnett formula?

1.2.2. Borrowing Powers

Calman recommended that an *additional* power be given in respect of borrowing for capital investment purposes. With respect to current (also known as 'resource') expenditure, the Calman Commission recommended, at most, the modest extension of *existing* powers. Indeed, it was the belief of the Scottish Government that the Calman proposal to enforce limits on borrowing would limit the ability of the Scottish Government to effectively manage its budget over the economic cycle.²¹

¹⁶ Scottish taxpayers are defined by the 1998 Act (as amended by the 2012 Act) **ss 80D-F** as one who has a place of residence in Scotland and/or stays in Scotland for more days of the year than in any other part of the UK.

¹⁷ From April 2013, under current plans.

¹⁸ This rate must be one whole number applied across each of the income tax bands.

¹⁹ <http://www.scotland.gov.uk/Topics/Government/Finance/scottishvariabletrate> (accessed 16 Jan 2012)

²⁰ Scottish Government (2012c) [Revenue Scotland](#).

²¹ Scottish Government (2009) [Response to the recommendations of the Commission on Scottish Devolution](#) paras 14-16.

The Scottish Government instead believed that the power to borrow without restriction would enable it to manage its budget and to offset cyclical shortfalls in tax receipts – i.e. ‘volatility’. Nonetheless, the *2012 Act* **did place restrictions on this power**.

Existing powers to borrow are covered by the *1998 Act*, which contains provisions allowing borrowing by the Scottish Ministers to meet temporary overdrafts in the Scottish Consolidated Fund (SCF) in order to provide a working balance.²²

In addition to these existing powers, the *Scotland Act 2012* included provisions allowing the Scottish Government, with the permission of the Secretary of State, access to borrow:

*...any sums which in accordance with rules determined by the Treasury are required by them to meet current expenditure because of a shortfall in receipts from devolved taxes, or from income tax charged by virtue of a Scottish rate resolution, against forecast receipts.*²³

There will therefore be strict rules - overseen by the Treasury - in place if the Scottish Government needs to borrow to manage tax volatility.

Furthermore, the Scottish Government will be given the power to borrow in order to fund capital expenditure from April 2013. Again, **the provision contained with the 2012 Act implementing this proposal requires Treasury approval before any borrowing can take place**. The *2012 Act* also contains provisions allowing the maximum amount that Scottish Ministers are able to borrow to be increased by the Secretary of State.²⁴

As defined by the *1998 and 2012 Acts*, any borrowing that Scottish Ministers undertake must be backed by the National Loans Fund (NLF - issued via the Secretary of State) or from commercial banks.²⁵ However, this does not include the issuance of bonds.²⁶ The *2012 Act* permits future amendments that could enable such powers.²⁷ A recent consultation by the Treasury considers the issue of bonds which is discussed in the following section.

1.2.3. Bonds

During the latter parliamentary stages of the *Scotland Act 2012* in Westminster, UK ministers agreed to consider options to open the way for Scottish bond issues. The Treasury subsequently issued a consultation document in June 2012:

...to gather views and evidence on the costs and benefits, to both Scotland and the rest of the United Kingdom, of granting Scottish Ministers the

²² *1998 Act* [s 66](#) and [s 67](#).

²³ *2012 Act* [s 32\(3\)](#) and Scotland Bill 2010-11, as introduced, [s 32\(3\)](#).

²⁴ *2012 Act* [s 32\(10\)](#). Such amendments would be subject to House of Commons draft affirmative procedure approval.

²⁵ N.B. any borrowing from commercial banks that Scottish Ministers undertake would not be underwritten by the UK Government, and would normally be at a higher rate of interest than borrowing from the NLF.

²⁶ A bond is essentially a tradeable IOU which usually carries a fixed rate of interest - Financial Times Lexicon <http://lexicon.ft.com/Term?term=bond>

²⁷ *2012 Act* [s 32\(5\)](#). Such amendments would be subject to House of Commons draft affirmative procedure approval.

power to borrow by means of bond issuance for capital expenditure up to the amounts stipulated in the Scotland Act 2012 (£2.2 billion).²⁸

In other words, any power to issue bonds would be **in place** of borrowing from the National Loans Fund or from commercial banks, **not in addition**.

The consultation sets out the parameters of any new power in the context of **devolution**, rather than Scottish independence:

The consultation is also explicitly not seeking views on the issues that would be posed by bond issuance in the case of an independent Scotland. The analysis in this document is focussed on the potential costs, benefits and risks of bond issuance by the Scottish Government as a constituent member of the United Kingdom within the parameters of the Scotland Act 2012. Little can be inferred from this analysis about the likely borrowing costs and set of risks that an independent Scotland would face in its financing activities.²⁹

The reasons for controlling devolved Scottish borrowing are explained in the following terms:

Other things being equal, borrowing by the Scottish Government will increase UK public sector net borrowing (PSNB) and public sector net debt (PSND) or require spending cuts or tax increases elsewhere in the UK. Any change to the borrowing powers of Scottish Ministers therefore has to work for the UK as a whole as well as for Scotland. Setting limits and controls on any new borrowing is critical to ensuring that any borrowing is manageable from within the UK fiscal position, consistent with the continuing reservation of overall macro-economic policy.³⁰

The Treasury consultation also makes the following points:

- Bonds can encourage greater fiscal responsibility and their multi-year nature can improve forward financial planning of capital projects;
- Benefits are contingent on a 'no bail-out' policy from the sovereign (ie the UK) government;
- There is a risk of financial crisis if markets lose faith in the capacity of the borrowing government to make good its debts; and,
- Interest rates can also be higher for sub-sovereign (i.e. devolved rather than independent) governments.

At the time of writing, no Treasury report on the outcome of the consultation or of responses to it is available.

²⁸The Scotland Act: a consultation on bond issuance by the Scottish Government, http://www.hm-treasury.gov.uk/d/condoc_scotlandact2012_bond_issuance.PDF (paragraph 1.1)

²⁹http://www.hm-treasury.gov.uk/d/condoc_scotlandact2012_bond_issuance.PDF (paragraph. 1.3)

³⁰http://www.hm-treasury.gov.uk/d/condoc_scotlandact2012_bond_issuance.PDF (paragraph 1.14)

Issue for consideration: should the power of the Northern Ireland Executive to borrow through the issuance of bonds be investigated?

1.3. Observations on developments in Scotland

The *Scotland Act 2012* devolved many new financial powers to the Scottish Parliament as a result of the Calman Commission's report.

However, the Scottish Government believed that the Calman Commission was a “*missed opportunity*”, as it did not go far enough in devolving full fiscal powers, which the Scottish Government believed would allow Scotland to take full responsibility for the money it spends and to take economic decisions for itself.³¹

Devolution commentator Alan Trench referred to the UK Government's implementation of the Calman Commission's proposals as ‘Calman minus’, rather than ‘Calman plus’.³² This is because it **restricted the income tax proposal to apply to only non-savings income (i.e. income from employment), and not to savings and dividends income, which would remain to be taxed at UK levels.** However, Calman had recommended that half of the yield from the savings and dividends proportion of income taxes raised in Scotland should be assigned to the Scottish Parliament.³³

In addition, the Calman Commission had recommended the transfer of powers over air passenger duty (APD) and the aggregates levy (a tax on mineral mining) to the Scottish Parliament, but these powers were not included in the Scotland Bill, as introduced.³⁴ The aggregates levy was subject to a legal challenge at the time of the Bill's drafting, and the UK Government did not believe that it was the right time to devolve APD (subject to other discussions on the future of aviation taxation).³⁵

The new borrowing powers as a result of the *2012 Act* extend to the Scottish Government the ability to borrow from the National Loans Fund (NLF) - up to a total control limit - in order to manage the volatility of revenues as a result of partially devolved income tax responsibility. Also included are powers to borrow from the NLF in order to fund capital spending, up to a limit of £2.2 billion.

Both powers are subject to further control by HM Treasury (i.e. Treasury may permit or deny funding based on the proposals for spending or basis of repayment). The Scottish Government does not have the power to issue its own bonds, although Treasury is consulting on this issue (however, any issuance of gilts would fall under the current maximum borrowing limit) – see section 1.2.3.

The Scottish Government sees these annual and cumulative caps for short-term borrowing as inadequate. As the cap for borrowing in the *1998 Act* is £500 million, it does not think the *2012 Act* provisions keep pace with the scale of change in the

³¹ Scottish Government (2009) para 32.

³² The Scotsman 13 May 2010 [Alan Trench: Calman plus can rule Scotland within Union.](#)

³³ Calman Commission (2010) recommendation 3.1(c) (p 111)

³⁴ *Ibid* recommendation 3.2 (p 111)

³⁵ HM Government (2010b) p 32.

revenue funding framework of devolved taxes. In other words, the increased reliance on new revenue streams introduces the prospect of volatility and the current cap may not be sufficient to manage new developments.

In relation to devolved funding arrangements, there is no apparent intention to reform the Barnett formula, and the *2012 Act* made no changes to the current funding situation.

During its investigations, the Calman Commission noted that the Barnett formula does not sufficiently address need, and that the spending levels which resulted from it were not equitable when applied in practice.³⁶ The Commission considered the issue of devolved funding to be outside its terms of reference, and so did not make any specific recommendations on what should be done, but did note that the Barnett formula provides stability and predictability. However, it did recommend that any basis for funding devolved institutions across the UK must use needs as the foundation for any future inquiry into this area.³⁷

Members may be interested to note that the proposals made by the Silk Commission in Wales (which are presented in the following section) echo a number of the proposals made in relation to Scotland.

³⁶ http://www.hm-treasury.gov.uk/d/pesa_complete_2012.pdf - The latest data published in the Public Expenditure Statistical Analysis shows in disparities in the total amount of public spending per head across the regions (UK base = 100; England = 97, Wales = 113, Scotland = 114, Northern Ireland = 120), as the Barnett formula is not related to need, it is difficult to explain disparities.

³⁷ Calman Commission, p. 111

2. Wales

Three recent developments have taken place in Wales in relation to fiscal devolution and funding arrangements:

- an agreement between the Welsh and UK Governments on funding reform and borrowing powers (see section 2.1 below);
- the publication of the first report by the Commission on Devolution in Wales (the Silk Commission) on the fiscal powers and financial accountability of the National Assembly for Wales (see section 2.2. below); and,
- The National Assembly for Wales' Finance Committee report on borrowing powers (see section 2.3).

At the end of this section, some observations relating to these developments are presented (see section 2.4.).

2.1 Intergovernmental talks on funding reform

On 24 October 2012 a joint announcement was made by the Welsh Government and the UK Government about their agreement on how to proceed with regards to funding reform - i.e. the future prospects for devolved funding and borrowing powers.³⁸ The joint statement announced that both Governments would give the Silk Commission proposals on devolving additional fiscal powers to Wales "*serious consideration*". In addition, there is an intention to jointly agree and implement reform to deliver "*fair and accountable funding for Wales.*"

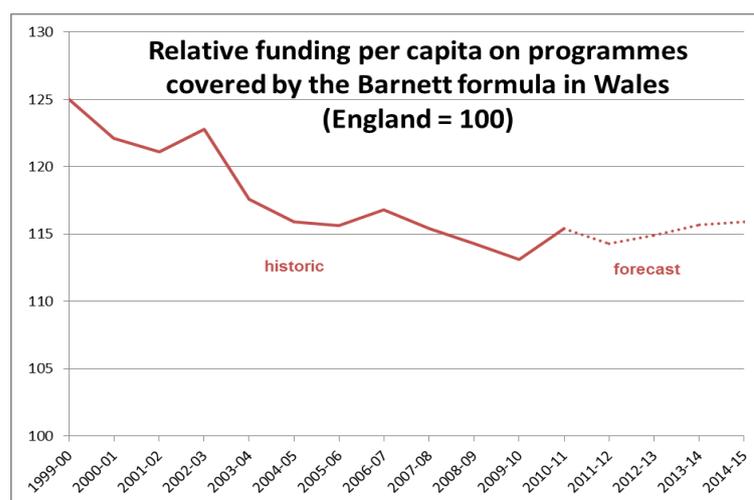
2.1.1. Devolved funding

The Welsh and UK Governments agreed that there has been convergence in Welsh relative funding since the start of devolution (see Figure 2). Put another way, the level of spending in Wales per head has moved towards, or 'converged' with, the level of spending in England per head.

On the other hand, if spending had decreased as a result of decisions taken by the UK Government, convergence would have halted – and there may have been divergence.³⁹ In other words, if spending in England per head had gone down, the level of spending per head in Wales would have moved away from ('diverged') from that level.

³⁸ HM Government and Welsh Government (2012a) [Funding Reform: joint statement of progress](#).

³⁹ A technical annex to the joint statement explains that as spending per capita in Wales is above that in England (roughly £1.15 for every £1 in England), an equivalent increase in a spending programme in England to its devolved programme in Wales will be smaller, in percentage terms, in Wales on a per capita basis. This observable trend is known as "Barnett convergence" or the "Barnett squeeze". This means that per capita spend in the two regions will converge over time due to the effects of the Barnett formula, a trend that was highlighted by models produced by the Holtham Commission. Higher spending growth increases this convergence, but as the current Budgetary programme of restrained spending is in place, this is unlikely to be the case for the next few years (in fact, a small amount of divergence is likely to occur). HM Government and Welsh Government (2012b) [Intergovernmental Talks on Funding Reform: technical annex agreed jointly by the UK Government and Welsh Government](#)

Figure 2: Convergence of devolved spending in Wales relative to English programmes.⁴⁰

The Welsh Government believes that there is “no case for further convergence” occurring in devolved spending programmes for the current Spending Review period (2011–15). The Governments therefore agreed to undertake a joint review of the pattern of convergence/divergence in advance of any future Spending Review. **If they determine and agree that convergence is to occur, they will enter into discussions to address the issue and negotiate a “sustainable arrangement for Welsh devolved funding and the UK public finances”.**⁴¹

This is a notable shift in thinking in relation to the operation of the Barnett formula because one of the reasons for its long-running success is that it removes the need for negotiation around devolved funding.⁴²

Issues for consideration: CFP may wish to investigate if there has been convergence or divergence in spending in Northern Ireland over the same period? If so, how has that impacted on ‘need’? In a future spending review, if convergence between Northern Ireland and England were to occur, would the UK government also negotiate a ‘sustainable arrangement’ with the NI Executive as it proposes to do with the Welsh Government?

2.1.2. Borrowing powers

The UK Government agreed that the Welsh Government should have the power to borrow funds to finance capital infrastructure projects - subject to the placement of an appropriate independent stream of revenue to support it. The agreement states:

*Decisions on the devolution of taxes – which could provide an appropriate revenue stream – will be made after the Silk Commission reports..*⁴³

⁴⁰ HM Government and Welsh Government (2012b) based on *Public Expenditure Statistical Analyses* data. Notably, the calculations performed by the Holtham Commission forecast further convergence, rather than the divergence illustrated here, though those calculations were performed before the Spending Review 2010. See Independent Commission on Funding and Finance for Wales (Holtham Commission) Final Report (2010) [Fairness and Accountability: a new funding settlement for Wales](#) chart 9.1 (p 116).

⁴¹ Joint Statement, HM Government and Welsh Government (2012a) [Funding Reform: joint statement of progress](#)

⁴² See RalSe (2012) [Pros and Cons of the Barnett Formula for Northern Ireland \[NIA 29/12\]](#)

Little further information or detail is given in the Joint Statement issued by HM Treasury and the Welsh Government. **The agreement document does not provide any clarity on what form those borrowing powers might take** (i.e. yearly and stock limits, where the money could be borrowed from, what the interest rate and form of repayments would be).

Issues for consideration: CFP may wish to investigate whether the Welsh Government is to be granted a borrowing power similar to, or the same as, the Northern Ireland Executive's under the Reinvestment and Reform Initiative (RRI)? If a different form of borrowing is proposed, would that form be more or less advantageous to Northern Ireland than the RRI arrangements?

2.2. The Silk Commission⁴⁴

The Silk Commission's terms of reference (ToR) stated that its purpose was:

*To review the case for the devolution of fiscal powers to the National Assembly for Wales and to recommend a package of powers that would improve the financial accountability of the Assembly, which are consistent with the United Kingdom's fiscal objectives and are likely to have a wide degree of support.*⁴⁵

The preceding Independent Commission on Funding and Finance for Wales (the Holtham Commission) had reviewed and made recommendations on the application of the Barnett formula to Wales, and some related operational issues. The Silk Commission, therefore, did not examine this area of devolved funding.⁴⁶ In addition, existing borrowing powers fell under the remit of the Holtham Commission,⁴⁷ so that area was also excluded from the Silk Commission ToR.

The Silk Commission's first report *Empowerment and Responsibility: Financial Powers to Strengthen Wales*, was published on 19 November 2012.⁴⁸

The main finding was:

*The current funding arrangements for the Welsh Government **do not meet the requirements of a mature democracy and are anomalous in an international context.** The funding model of a block grant and some devolved taxes best meets sound principles for funding the Welsh Government. We therefore recommend that part of the budget for the*

⁴³ Joint Statement, HM Government and Welsh Government (2012a) [Funding Reform: joint statement of progress](#)

⁴⁴ The Commission on Devolution in Wales was launched by the former Secretary of State for Wales on [11 October 2011](#).

⁴⁵ Commission on Devolution in Wales (Silk Commission) (2011) [Terms of Reference](#)

⁴⁶ Holtham Commission, Final Report (2010)

⁴⁷ The Holtham Commission recommended "limited powers to borrow in order to finance capital expenditure should be devolved to the Assembly Government."

⁴⁸ The Silk Commission will continue its work in relation to the remaining requirements of its *Terms of Reference* (Part II: reviewing the powers and constitutional arrangement of the National Assembly for Wales) by Spring 2014. It is likely that the UK Government will put forward a response to the Commission's recommendations after this date.

Welsh Government should be funded from devolved taxation under its control. [emphasis added]

The Silk Commission's recommendations on tax, borrowing and the availability of information are considered below.

2.2.1. Taxation powers

The Silk Commission recommended that the following small-yield taxation powers should be within the remit of the National Assembly for Wales.⁴⁹

- Stamp duty land tax;
- Landfill tax;
- Aggregates levy;⁵⁰
- Air passenger duty (long-haul rates, with consideration to full devolution in future); and,
- Business rates.

It argued that these taxes align, to some degree, with currently devolved functions; further devolution would therefore better empower the Welsh Government to make improved policy choices. Further detail can be found in Box 5. Other small taxes did not meet the Commission's criteria for devolution: for example, tax bases which are highly mobile were excluded.

The Silk Commission also recommended partial devolution of income tax, as outlined in Box 5.

⁴⁹ Silk Commission (2012a) [Empowerment and Responsibility: Financial Powers to Strengthen Wales](#) pp 53-79.

⁵⁰ The potential devolution of the aggregates levy will be subject to on-going state aid discussions.

Box 5: the Silk Commission recommendations on taxation⁵¹

Fixed deduction from block grant – Similar arrangements to those for the devolution of long-haul rates of air passenger duty (APD) to Northern Ireland should be made: a fixed deduction from Wales’ block grant be made - subject to agreement between the UK and Welsh Governments - to fund each of the devolved taxes.⁵²

New UK-wide taxes – if a new tax is to be introduced UK-wide, a presumption in favour of devolution should be made where the tax is within the scope of a devolved policy area.

New Welsh taxes – the National Assembly for Wales (NAW) should be given the power to bring in new taxes/tax credits in Wales, with the agreement of the UK Government. The Welsh Government should retain the revenue from such taxes without incurring a deduction from the block grant.

Partial devolution of income tax – income tax should be partially devolved, subject to a referendum. A significant improvement in financial accountability and empowerment of the NAW requires powers over a tax that most people pay and are conscious of. The UK and Welsh Governments should share the yield from income tax - though not on revenue from the savings and dividends aspects of income tax. Rates of income tax for Wales (at basic, higher and additional levels) should be set at 10p in the pound below the current UK rates and the block grant reduced by the equivalent amount. The NAW would be able to set each of the income tax rates independently, (including setting a rate above the UK level) and retain the revenue raised from this ‘Welsh element’ of the tax.

Members should note that the partial income tax devolution proposed by the Silk Commission differs from that contained in the *Scotland Act 2012* i.e. the “lockstep” system which applies to the Scottish rate of income tax. The term ‘lockstep’ is used by the Silk Commission to describe how under the *Scotland Act 2012*, the SRIT will be applied equally to each UK-wide tax band. In other words, the Scottish Government cannot change the ‘steps’ between higher and lower tax bands.⁵³

This system was rejected for Wales by the Holtham Commission, based on the greater perceived impact on behavioural responses to a change in the higher rate of income tax. The reason cited was that a greater proportion of the Welsh and English population live near to the border when compared with the Scottish and English population living near to the Scottish/English border.

If the Welsh Government were able to set the income tax rate, it could therefore manipulate the amount of revenue up or down. Any devolved income tax regime for Wales would be based on the location of residence of an individual, rather than where the individual works. Potentially, a lower rate in Wales could lead to immigration flows across the border with England (approximately 10% of the English population lives within 25 miles of the Welsh border), or vice versa. Based on the evidence received, the Silk Commission did not, however, believe there would be a significant behavioural response to such a situation.⁵⁴

⁵¹ Silk Commission (2012a) recommendations 3, 4, 5 and 6, and pp 59-70, recommendation 9 and para 4.5.1 (pp 76-6), recommendation 11 and chapter 4.6 (pp 76-9) and recommendations 16, 17 and 18 and chapter 5.5 (pp 90-107).

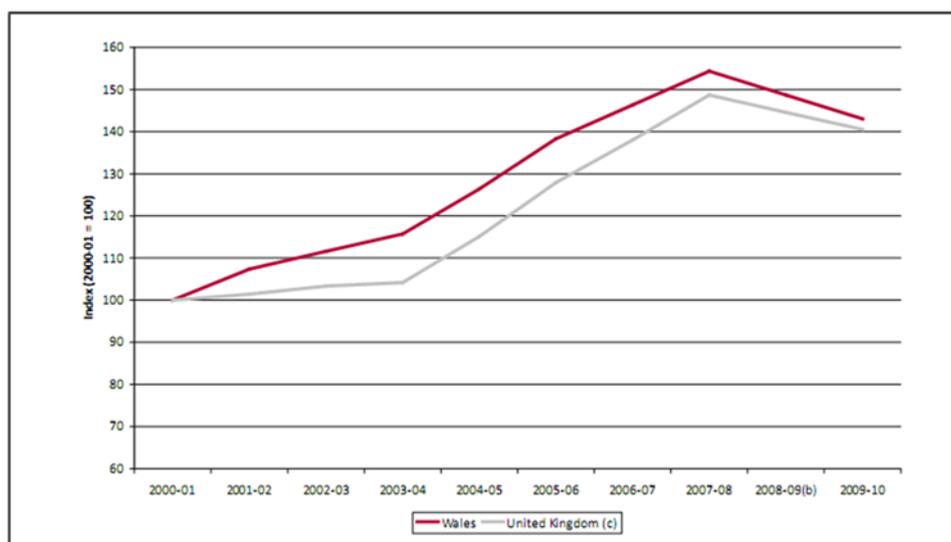
⁵² The “indexed deduction” block grant adjustment mechanism put forward by the Holtham Commission is the proposed calculation to be used in making the funding reduction accounting for devolved income tax. See Holtham Commission, Final Report (2010) para 5.16-17 (pp 50-1).

⁵³ Silk Commission (2012a) page 102

⁵⁴ Silk Commission (2012a) Annex F (pp 176-84) – See Annex F, “Cross- border Analysis”. The annex states that “the international evidence does not present a clear picture on the extent that differences in tax rates between regions within a country result in a significant migratory response.”

It could be expected that there would be a significant impact on the Welsh budget if this proposal were adopted. Figure 2 shows how income tax revenues in Wales have grown at a faster rate than in the UK as a whole. If this were to continue - and the Welsh Government had a share in the yields from this tax – the resources available to it might be greater than under the current block grant system.

Figure 2: growth in income tax revenues in Wales and the UK (excluding revenues from savings and dividend income) from 2001-2010 (2000-01=100).⁵⁵



Source: Commission calculations

- (a) We have excluded income tax from savings and dividend income as we agree with the Holtham and Calman Commissions and do not recommend that this source of income tax be devolved (set out below).
- (b) HMRC has not yet published data for 2008-09 due to methodological issues. We have used the mid point of the data for 2007-08 and 2009-10.
- (c) UK figure includes Wales. In practice it makes little difference to the trends if we exclude Wales from the UK to compare growth in Wales to the “rest of the UK” as income tax revenues in Wales account for such a small proportion of total UK income tax revenues.

It should be noted that the Commission suggested that the transfer of income tax powers should be “*conditional upon resolving the issue of fair funding in a way that is agreed by both the Welsh and UK Governments.*”⁵⁶ This is a significant caveat due the potential complexities in satisfying that condition.

‘Fair funding’ was outside the Silk Commission’s ToR, but was addressed by the Holtham Commission. **In effect, issues surrounding the underlying method of funding Wales (i.e. the Barnett formula) should be resolved (to the satisfaction of both parties) before a decision is made on the recommendation to devolve income tax powers.**

Issues for consideration: CFP may wish to consider the arguments for and against the partial devolution of income tax to Northern Ireland. Should the issue be considered alone, or together with consideration of reform of the Barnett formula?

⁵⁵ Silk Commission (2012a) page 94

⁵⁶ Silk Commission (2012a) recommendation 18 and para 5.5.70 (pp 105-6).

Finally, Members may also be interested to note that the Silk Commission **did not recommend devolving corporation tax** to Wales - unless it is also devolved to both Northern Ireland and Scotland. More information is provided on this issue in Appendix 1.

2.2.2. Borrowing powers

The Silk Commission's recommendations in relation to borrowing powers are set out in Box 6.

Box 6: the Silk Commission recommendations on borrowing

Power to borrow for capital investment - the Welsh Government should be able to borrow to increase capital investment above the limits set by the UK Government in spending reviews.

Borrowing limits - Borrowing for capital purposes should be limited to £130m per year and an overall capital stock limit of £1.3bn. Both upper limits should be open to review at the time of UK Spending Reviews.

Bonds - the Welsh Government should have the power to issue its own bonds.

Borrowing in relation to devolved taxation - In addition to borrowing for capital spend purposes, and with regard to the recommendation for devolved income tax powers, the Welsh Government should also have powers to borrow in order to fund short-term shortfalls in revenue (for current spending purposes) due to the potential volatility of income tax receipts.

2.2.3. Improving the availability of information

CFP may also be interested to note that the Silk Commission made a number of recommendations about improving the availability of information to increase financial accountability and transparency – see Box 7.

Box 7: the Silk Commission recommendations on the availability of information⁵⁷

- Estimates of spending in England on services which are devolved in the case of Wales should be made available [...];

- Consideration should be given to whether the [Office for National Statistics] UK accounts should include a 'sub-national' tier of government spending;

- Figures on the amount of tax collected in Wales should be produced. Such figures should also include estimates of the Welsh fiscal balance. This country and regional analysis should be done on a consistent basis across the UK.

- We encourage the UK Government and the devolved administrations to publish annually key comparative statistics in devolved and non-devolved areas; and

- The Welsh Government should consider whether other information could be published on the economy in Wales including on Welsh gross value added (GVA) or other income measures, as well as on economic forecasting.

⁵⁷ Silk Commission (2012) recommendation 22 (pp 121-3).

Issue for consideration: CFP might wish to consider the potential impact of these recommendations, if implemented, on Northern Ireland.

2.3 The Finance Committee report on other capital funding options

In July 2012, the National Assembly for Wales Finance Committee recommended that a power to borrow be devolved to Wales. Its report, *Borrowing Powers and Innovative Approaches to Capital Funding* is closely linked to the work of the Silk Commission, and the Commission considered the report when making its recommendations.

Amongst other things, the Finance Committee recommended any borrowing power would be subject to a negotiated borrowing limit and:

Any legislation which granted borrowing powers to the Welsh Government should make provision for HM Treasury Ministers to grant the Welsh Government the power to issue bonds.⁵⁸

In addition to these proposals for borrowing to fund capital investment, the Finance Committee also recommended the use of revenue-financed models. It viewed, however, private finance initiative (PFI) style-schemes as “discredited” in terms of its value for money.⁵⁹ Instead, the Committee suggested that a “non-profit distributing” (NPD) model (as trialled by the Scottish Government⁶⁰ and currently under consideration by the Welsh Government) could be used to explore alternative means of financing infrastructure developments.⁶¹

2.4. Observations on developments in Wales

The devolved funding and finance-related developments described in this section give rise to a number of potential considerations for CFP. Arguably the most significant of these are:

- Whether the assurance given by the UK Government on the future pattern of convergence through the Barnett formula will (or should) have implications for the operation of the funding mechanism in relation to Northern Ireland;
- Whether the emerging proposals for a Welsh borrowing power will simply mirror the RRI in Northern Ireland, or whether improvements to that mechanism may be identified; and,
- Whether Northern Ireland should consider partial devolution of income tax and/or other minor taxes.

⁵⁸ National Assembly for Wales Finance Committee (2012) [Borrowing Powers and Innovative Approaches to Capital Funding](#)
See page 27

⁵⁹ National Assembly for Wales Finance Committee (2012) recommendation 12 and pp 37-41. In evidence to the Finance Committee, the Welsh Minister of Finance made reference to a £1bn repayment bill owed by Scotland on PFI, compared to a £100m bill in Wales, due to Wales’ earlier rejection of PFI schemes. [Record of Proceedings, 16 May 2012, Finance Committee](#) para 93.

⁶⁰ The Scottish Futures Trust (2011) [NPD Model Explanatory Note](#).

⁶¹ Welsh Finance Committee, [Record of Proceedings, 16 May 2012, Finance Committee](#)

Given that many of recommendations made by Calman for Scotland broadly speaking echo those made by Silk for Wales, it is worthwhile considering all of these developments in the context of the future of Northern Ireland.

3. Northern Ireland

There have been some developments in the area of fiscal devolution in Northern Ireland in recent months:

- Devolution of responsibility for setting the rate of APD on certain long-haul flights departing from Northern Ireland;⁶² and,
- The Joint Ministerial Working Group on the devolution of corporation tax presented its report to the Prime Minister on 16 November 2012 – though a decision is still outstanding.

In addition, CFP may be interested to note that the Northern Ireland Council for Voluntary Action's (NICVA) Centre for Economic Empowerment has recently put out a tender for a review of devolved fiscal powers in Northern Ireland. The specifications requires the contractor to:

- Explain the current scope of the Northern Ireland Assembly to tax, borrow and spend;
- Review developments in Wales and Scotland towards greater financial autonomy;
- Examine the feasibility and desirability of enhancing the Northern Ireland Assembly's fiscal powers, on the basis of a robust evidence base; and,
- Set out how any additional powers could be administered (for example in relation to calculating the block grant).

The tender document states:

*It is envisaged that this report will help stimulate and inform a public debate on the Assembly's fiscal powers. To this end it is crucial that the evidence presented in the report is rigorous, transparent and accessible to a general audience.*⁶³

The timetable anticipates publication of a report in June 2013.

Furthermore, the Committee may also be interested to note that fiscal devolution commentator Alan Trench is due to publish comprehensive work on the nature of fiscal federalism in the UK in January 2013, with specific reference to the future of the devolved regions.⁶⁴

RaISe will keep a watching brief on both these ongoing developments.

⁶² The Air Passenger Duty (Setting of Rate) Act (Northern Ireland) 2012 received Royal Assent on 11 December 2012: <http://www.legislation.gov.uk/nia/2012/5/enacted>

⁶³ http://www.nicva.org/sites/default/files/Fiscal%20Powers_Invitation%20to%20Tender_Dec%202012.pdf

⁶⁴ <http://devolutionmatters.wordpress.com/2013/01/14/financing-devolution-and-the-more-or-less-federal-model-report-launch/>

In light of this, and the developments in Scotland and Wales presented in this paper, CFP may wish to consider the following issues when framing the ToR for its inquiry into the Barnett formula and devolved funding:

- 1. What are the impacts on the operation of the Barnett formula of the developments in Scotland and Wales, and what, if any, are the implications for Northern Ireland?**
- 2. Do the borrowing powers proposed for Scotland – and yet to emerge for Wales – confer advantages on those administrations that Northern Ireland does not have through the RRI?**
- 3. If partial devolution of income tax is considered desirable for both Scotland and Wales, is it equally desirable for Northern Ireland?**
- 4. It has been recommended for both Scotland and Wales that the devolved administrations be given the powers to introduce certain new taxes. Is such devolved power desirable for Northern Ireland?**
- 5. Would Northern Ireland benefit from a presumption for devolution if any new UK-wide tax were proposed - if it corresponded with a currently devolved function?**

Appendix 1: the Silk Commission's recommendation in relation to corporation tax

The Silk Commission heard evidence reflecting a wide range of views both in favour and opposed to the devolution of corporation tax. Some, such as the Federation of Small Businesses and Confederation of British Industry, were sceptical of the argument to devolve corporation tax powers to Wales, in contrast to their position on Northern Ireland's case.⁶⁵ They cited other policies which would be more beneficial to Welsh businesses, such as capital allowances.⁶⁶ Additionally, the inter-connectedness of the English and Welsh economies and the distortion of cross-border business activity were cited as arguments against devolving the tax.

The Welsh Government's view is that there could be significant budgetary risks to the devolution of corporation tax, which would need to be mitigated in any proposal for devolution. At public events and evidence from individuals, the Commission heard support for the devolution of this tax power, relating to its successful impact on economic growth in other countries when held at a low rate.⁶⁷

However, in the case of the UK Government agreeing to devolve corporation tax to both Scotland and Northern Ireland, the Commission recommended that the same powers should also be devolved to Wales.⁶⁸ It also recommended that enhanced capital allowances should be offered within more Enterprise Zones in Wales, with the Welsh Government paying the incremental cost.⁶⁹

⁶⁵ Federation of Small Businesses (FSB) [written evidence](#) pp 4-5. Institute of Directors (IoD) [written evidence](#) p 2. Confederation of British Industry (CBI) Wales [written evidence](#) p 3 and [oral evidence](#) para 5.

⁶⁶ Capital allowances can be claimed on business spends on certain assets for use in production (e.g. equipment, research and development, some buildings fixtures, patents etc.) provided that certain conditions are met, but not on assets which a business buys and sells as part of its trading. Capital allowances can be claimed in the form of a tax deduction to income tax or corporation tax, depending on whether a business pays corporation tax or not. See <http://www.hmrc.gov.uk/capital-allowances/basics.htm>.

⁶⁷ Minutes of public events in [Llangefni \(29 May 2012\)](#) and [Swansea \(15 March 2012\)](#). Written evidence from [Dr Ian Johnston](#) and [Madoc Batcup](#).

⁶⁸ Silk Commission (2012a) chapter 5.2 (pp 80-84).

⁶⁹ Silk Commission (2012a), recommendation 13 and pp 84-5