

Final Report of the Independent Commission on Funding and Finance for Wales (Holtham Commission)

Quick Guide

July 2010

Background

The **Independent Commission on Funding and Finance for Wales** (Holtham Commission) published its first report in July 2009.¹ This interim report assessed the Barnett formula,² as it has been applied to Wales, and considers the case for change. Further information on the interim report and its recommendations can be found in the Members' Research Service Quick Guide: **First Report of the Independent Commission on Funding and Finance for Wales**.

The final report of the Commission was published on 6 July 2010.³ This presents the findings and recommendations from the second stage of the review, which aimed to identify possible alternative funding mechanisms, including the scope for the Welsh Government to have tax varying powers and greater powers to borrow. The Commission's final report:

- provides evidence of how a **needs-based funding system** could work in a way that is fair to all parts of the UK;
- makes the case for the **devolution of selected tax-varying powers** to Wales; and
- recommends **limited borrowing powers** to Wales.

The Commission considered options which are consistent with the current devolution settlement (or that following a referendum in favour of enhanced legislative powers), and therefore have **not** considered models of fiscal autonomy.

The main weaknesses of the current system are lack of equity and accountability, therefore the Commission's recommendation to replace it with a **needs-based system** and aims to ensure an equitable funding system. The report also states that **some devolution of tax powers would greatly enhance the accountability** of the current settlement.

Needs-based formula

The report expands on the recommendation in the first report that Barnett should be replaced by a needs-based formula, and sets out how this could be achieved. It recommends that the Welsh Government should **pursue the introduction of a needs-based system for determining the Welsh block grant**.

¹ Independent Commission on Funding and Finance for Wales, *First Report, Funding devolved government in Wales: Barnett and beyond*, July 2009 [accessed 9 July 2010]

² Further background information on the operation of the Barnett formula and funding of the devolved administrations can be found in the Members' Research Service paper **The Barnett Formula: funding the devolved administrations** or in the Quick Guide **The Barnett Formula** [accessed 9 July 2010]

³ Independent Commission on Funding and Finance for Wales, Final Report, *Fairness and accountability: a new funding settlement for Wales*, July 2010 accessed 9 July 2010]

The report **proposes a methodology for the development of a needs-based formula** that combines indicators relating to demographics, deprivation and the cost of delivering services, and weights each one in proportion to its importance in determining spending decisions in Wales, England and Scotland. The report states that the methodology it proposes is not intended to be 'the final word', but rather aims to:

- demonstrate that a needs-based funding regime is achievable given the political will;
- show that such a formula need not be prohibitively complicated; and
- provide a starting point for discussion about how a needs-based replacement for Barnett could be put into practice.

When applied to Wales the proposed formula produces an overall estimate of Welsh need of 115 per capita (where the value for England is 100). **This suggests that Wales should receive £115 per person to spend on devolved activities for every £100 per person spent on comparable activities in England, equivalent to a funding gap of around £400 million.**

The report suggests that the **current Barnett formula could be modified** to align changes in relative funding with relative need and to address any over- or under-funding, and proposes a mechanism for doing so.

The report states that even if the recommendations on tax devolution are implemented, the block grant would still account for around 85 per cent of resources available to the Welsh Government. Thus, **adoption of a needs-based formula should be a priority.**

The report also reiterates the recommendation from the Commission's interim report that an **independent arm's length body** should be established to operate the formula, oversee technical aspects and calculate the annual budgets.

Tax devolution

In looking at tax devolution, the report states that Wales is more integrated into the UK economy than is Scotland; therefore, it may be more difficult to devolve tax-varying powers due to the potentially greater risk of avoidance or economic distortions.

In relation to tax revenues raised in Wales, the report states that **£17 billion** was raised in Wales during the financial year 2007-08 (rising to £19 billion when non-domestic rates and council tax are included). This is greater than the Welsh block of £13 billion for the same year. However, total expenditure in Wales for 2007-08 was in the region of £25 billion (creating a £6 billion deficit between tax receipts and expenditure).

The Commission suggest in their report that the following options are worth pursuing in terms of tax devolution:

- **income tax** – the basic and higher rates should be reduced by 10p, 20p and 25p and the National Assembly should vote annually to set Welsh income tax rates. These should vary from the UK rates by no more than 3p.
- **corporation tax** – the Welsh Government should explore the feasibility of devolving corporation tax, as it could boost Wales' economic performance.
- **stamp duty land tax** on property and land – should be devolved and reform considered.

- **capital gains tax** – on property and land should be explored as a potential candidate for devolution.
- **landfill tax, aggregates levy and air passenger duty** - which are aligned with existing devolved responsibilities could be used as 'policy levers'.
- **new taxes** which could be introduced by the Welsh Government – suggested that 'Financial Competence Orders' could be sought, in a manner similar to the current process for legislative competence.

The devolution of taxes may expose the Welsh block to an element of risk, currently managed at the UK level. For example, risk of volatility on tax revenues, differences on the rate of growth of the tax base and risk of policy changes at the UK level impacting upon devolved tax revenues.

The devolution of taxes involves the **exchange of a portion of the block grant** for an element of funding derived from taxes levied in Wales. The 'cost' of this is:

- an offset to the block grant at the time of devolving the tax; and
- the way in which this offset is calculated in future years.

The report looks at a number of mechanisms by which this could be achieved. The **Calman Commission** recommended that a common approach to this should be applied to all devolved taxes in Scotland. However, the Holtham report suggests that this is 'unlikely to represent a reasonable deal for the Assembly Government' and that each tax should be considered on a case-by-case basis.

Devolution of borrowing powers

The Welsh Government does not have the power to borrow to fund public services. Similar rules currently apply in Scotland, although the **Calman Commission** recommended giving the Scottish Ministers a limited ability to borrow, to fund capital investment. The Northern Ireland Executive does have limited borrowing powers, as it conducts functions carried out by local authorities elsewhere. Local authorities have limited powers to borrow to finance capital investment. NHS Trusts in Wales also have some limited borrowing powers.

The Commission's interim report made a number of recommendations to improve the flexibility of funding to the Welsh Government, such as the ability to draw forward capital budgets and ability to access end year flexibility (EYF)⁴ without Treasury agreement.

The Commission's final report goes further, recommending that:

- The Welsh Government should seek agreement with the UK Government to be able to **invest EYF stocks in government securities** to ensure future access without the need for Treasury agreement; and
- **Limited powers to borrow to finance capital investment** should be granted to the Welsh Government.

These arrangements would better enable the Welsh Government to plan capital expenditure and develop long-term strategies. The report goes on to state that the case for borrowing powers is stronger when tax devolution is a

⁴ Further information on end year flexibility (EYF) can be found in the Members' Research Service Quick Guide: **End year flexibility** [accessed 9 July 2010]

possibility, as the Welsh Government would have a revenue source with which to provide assurance on its ability to repay.

The way ahead

The Commission's report suggests that the **earliest practical option of any devolution of tax-varying powers would be 2015**. However, more limited powers relating to borrowing or minor taxes could occur sooner. The report makes the case that, as discussions are underway in relation to fiscal devolution in other areas of the UK, **Wales should be involved in all stages of these discussions**, on the assumption that similar powers may be granted to Wales.

It is suggested that **responsibility for any devolved taxes should remain with HMRC** (consistent with the Calman recommendations). However, should tax-varying powers be devolved there is likely to be a need for some form of specialist support to help determine tax policy.

The report states that it would be for Minister to decide whether there would be a **need for a referendum prior to any devolution of tax-varying powers**, although it does suggest that it is likely that devolution of power over income tax would take place only after a referendum, as this may be too significant a change without public endorsement.

The Commission's report also recommends that **official statistics could be modified** to enable a distinction between expenditure by UK Government departments and that of the devolved administrations.

Further information

For further information on aspects of the Independent Commission on Funding and Finance for Wales, please contact **Dr Eleanor Roy (Eleanor.roy@wales.gov.uk)**, Members' Research Service.

For further information on the topics below, double click on the links:

- **Independent Commission on Funding and Finance for Wales** – from which both the interim and final reports can be accessed, as well as evidence from both stages of the review.
- Members' Research Service Quick Guide: **First Report of the Independent Commission on Funding and Finance for Wales**
- For further information on the Barnett formula: Members' Research Service paper **The Barnett Formula: funding the devolved administrations** or in the Quick Guide **The Barnett Formula**
- **Commission on Scottish Devolution** (Calman Commission)

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