Canolfan
Llywodraethiant Cymru

Wales Governance
Centre

Fair Funding
for Taxing Times?

Assessing the Fiscal
Framework Agreement

Third Report on the 2016-17 Fiscal Framework
Negotiations for Wales

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Institute for
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About us

The **Wales Governance Centre** is a research centre that forms part of Cardiff University's School of Law and Politics undertaking innovative research into all aspects of the law, politics, government and political economy of Wales, as well the wider UK and European contexts of territorial governance. A key objective of the Centre is to facilitate and encourage informed public debate of key developments in Welsh governance not only through its research, but also through events and postgraduate teaching.

The **Institute for Fiscal Studies (IFS)** is Britain's leading microeconomic research institute. Its research remit is one of the broadest in public policy analysis, covering subject from tax and benefits to education policy, from labour supply to corporate taxation, and from international development to devolution in the UK. The Institute is committed to rigorous, independent policy analysis and research. All statements in publications by IFS authors (and co-authors from other organisations) are the opinion of those authors; the IFS has no corporate views. Funding from the ESRC via the Centre for the Microeconomic Analysis of Public Policy (Grant No. ES/M010147/1) is gratefully acknowledged.

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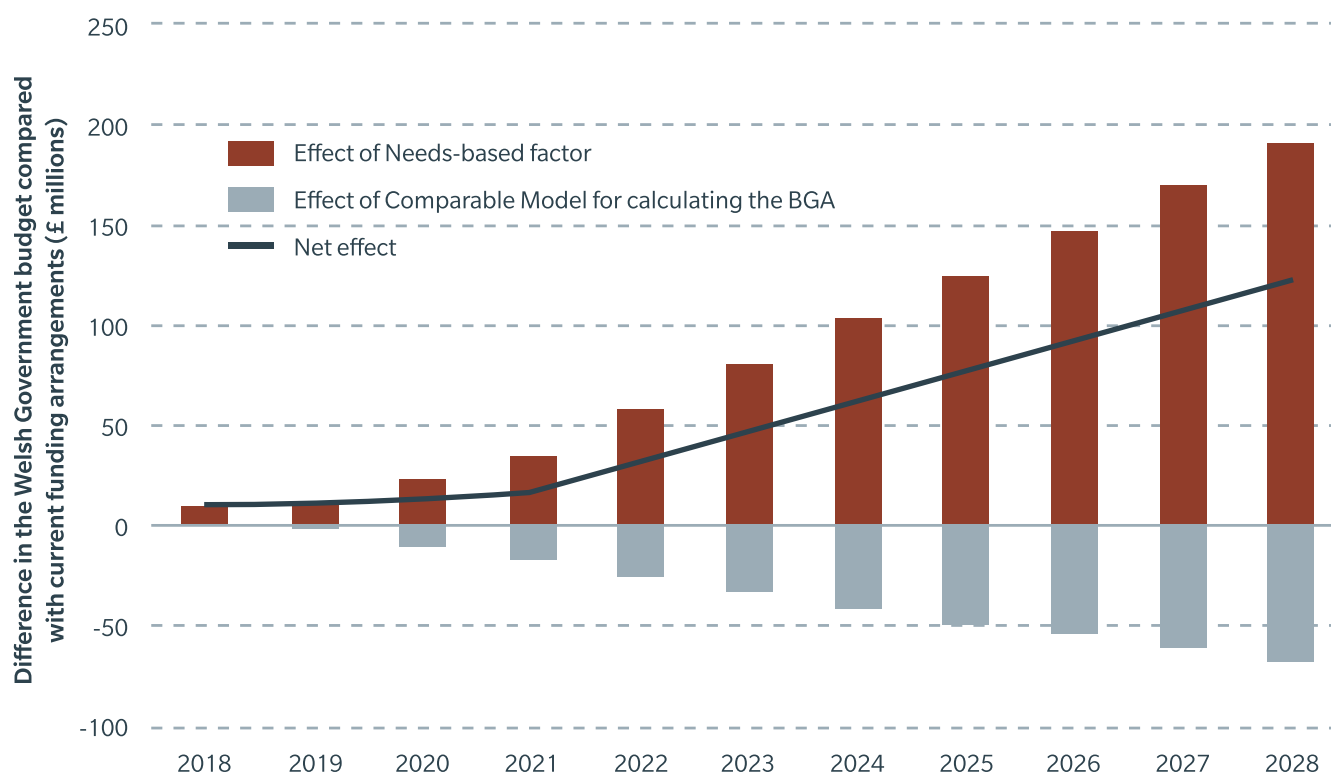# Contents

Executive Summary

On 19 December 2016, the UK and Welsh governments jointly published an agreement setting out a new set of rules governing the Welsh Government's future funding and fiscal powers. This 'Fiscal Framework' followed several months of negotiations, and was prompted by significant changes to the way devolved public services will be funded after the devolution of powers over several taxes.

This paper, a third in a joint series by Cardiff University's Wales Governance Centre and the Institute for Fiscal Studies, aims to shed light on this agreement by explaining the deal and assessing its likely consequences for Wales' funding after fiscal devolution.

Block Grant Funding and Tax Devolution Arrangements

- After approximately £2.5 billion of tax revenues are devolved to Wales in 2018 and 2019, the existing Welsh block grant will be cut by a corresponding amount. **This 'Block Grant Adjustment' (BGA) will then change from year to year according to what happens to equivalent UK government revenues in England & Northern Ireland (E&NI).**[1] The relative performance of Welsh revenues (and Welsh Government tax policy) will for the first time become very important to the Welsh Government budget. For the partial devolution of income tax, there will be three BGAs, one for each of the basic, higher and additional rates of income tax. This will insulate the Welsh Government from some of the risks associated with the fact that a much higher share of Welsh incomes is earned at the basic rate, such as UK government changes to the income tax Personal Allowance.

- Unlike in Scotland, the agreed method of calculating BGAs means the **Welsh Government will bear population-related revenue risk.** Because Wales' population has been growing more slowly than the English population for some time and is projected to continue to do so, the Welsh budget would lose out from slower population growth even if revenues *per person* in Wales grow as quickly as in E&NI.

- The agreement also introduces a **new "needs-based factor" in the Barnett formula.** From 2018-19, increments passed onto the Welsh budget from the Barnett Formula will be 5% greater than they would have been under the original formula (e.g. if the increment calculated through the existing Barnett formula would be £100 million, the Welsh block grant will now increase by £105 million). The multiplier is designed to ensure that relative funding per person in Wales stays above the level of relative need estimated by the Holtham Commission (approximately 115% of the level in England). At the point at which funding per person in Wales converges to this level, the 'transitional period' will end and the needs-based factor will convert from 105% to 115%. **Under reasonable assumptions of expenditure and population growth, this 'transitional period' will last for decades.**

- Assuming government spending in England grows by more than around 1% a year in cash-terms, and population growth matches current projections, **the extra funding provided by the 105% needs-based factor will more than outweigh population-related revenue losses.** For instance, with cash-terms spending growth of 4% a year after 2021-22 (roughly in line with projected cash-terms growth in GDP), this could mean, cumulatively, almost £600 million more being available for the Welsh Government to spend over the first 10 years of the agreement, compared with existing funding arrangements. The projected cumulative effect of the deal varies from under £250 million (assuming 2% spending growth) to over £940 million (with 6% spending growth).

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1 Revenues in Scotland will be excluded because the taxes devolved to Wales are already devolved to the Scottish Government.

FIGURE E1: Projections of the effect of the fiscal framework agreement on the Welsh Government budget (compared with pre-reform arrangements, in 2016-17 prices)

Other aspects of the Fiscal Framework agreement

- The limit on the Welsh Government's borrowing for **capital** spending will be increased to £1 billion, from £500 million. The annual limit will also be increased to £150 million. Relative to devolved revenues, this new limit for the Welsh Government is higher than the £3 billion limit agreed for Scotland in February, but is roughly in line with the limit agreed for Scotland under its Scotland Act 2012 powers (which closely resemble the powers now being devolved to Wales). Given the scale of infrastructure projects under consideration such as the M4 relief road and South Wales Metro, the annual cap may be a limiting factor on the Welsh Government's borrowing aspirations.

- The limit on **current** borrowing will not be increased. Instead, the Welsh Government's budget management tools will be simplified by the creation of a single, new **Wales Reserve** from April 2018. This will allow the Welsh Government to carry forward much more of its budget from one financial year to the next than is currently the case.

- **'Direct and mechanical' financial spill-over effects from one government's policies on the budget of the other government will be subject to compensatory transfers.** However, behavioural spill-over effects will only be accounted for in exceptional circumstances, when they are "material and demonstrable". Although pragmatic, this arrangement may lead to disputes between the two governments on the need for and the size of any transfers.

- Any disputes arising from the implementation and operation of this agreement will firstly be discussed by government officials, and then by Ministers at the Joint Exchequer Committee (Wales). If no agreement can be reached, then the dispute falls and no transfers will take place. Independent oversight may however inform this process. The Welsh Government will also be able to decide whether to continue to use OBR forecasts of devolved revenues, or eventually put in place alternative independent forecasting arrangements.

Assessing the agreement

- In purely financial terms, the agreement represents a good deal for the Welsh Government, with more funding likely to be available as a result of changes to its block grant funding and extra capital spending as a result of increased borrowing powers.

- For the first time, **the arrangements put in place create a significant and direct link between the Welsh budget and the tax revenues collected in Wales.** The agreement does this in a sensible way – the BGA mechanism will provide relatively strong protection against macro-economic shocks that affect the whole of the UK. It also acknowledges Wales' initial lower tax capacity, while incentivising the Welsh Government to grow the Welsh tax base and reap the budgetary rewards.

- Any practical way of indexing the BGAs over time would expose the Welsh Government's revenues to at least some risks outside its control, in addition to the consequences of its own decisions. However, by indexing the BGAs in a way that does not account for differences in population growth, **it will be harder to assess the relative performance of the Welsh Government in managing its tax revenues than if the effects of differential population growth were stripped out.** Increased transparency and budgetary information on the underlying block grant, devolved revenues and the adjustments made for tax devolution will be crucial in boosting the fiscal accountability of the Welsh Government and aiding public understanding of annual changes to its budget. **Annual statements should be provided to individual taxpayers that clearly identify the portion of taxes that have been paid to the Welsh and UK governments.**

- Although the inclusion of a needs-based element in the Barnett formula is to be welcomed, **the agreement makes no provision for updating the assessment of relative need in future.** Even at the point of introduction, the need-based factor will be based on an already decade-old needs assessment. This could become a source of tension if Wales' relative needs change, and the agreement is therefore unlikely to end debate on territorial funding either for Wales or across the UK.

- As a result of the two very different framework agreements for Scotland and Wales, **devolved funding arrangements across the UK are increasingly asymmetric and ad hoc.** There are now significant differences in the scale and composition of devolved and reserved taxes across each country; in how block grants for each administration are determined and adjusted over time; and in the borrowing and budget management capacity of each devolved government.

- **What will probably be a good financial deal for Wales may not be so good for the Scottish Government.** Bearing population-related revenue risks (as the Welsh Government will) could cost the Scottish Government £380 million per year after just five years, growing to £740 million per year after 10 years. With the Welsh agreement setting a potential precedent, this could again become a source of tension when the Scottish Fiscal Framework is renegotiated after the 2021 Scottish Parliamentary elections.

1. Introduction

After several months of negotiations, on 19 December 2016 the UK and Welsh governments announced that they had reached agreement on a new set of rules governing the funding and fiscal powers of the Welsh Government. This 'Fiscal Framework' will have far-reaching implications for the future funding of Wales and was prompted by the need to consider how previously-announced tax devolution would be implemented.

Following two commissions on Welsh public finances (Holtham 2008-2010 and Silk 2010-2012), the Wales Act 2014 provided the legislative framework for the devolution of taxation and borrowing powers. From 2018-19, the UK-wide Stamp Duty Land Tax (SDLT) and Landfill Tax will be "switched off" in Wales and replaced by two devolved taxes that will be collected by the newly-formed Welsh Revenue Authority. More recently, by removing the requirement for an affirmative vote in a referendum, the Wales Act 2017 paves the way for the devolution of a £2 billion share of income taxes collected in Wales. The income tax rates paid by Welsh taxpayers to the UK Government will be reduced by 10p in the pound at each tax band (the basic, higher and additional rates) and will be replaced by tax rates set by the Welsh Government. After accounting for business rates which were fully devolved in 2015, from 2019 approximately a fifth of the Welsh Government's budget will come from its own tax revenues, up from effectively nothing just two years ago.[2]

With these significant changes to Wales' public finances pending, the two governments entered negotiations over how exactly this new system will work. First, a key point of discussion concerned the Welsh Government's existing block grant and how it would be adjusted to account for the devolution of taxes. As explored in the first joint report between the Wales Governance Centre and the Institute for Fiscal Studies, various methods chosen could have had a very significant (and negative) budgetary impact for future Welsh Governments.[3]

Second, the negotiations were expanded to include discussions over changes to the operation of the Barnett Formula, which determines year-to-year changes in the block grant. The Welsh Government's objective was to introduce a long-term funding floor to address concerns that the formula leads to convergence in funding per person in Wales towards the level in England, irrespective of the higher need for public services in Wales. As our second report examined, the different ways of implementing a funding floor would have profoundly different effects on relative spending per person in Wales.[4]

Third, the increase in own-source tax revenues merited consideration of changes to current limits on Welsh Government borrowing for resource and capital spending. Finally, a range of institutional and practical arrangements would need to be agreed, including how potential disputes would be resolved, how forecasts of tax revenues would be made, and how the agreed system would be reviewed in future.

Although these matters appear to be technical, they will have profound implications on the funding available for public services in Wales, the budgetary risks and incentives faced by the Welsh Government, and the extent to which tax devolution improves the fiscal accountability of Wales' devolved institutions. This report, the third and final joint report in the series, aims to shed light on the agreement by explaining the deal and assessing its likely consequences for Wales' funding.

The rest of the paper proceeds as follows. Section 2 describes and analyses the agreed block grant funding arrangements, while section 3 provides projections of the likely financial impact on the Welsh budget and relative spending per person in Wales. Section 4 discusses the agreed changes to the Welsh Government's borrowing and budget management tools, while section 5 explains how policy spill-overs and disputes will be dealt with under the agreement and the new institutional arrangements that will be established. Section 6 concludes.

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2 Prior to April 2015, Non-domestic (business) rates were pooled with revenues in England, and did not directly affect the level of the Welsh budget, although the Welsh Government had some control over NDR policy.
3 Poole, E. G., Ifan, G., and D. Phillips (2016) *For Wales Don't (Always) See Scotland: Adjusting the Welsh Block Grant after Tax Devolution.* October 2016.
4 Poole, E. G., Ifan, G., and D. Phillips (2016) *Barnett Squeezed? Options for a Funding Floor after Tax Devolution*. December 2016.

2. Block Grant Funding Arrangements

For the first 16 years of its existence, the Welsh Government was almost entirely funded by annual block grants from HM Treasury. Although Welsh Ministers have been able to allocate expenditure to different policy areas, they have had no say over the total amount available to spend. Instead, changes in the Welsh block grants from year to year have been determined by the Barnett Formula, influenced by UK Government decisions on spending on public services in England and almost completely insulating the Welsh Government from changes in tax revenues raised in Wales.

However, the process of fiscal devolution underway will dramatically change the current funding arrangement. From April 2018, the UK's Stamp Duty Land Tax (SDLT) and Landfill Tax will be "switched off" in Wales and replaced by two devolved taxes that will be collected by the newly-formed Welsh Revenue Authority. The Wales Act 2017 as approved by the Assembly in January 2017 will also result in the partial devolution of income tax without the need for a referendum.

When these devolved taxes form a part of future Welsh budgets, **a downward adjustment will be made to the existing block grant** to compensate HM Treasury for the tax revenue they will no longer receive. **A key issue arising in the Fiscal Framework negotiations was how this downward adjustment to the block grant would change in future years.**[5]

Recall that despite the growing importance of own-sourced revenues after 2018-19, the vast majority of Welsh Government budgets will still be funded by block grants from HM Treasury. A longstanding concern for Welsh policy-makers has been how the operation of the Barnett formula tends to squeeze down relative spending per person in the devolved countries towards English levels over time – a phenomena sometimes termed the 'Barnett squeeze'.

There had been calls from across the political spectrum for the higher levels of Welsh need for public spending to be recognised in the funding formula, and **a long-term funding floor was noted as a priority for the Welsh Government.**[6] **The second key issue in the Fiscal Framework negotiations therefore became how exactly such a funding floor would be implemented.**[7]

The following sections examine these two key aspects of the Fiscal Framework agreement, illustrating projections of future Welsh Government budgets and relative spending levels in Wales under the mechanisms agreed by the two governments after 2018.

2.1 Tax devolution and Block Grant Adjustments

The Comparable Model of Block Grant Adjustment

After tax devolution, the agreement states that an initial baseline adjustment will be made to the Welsh block grant to account for the revenues foregone by the UK Government at the point of devolution. This essentially ensures neither government is initially better or worse off at the initial point of tax devolution. But to borrow the infamous words of Ron Davies to describe Welsh devolution, this adjustment "is a process and not an event". Future **changes** to the block grant adjustment (BGA) will be determined by **changes in equivalent UK government taxes in England and Northern Ireland (E&NI).**[8]

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5 Poole, E. G., Ifan, G., and D. Phillips (2016) *For Wales Don't (Always) See Scotland: Adjusting the Welsh Block Grant after Tax Devolution*. October 2016.
6 Welsh Government (2015) *Developments in fiscal devolution*, Treasury Paper 2. WG25352.
   Available at: http://gov.wales/docs/caecd/publications/150515-treasury-paper-2-en.pdf
7 Poole, E. G., Ifan, G., and D. Phillips (2016) *Barnett Squeezed? Options for a Funding Floor after Tax Devolution*. December 2016.
8 Revenues in Scotland are excluded because the taxes to be devolved to Wales are already devolved to the Scottish Government, which has already made changes to tax policy.

For Stamp Duty and Landfill Tax, the baseline BGA will be set to equal the revenues collected in Wales during the year immediately prior to tax devolution (i.e. 2017-18). Thereafter, this amount will be updated according to what happens to comparable revenues in the rest of the UK in the year to 2018-19 (the exact mechanism of doing so is outlined below). **This means that the Welsh Government will bear revenue risk for Stamp Duty and Landfill Tax from the very first year of devolution.**

When income tax is partially devolved (with the earliest possible introduction date being 2019-20) the baseline adjustment will match actual receipts collected in that first year, assuming the Welsh Government sets a 10p tax rate in all tax bands (the share of income tax being devolved to Wales). Therefore, in the first year, any impact of devolution on the Welsh Government budget will be the result of tax rate changes by the Welsh Government away from 10p rates. **For income tax, the Welsh Government will begin to bear revenue risk with regards to its income tax base from the second year (2020-21) onwards.**

Both governments have agreed that the method that will be used to link changes in the BGA to changes in revenues in E&NI from equivalent UK government taxes will be the **Comparable model.** This was one of the several possible options under consideration, each with very different potential impacts on future Welsh budgets.

Under this method, the change in the BGA is determined by a *tax-capacity adjusted population share of the change in equivalent UK government revenues in E&NI.* Changes in the BGA for each tax will therefore be determined by the following equation:

Cash change in equivalent UK government tax in E&NI	X	Comparability factor	X	Population ratio

This method of updating the BGA can be best illustrated by a hypothetical example. Suppose that Stamp Duty (SDLT) revenue in E&NI were to grow by £1 billion. This cash change in the equivalent UK government tax would be multiplied by a 'comparability factor', reflecting the level of SDLT revenues per person in Wales as a proportion of SDLT revenues per person in the rest of the UK at the point of devolution, or in other words, initial relative Welsh 'tax capacity' for SDLT. In this example, this comparability factor would be set at approximately 25%, reflecting the much lower levels of SDLT raised per person in Wales. The resulting 'tax capacity' adjusted figure (£250 million) would then be multiplied by Wales' population measured as a percentage of E&NI's (5.4%) to arrive at a roughly £13 million increase in the BGA. If Welsh SDLT revenues grew by more than £13 million the Welsh Government's budget would increase by more than it would have in the absence of tax devolution, but if Welsh revenues grew by less than £13 million, the Welsh Government's budget would be reduced under the newly-devolved tax system.

As this example illustrates, in linking the BGA to equivalent revenues in E&NI the new Fiscal Framework means the **relative performance of Welsh revenues** will become very important to the Welsh Government budget. As first described by the Holtham Commission, this link to revenues in the rest of the UK has several benefits:

1. It provides further incentives for the Welsh Government to grow the Welsh economy and reap the rewards of faster revenue growth because the Welsh Government gains from any marginal increase in own-source revenues.

2. It effectively pools UK-wide economic risks, such as a recession that affects revenues across the UK. Although own-source tax revenues in Wales could fall during a recession, the reduction in revenues in the rest of the UK would also reduce the size of the adjustment to the Welsh block, thereby mitigating losses to the total Welsh budget.

Under this system, there will also continue to be a degree of redistribution of revenues from the rest of the UK via the Barnett Formula and the comparable model for indexing the BGAs. During the Scottish Fiscal Framework negotiations, the UK government had argued that devolved taxes should no longer be subject to 'pooling and sharing' across the UK, arguing instead for the 'Levels Deduction' approach of BGA.[9] If this method had been applied to Wales, changes in equivalent tax revenues in E&NI would not directly spill-over to changes in spending in Wales, ending the pooling or sharing of revenues from the devolved tax.[10] However, the inclusion of the 'comparability factor' in the BGA formula means that this will not be the case. Although the Barnett formula will continue to allocate a population-based share of extra spending funded by equivalent revenues in England onto the Welsh budget, the corresponding growth in the BGA will be a **tax-capacity adjusted portion** of this. This essentially means that a portion of revenues in E&NI will be used to "top up" Welsh revenues to ensure Wales is not disadvantaged from having a lower initial tax capacity.

However, the relative size of this "top up" is fixed: the comparability factors will not be adjusted if relative tax capacities change. As a result, while there will continue to be some degree of pooling and sharing of revenue growth, there is no pooling and sharing of the risks associated with changes in relative tax capacity between England and Wales. Although allowing the Welsh Government to keep 100% of the marginal change in devolved revenues (relative to equivalent revenues in E&NI) creates budgetary incentives for growth-oriented policies, this effect is also associated with greater risks from changes in tax capacities that may fall outside the devolved (or even UK) governments' control.

Risks associated with the differential nature of the Welsh tax base

The significant difference in the Welsh income tax base compared with the rest of the UK is further recognised in the agreement by the creation of **separate BGAs for each band of income tax** (i.e. the basic, higher and additional rates). This is an important departure from the agreed arrangements in Scotland. As shown in figure 1, because of lower levels of taxpayer incomes in Wales, a much greater share of Welsh taxable income is earned at the basic rate of income tax, compared with the rest of the UK. This means that UK-wide factors which disproportionately impact taxable income at the basic rate band have much more of an impact on total tax revenue in Wales compared with the rest of the UK. For example, the rapid increases in the personal allowance in recent years have significantly reduced taxable income at the basic rate, resulting in a much more pronounced impact on total Welsh revenues than in the rest of the UK. Conversely, the much greater share of taxable income earned at the additional rate in the rest of the UK means that UK-wide factors which influence very high incomes will have a much greater impact on total revenues in the rest of the UK than is true for Wales.
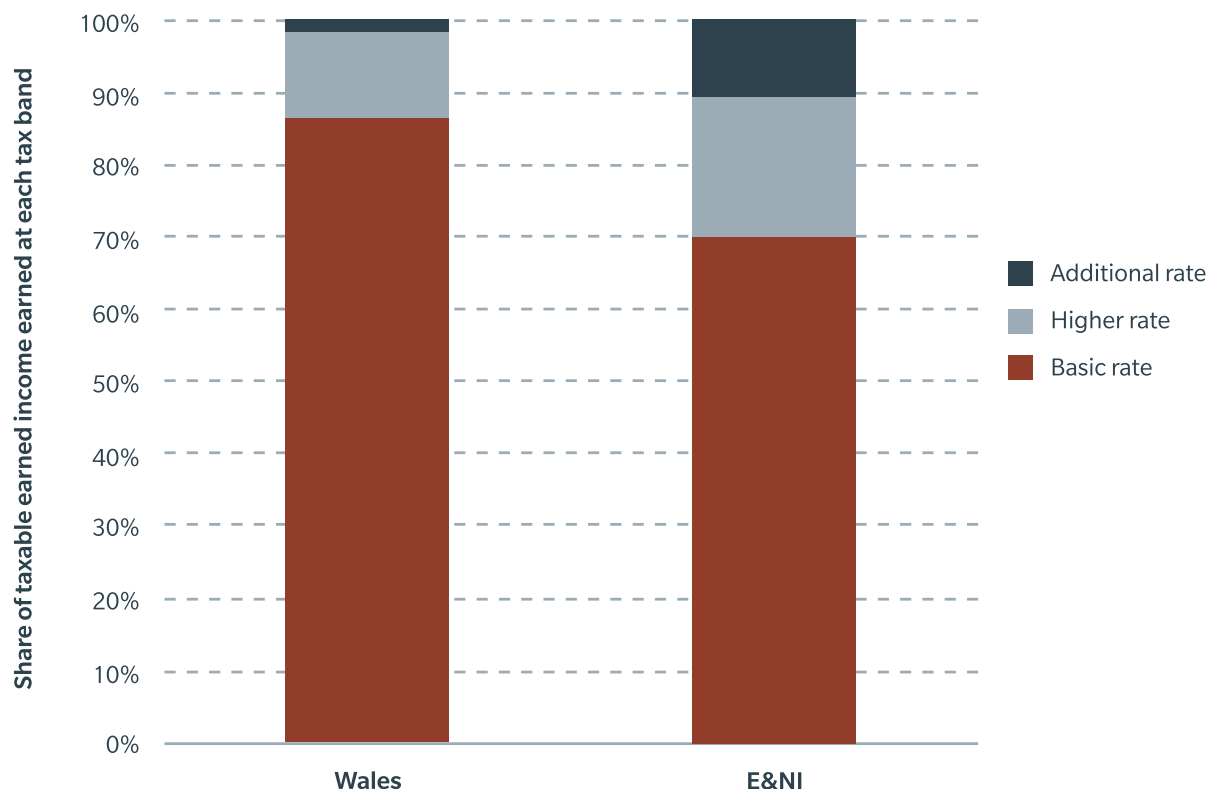
Creating separate BGAs for each income tax band means that the BGA is likely to match the trends in devolved Welsh revenues more closely than it would have using a single BGA for income tax as a whole.

The potential effect of this aspect of the agreement can be illustrated by analysis of recent data. As explored in our previous paper, had partial income tax devolution been in place from 2010-11 to 2013-14, and with BGAs indexed to changes in total revenues in the rest of the UK, the shortfall in the Welsh budget compared with full block grant funding would have been over £150 million by 2013-14.[11] In contrast, indexation by tax band (as agreed in the deal) would have reduced this budgetary loss to around £30 million.

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9   For further discussion of this, see page 21 of Bell, D., Eiser, D., and D., Phillips (2016). *Scotland's Fiscal Framework: Assessing the Agreement*. IFS Working Paper W16/05.

10 Three points are worth noting though. First, because the initial BGAs are based on actual revenues in Scotland and Wales at (or just prior) to devolution, rather than a population-based share of revenues in E&NI, even under the Levels Deduction, the initial cash-terms implicit redistribution of revenues would continue, although this would fall in both real-terms and relative to overall funding as additional increments to the block grant and BGAs (both based on population-shares) occur. Second, use of the Levels Deduction would only mean BGAs exactly offsetting underlying block grant increments if all the increase in revenue from equivalent taxes in E&NI were utilised to boost comparable spending on services devolved to Scotland and Wales. If some of the increase were used to fund increases in non-devolved areas of spending (like the state pension or defence spending), the share of spending change accruing to Scotland and Wales may not be a population-share (as under the Barnett formula). Third, that with the introduction of a needs-based factor in Wales' version of the Barnett formula (see Section 2.2), Wales receives a more-than-population share of any change in comparable spending. Population-share based increases in the BGAs would therefore not fully offset this meaning part of the marginal increase in revenues in E&NI would still continue to flow to Wales under the Levels Deduction approach.

11 See page 27 of Poole, E. G., Ifan, G., and D. Phillips (2016) *For Wales Don't (Always) See Scotland: Adjusting the Welsh Block Grant after Tax Devolution*. October 2016

FIGURE 1: Taxable earned income by tax band, Wales and the rest of the UK, 2013-14

Source: HMRC Survey of Personal Incomes, 2013-14

A similar (and perhaps greater) disparity exists in the case of the Stamp Duty Land Tax: a much higher share of Welsh revenues are generated by lower-value property transactions. The Welsh housing market over the last decade has also been much less buoyant than elsewhere in the UK, particularly London and South East England.[12] A potential option would have been to discount certain regions from the equivalent UK government taxes (such as London and the South East), or to create separate BGAs for different bands of SDLT, in order to create a BGA more akin to the Welsh tax base.

However, the agreement **does not make such an adjustment in the case of Stamp Duty.** Welsh revenues will therefore need to keep pace with revenues from across E&NI to prevent a shortfall in the Welsh budget. Given the recent slowdown in the higher end of the property market in South East England, this may be less of a concern than it might otherwise have been. However, it does increase the likelihood of the Welsh Government budget being negatively affected by factors largely outside of its control, such as changes in the demand for houses at the very top of the market due to international investment (which will almost certainly have different impacts on revenues in Wales than in E&NI, which includes London, where most such activity takes place).

Population-related risk

In a further departure from the Scottish Fiscal Framework, the implementation of the Comparable Model of BGA will mean that **the Welsh Government will bear population-related revenue risk.** Wales' population has been growing more slowly than the E&NI population for some time, and these trends are projected to continue. A direct consequence of the Comparable Model is that the Welsh budget will now lose out from slower population growth on the revenue side, even if revenues per person in Wales grow as quickly as in England and Northern Ireland.

To illustrate this effect, suppose that tax revenues in E&NI grow, but only as a result of population growth (revenue per person stays constant). Similarly for Wales, assume that revenues per person are constant, but that so too is population. In Wales' case, overall tax revenues are also constant.

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12 Ifan, G., and E.G. Poole, (2016) *Devolving Stamp Duty and Landfill Tax to Wales.* July 2016.

Because the Comparable Model increases Wales' BGA by a **population share of the tax revenue increase in E&NI**, this would lead to a reduction in the Welsh budget simply as a result of population growth in England and Northern Ireland.

In reality, both the UK and Welsh populations are growing, but the Welsh population is growing more slowly, meaning the BGA will grow faster than devolved revenues even if per-person revenue growth is the same in Wales. Updating the population share used in the Comparable Model calculations will not address this, because it will only calculate **changes** in the BGA. The overall level of the BGA (carried forward from the previous year) will not be adjusted to reflect the difference in population growth.

As noted in our previous report,[13] the fact that the Welsh Government will bear population-related revenue risk will somewhat reflect the treatment of population growth on the expenditure side through the Barnett formula. Again to illustrate this, suppose that spending increases in England because of population growth (so that spending per person stays constant), and suppose that Wales' population also stays constant. Through the Barnett formula, Wales would be allocated a population share of changes in spending in England even though its population has stayed constant, increasing relative spending per person in Wales compared with England.

The agreement states that the Comparable model delivers **consistent treatment of population change** on both the expenditure and revenue side, and that "any impacts of differential growth will offset within the Welsh Government's funding". However, the effect of differential population growth will not be totally symmetric on the expenditure and revenue side. The 'bonus' from slower population growth on the expenditure side is dependent on the rate of growth in comparable expenditure in England.[14] The extra spending per person due to slower population growth through the operation of the Barnett formula may not be totally offset by the population-related revenue loss.

The Scottish Fiscal Framework means that the Scottish Government will not bear population-related revenue risk because its BGAs will strip out the effect of differences in population growth between Scotland and E&NI, at least until the renegotiation planned for after the 2021 Scottish Parliament elections. This was the result of the Scottish Government refusing to bear population-related revenue risk, arguing that the levers for controlling relative population growth (such as immigration policy) were reserved to Westminster. It is likely that the Welsh Government would similarly not have agreed the Comparable Model in the absence of a UK Government offer to significantly modify the Barnett formula (see Section 2.2).

The BGA and fiscal accountability

When assessing how the BGA should change from year to year, a possible argument would be that it should (as closely as possible) reflect the ongoing 'opportunity cost' of devolution for the Treasury – the amount of revenue the Treasury would have collected in Wales had devolution not occurred. Ideally, the BGA mechanism would also serve to incentivise the Welsh Government to grow its tax base, with the Welsh Government gaining extra funds or losing out as a result of factors under its control.

While accounting for Wales' significantly lower tax base (largely achieved in the case of income tax by the creation of separate BGAs), a good proxy for the Treasury's opportunity cost (and a fair target for the Welsh Government) would arguably be **per-person growth in revenues in England and Northern Ireland**. This is the basis on which Scotland's BGA will change from year to year. The BGA would then serve as a benchmark for determining how successful the Welsh Government is in managing its revenues.

In Wales' case however, **not accounting for Wales' slower population growth means that the BGA will probably exceed devolved revenues in future**, unless there is sustained faster *per-person* revenue growth in Wales after devolution. In all likelihood, **the amounts taken away from the block grant in future will exceed the Treasury's opportunity cost**, and a shortfall could be created in the Welsh budget by slower population growth, the policy levers for which are largely outside Welsh Government control. As one of the aims of tax devolution is to increase the financial accountability of the Welsh Government, this will potentially obscure one of the most important accountability mechanisms which tax devolution was meant to introduce.

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13 See page 22 of Poole, E. G., Ifan, G., and D. Phillips (2016) *Barnett Squeezed? Options for a Funding Floor after Tax Devolution*. December 2016
14 See box 1 on page 12 of Poole, E. G., Ifan, G., and D. Phillips (2016) *Barnett Squeezed? Options for a Funding Floor after Tax Devolution*. December 2016

Box 1 outlines in more detail the type of budgetary information that should be published to help ensure tax devolution and the new Fiscal Framework facilitates the fiscal accountability of the Welsh Government.

BOX 1: Information to facilitate the future fiscal accountability of the Welsh Government

As Wales moves towards a more complex system of determining the size of the Welsh Government budget, public finance statistics will play a crucial role in assisting public understanding and allowing the performance of the Welsh Government to be scrutinised. At a minimum, the following information would provide a clearer view of how Welsh Government budgets of the future have been determined:

- Information on the underlying Barnett-determined block grant (before adjustments for tax devolution are made). Adjusted on a per person basis, this is the amount of funding that will determine when the 'transitional period' of the deal comes to an end, once it reaches 115% of the level in England. Furthermore, additional information should be provided on the impact of the 'needs-based factor' which will be included in the Barnett formula from 2018-19 (see section 2.2).

- The size of each BGA applied for each devolved tax, including separate information on the forecast BGA for each year in question and any reconciliation payments made for previous years.

- Statements of Welsh Government revenues from devolved taxes (on an aggregate and per capita basis). Such statements would include at least a qualitative discussion of the impact of policy changes on revenues, and ideally a set of estimates that quantify the budgetary changes from policy initiatives.

Just as in a homework problem from a Maths class, this information would "show your workings" on the derivation of Welsh Government budgets of the future. In the absence of data on the underlying block grant, the BGA and devolved revenues, it will be much harder to distinguish the causes of any changes to Welsh funding.

A simple illustrative example of this type of information (for the 2021-22 Welsh Government budget) is shown in Table 1. Further information on how each aggregate figure presented in the table is arrived at, along with the change from the previous year, would further boost transparency.

TABLE 1: Illustrative presentation of the 2021-22 Welsh Government Budget	
Funding Source	2021-22
Underlying block grant	**15,000 million**
(Of which resulting from Needs-based factor)	(+50 million)
Block Grant Adjustment (BGA)	**-2,700 million**
Of which	
Initial BGA with regards to 2021-22	-2,660 million
Reconcilliation of 2020-21 BGA	-40 million
Welsh Revenues	**+2,650 million**
Of which	
Forecast revenues for 2021-22	+2,620 million
Reconcilliation of 2020-21 revenues	+30 million
Overall Budget	**14,950 million**

As the Welsh Rates of Income Taxes will still be collected by HMRC, information provided directly to individual taxpayers will be essential in boosting financial accountability:

- Statements should be provided to taxpayers that clearly documents the taxes they have paid to the Welsh and UK governments; for example, in the form of a separate Annual tax summary[1] for Welsh taxpayers, and clearly stated on P60 documents provided by employers.
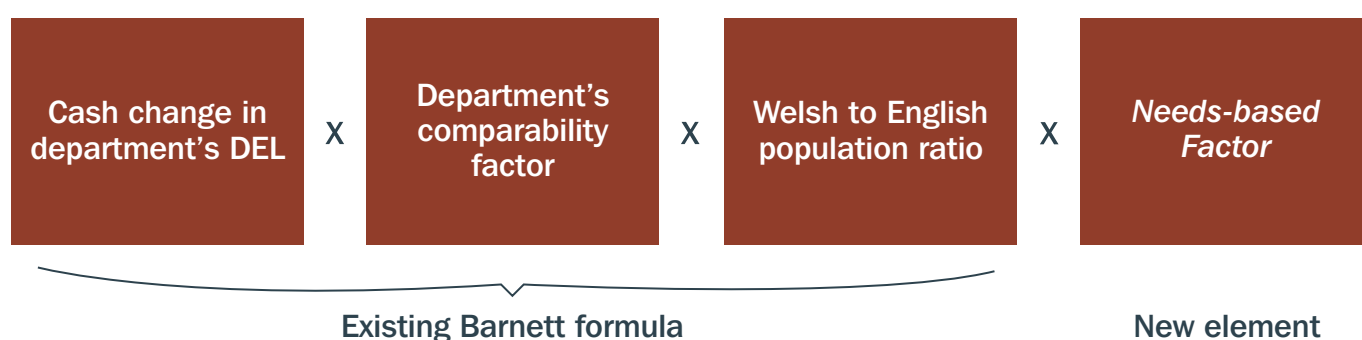
1 https://www.gov.uk/guidance/annual-tax-summary

2.2 Barnett Needs Factor

The second key funding reform outlined in the agreement is the implementation of a **new "needs-based factor" in the Barnett formula**, to be introduced from 2018-19 onwards. This reform represents the first major modification of the Barnett formula since its introduction in the late 1970s.

At the 2015 Spending Review, the UK government introduced a long sought-after "funding floor". This mechanism was designed to prevent per-capita funding for the Welsh Government from falling below 115% of comparable spending per person in England for the duration of the current Parliament. This guarantee did not however affect the operation of the Barnett formula. Moreover, because spending per person in Wales is currently some way above the level of the floor, the announcement was very unlikely to have any medium-term impact on Welsh funding. In contrast, the inclusion of a needs-based factor will begin to influence the operation of the Barnett formula and the funds available to the Welsh Government immediately from the point of its introduction. For the first time, the Barnett formula will include explicit recognition of the higher level of spending need in Wales.

Under this reform, changes to the Welsh Government's block grant will be calculated as a product of the following calculation for every UK Government department:[15]

Cash change in department's DEL	X	Department's comparability factor	X	Welsh to English population ratio	X	*Needs-based Factor*

| Existing Barnett formula |||||| New element |

The agreement states that the **needs-based factor will be set at 115%**, based on the "range recommended by the Holtham Commission and the funding floor implemented at the Spending Review 2015". This means that the per-person increments passed onto the Welsh budget (resulting from increases in spending on services in England) will be 15% higher than was previously the case. Although suggested by the Holtham Commission as an immediate priority, it was considered only as a temporary arrangement to prevent any further convergence before more comprehensive Barnett reform could be agreed.

Despite the headline level of 115%, the needs-based factor will actually **be set at 105% for a "transitional period"**. The factor will be increased to 115% only at the point at which relative Welsh funding per person converges to below 115% of the level in England. The agreement provides no rationale for the choice of 105% during the transitional period. As was argued in our previous report, unless it was based on an assessment of trends in relative population and comparable spending growth,[16] the immediate level chosen for any needs-based factor is effectively a zero-sum bargain between the Welsh and UK governments over who gets what slice of the pie.

The lower level of the needs-based factor during the transitional period seems to be recognition of the effect of Wales' lower rate of population growth on trends in relative spending. Under the agreement, if Welsh population growth matches that of England, relative funding per person in Wales will trend towards 105% of the level in England "during the transitional period". At the point at which relative funding squeezes down to 115% of the level of England, the transitional period would end and the "long term" factor of 115% would be used, maintaining spending per person at this higher relative level.

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15   For detailed discussion of the Barnett formula see section 2.1 of Poole, E. G., Ifan, G., and D. Phillips (2016) *Barnett Squeezed? Options for a Funding Floor after Tax Devolution.* December 2016

16 One such approach would be to vary the value of the needs-based factor to ensure relative funding converges towards 115%, by factoring in the effect of differences in population growth and the rate of growth in comparable spending in England. We termed this approach the Variable Barnett Needs Factor (see page 18 of Poole, E. G., Ifan, G., and D. Phillips (2016) *Barnett Squeezed? Options for a Funding Floor after Tax Devolution.* December 2016).

However, if the Welsh population grows at a slower rate than England's, then the rate of convergence in relative funding per person will also be slower, and towards an eventually higher level compared with England. This is because the Barnett formula only determines changes in the block grant reflecting the latest population shares, but the size of the previous year's grant that constitutes the majority of the current year block is not adjusted to account for the new population ratio.

When population growth differs between England and Wales, the trends in relative spending per person in Wales will also crucially depend on how quickly comparable expenditure is growing in England. If spending continues to grow very slowly, then the inclusion of the needs-based factor of 105% increases the possibility of further *divergence* in Welsh relative spending per person, as has been seen since 2009-10. As can be seen in the projections in the next section, **the transitional period described in the agreement could feasibly last for decades**.

The absence of any commitment to reassess the level of relative need in Wales in the future is notable in the agreement. This could mean that the post-transitional period needs-based factor of 115% (which may not come into effect much earlier than 2040) will be based on an assessment of relative need from 2010, which in turn was based on much earlier data, including the 2001 census. Given different economic and demographic trajectories, the level of relative need for public spending in Wales compared with England is unlikely to remain unchanged. If there is no intention to update the assessment of relative need (and hence the basis of the needs-based factor), then the Welsh Government will in effect bear the risks and rewards of its spending needs changing from this initial (and already out-of-date) level over the period of this agreement.
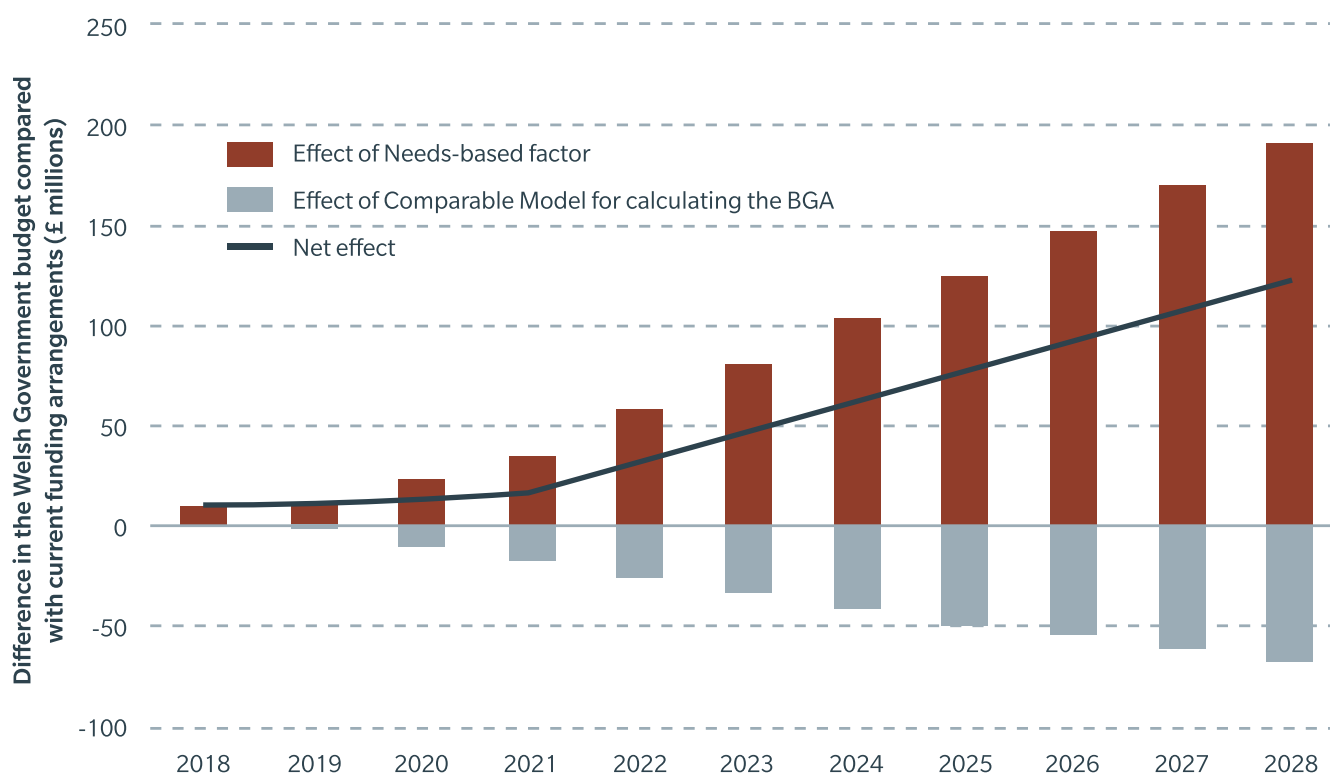
3. Projections of the impact of the Agreement on Wales' future funding

The likely effect of the agreed funding arrangements for future Welsh Government budgets will depend on a number of factors, including trends in population, spending growth and tax receipts. This section develops simple projections using a number of assumptions:

- Devolved tax revenues per person in Wales and E&NI are assumed to grow at the same rate, in line with trends for revenue growth in E&NI set out in the most recent Office for Budget Responsibility's Economic and Fiscal Outlook, and projected forward.

- The Office for National Statistics' principal population projections for Wales and the E&NI are used. From 2018-19, the Welsh population is projected to grow at 0.3% per year, while the population in E&NI is set to grow by 0.72%.

- Comparable spending growth in England for 2018-19 and 2019-20 is projected according to spending plans outlined in PESA 2016. We then assume that comparable spending grows by 2% in nominal terms until 2021-22 (roughly fixed in real terms), before returning to the longer-term trend of 4% thereafter.

Each assumption affects the projection in different ways. Importantly, under the central assumption that revenues per person grow at the same rate but population increases more slowly in Wales than in E&NI, aggregate tax revenues would grow at a slower rate in Wales than E&NI. Under the Comparable Model for indexing the BGA – which does not take full account of differential population growth – amounts taken off the block grant will outpace Wales' tax revenues. The magnitude of this effect will depend both on the growth rate in revenues per person and the extent to which Welsh population growth differs from that in E&NI. However, with the introduction of the 105% needs-based factor, increments to the Welsh budget will now be larger than would otherwise be the case. Exactly how much extra funding this will produce will depend on how quickly expenditure grows in England: the greater the growth in English expenditure, the greater the value of the extra 5% to the Welsh budget.

Using the assumptions outlined above, Figure 2 presents projections of the net effect on the Welsh Government budget, for a ten year period starting in 2018-19.

FIGURE 2: Projections of the effect of the fiscal framework agreement on the Welsh Government budget (compared with pre-reform arrangements, in 2016-17 prices)

In this central projection, the positive effect of the Barnett Needs Factor on the Welsh budget (represented by the red bars) is expected to outweigh the shortfalls created by slower revenue growth (represented by the grey bars). The net effect of the funding deal is represented by the black line. Although the deal has limited impact on Welsh funding in its early years, the Welsh budget is projected to be approximately £123 million greater after 10 years (in 2016-17 prices), compared with existing arrangements. Cumulatively, this represents just under £600 million more being available to the Welsh Government over this decade, growing to £1,400 over the first 15 years.

In addition to altering the overall size of the Welsh budget, the agreed funding arrangements will also influence the relative level of funding per person in Wales compared with England. This will be an important consideration, as it will determine when the 'transitional period' ends and the needs-based factor of 115% comes into effect.
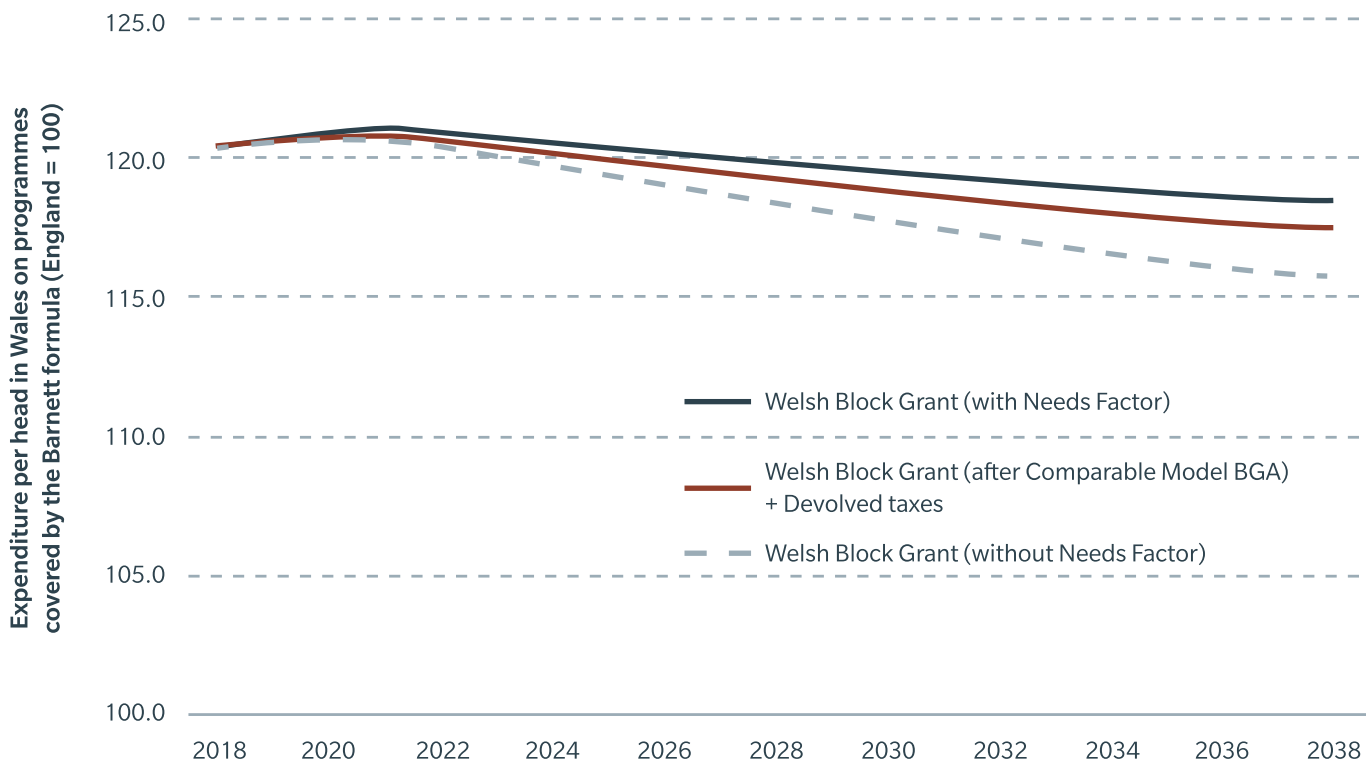
Figure 3 presents the projected effect on relative funding per person in Wales on programmes covered by the Barnett formula over a longer period of 20 years, using the assumptions outlined above. The initial level of funding per person in Wales is set at 120% of the level in England, close to the estimates presented by the two governments in the agreement.

The dotted grey line represents the projected trend in relative funding per person had the agreement not been implemented. Due to the slow growth in comparable spending, relative funding is projected to further diverge away from England at the start of the time series, before converging slowly down towards England's level when projected spending returns to a higher rate.

The black line represents relative funding with the needs-based factor in place (but without adjustments made to reflect tax devolution under the Comparable Model). This is the line which would need to reach 115% of England's level for the transitional period to end and for the needs-based factor to increase. Under the assumptions listed here, this will not occur at any point in this 20 year period, meaning the needs-based factor would remain at 105% for at least two decades.

The red trend line represents relative Welsh Government funding after taking into account the needs-based factor, the block grant adjustment and devolved taxes. As outlined above, the shortfall compared with the black line (the pre adjustment block grant) represents the effect of slower population growth on devolved revenues.

FIGURE 3: Projections of the effect of the agreement on relative spending per person in Wales on programmes covered by the Barnett formula
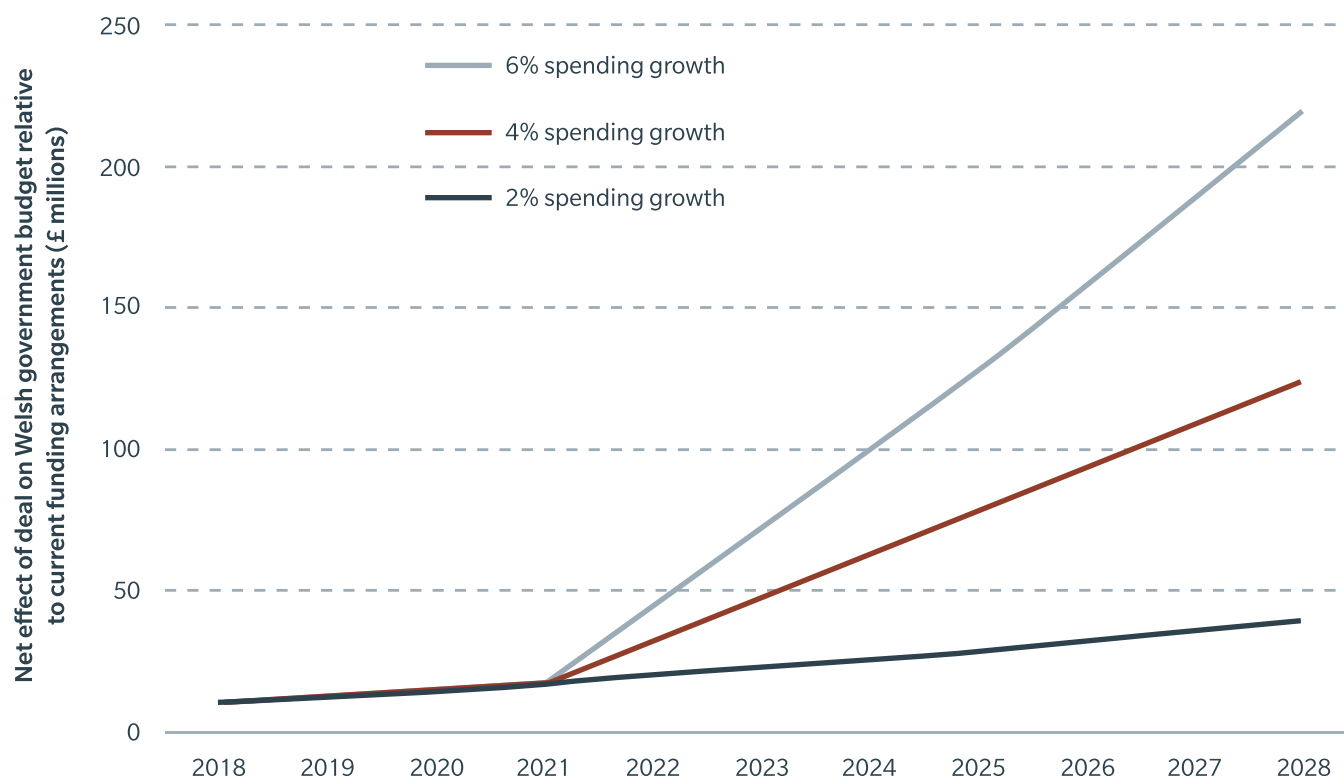

Under the assumptions outlined in this section, the agreement is likely to lead to more funding being available to the Welsh Government and higher relative spending per person in Wales than would otherwise have been the case. Notwithstanding, the significant UK and global economic uncertainties at the time of writing means there are several factors that could significantly impact the ultimate net benefit to Wales of this deal. These projections can only therefore be seen as rough approximations only – minor changes to the underlying assumptions can have a large impact on the projected cumulative effect of the deal.

A key assumption relates to the rate of growth in comparable spending in England. Figure 4 presents alternative projections of the net effect of the deal (i.e. the black line in figure 2), assuming different rates of spending growth after 2021-22 (while keeping the same assumptions for tax and population growth). When spending grows by just 2% per year (fixed in real terms), the extra funding from the Barnett needs-factor is much lower. However, the net effect of the deal is still positive, with the extra funding slightly outweighing the losses from the Comparable Model of block grant adjustment.

When spending is projected to grow by 6% per year, the extra funding from the Barnett needs-factor is substantially higher. Under this albeit extremely optimistic scenario, the Welsh Government budget would be projected to be £219 million higher in 2028 than under existing funding arrangements.

Different assumptions on the future path of public spending growth greatly impact the projected net effect of the deal. For example, if public spending begins to grow at 4% from 2020-21 (instead of from 2022-23, as we assume in our central projection), then the cumulative extra resources available to the Welsh Government would be over £800 million.

FIGURE 4: Projections of the effect of the agreement on the Welsh Government budget (compared with pre-reform arrangements, in 2016-17 prices) under different assumptions of spending growth from 2021-22

The net effect of the agreement on the Welsh budget will also depend significantly on patterns of population growth in Wales compared with the rest of the UK in coming years. A central uncertainty relates to immigration levels in future years, which may affect population growth differently in Wales than the rest of the UK. If the relative population growth differential narrows (e.g. if England's population growth rate falls), then the population-related revenue shortfalls for the Welsh Government would become smaller. With faster relative population growth in Wales, convergence in relative funding would happen sooner and faster. This may result in relative funding reaching 115% of England's level sooner, causing the needs-based factor to revert to 115%, and increasing the extra funding increments passed onto the Welsh budget.

Finally, recall that the projections presented here assume that revenues per person in Wales grow at the same rate as the rest of the UK. The Welsh budget and relative funding will of course deviate away from the projections outlined here if devolved revenues per person grow at a different rate from equivalent UK Government revenues. Sustained differences in revenue growth will have a large impact on the Welsh budget, potentially greater in magnitude than the budgetary effects projected here. This reflects the tax base risks and incentives being bestowed on the Welsh Government under these new funding arrangements.

4. Borrowing and budget management

4.1 Capital borrowing

Alongside the introduction of devolved taxes, the Wales Act 2014 provided the Welsh Government with new capital borrowing powers. From April 2018, the Welsh Government will be able to borrow up to £125 million per year, within an overall cap of £500 million, for any capital investment purpose within its devolved responsibilities. The Welsh Government will also make use of limited early access to borrowing in its 2017-18 budget to begin financing improvements to the M4.

Under this agreement however, the governments have agreed that **the Welsh Government's statutory limit for capital borrowing will be increased to £1 billion. The annual limit for capital borrowing will also be increased to £150 million**, or 15% of the overall borrowing cap. This increase will come into effect with the passage of the Wales Act 2017.

Relative to its devolved revenue, the new Welsh Government capital borrowing limit is roughly in line with the limit agreed for Scotland under its Scotland Act 2012 powers (which closely resemble the powers now being devolved to Wales). However, **the new limit for the Welsh Government is much higher (relative to devolved revenues) than the £3 billion limit agreed for Scotland in February**. It is perhaps significant that the Scottish Fiscal Framework negotiations took place in the context of the previous Chancellor's UK-wide strict fiscal rule, while the Welsh negotiations took place in the context of the new Chancellor's looser 'fiscal mandate'. However, relative to the overall devolved government budget, the Welsh capital borrowing limit will be slightly smaller than in Scotland. Moreover, given the scale of infrastructure projects under consideration such as the M4 relief road and South Wales Metro, the annual cap may be a limiting factor on the Welsh Government's borrowing aspirations.

The sources of borrowing available to the Welsh Government will remain the same as under the Wales Act 2014. It will be able to borrow from the UK Government's National Loans Fund, through a commercial loan or by issuing its own bonds.

4.2 Budget management tools

Similar to UK Government departments, the Welsh Government can currently make use of a mechanism known as the Budget Exchange facility. This allows it to carry forward up to 0.6% of its resource Department Expenditure Limit (DEL) budget and 1.5% of its capital DEL budget into the next financial year. The Wales Act 2014 provided the Welsh Government with a new cash reserve (separate from the Budget Exchange facility), which would allow it to save any surplus arising from tax revenues being higher than forecast, to be drawn down as required in future years, creating two separate, relatively restricted pools.

The new agreement combines the Welsh Government's cash reserve and the Budget Exchange facility into **a new Wales Reserve from April 2018**. This new reserve will be held by the UK government and will be separated between a resource reserve (which will hold funding from the Welsh Government's resource block grant and tax receipts) and a capital reserve (holding funding from the capital block grant and capital borrowing).

Although there will be **no annual limit** for payments into the Wales Reserve, it will be capped in aggregate at £350 million. In practice, this move will likely allow the Welsh Government to carry forward much more of its budget from one financial year to the next than is currently the case. The terms of the previous cash reserve required any surplus tax revenues to be used first to repay any outstanding resource borrowing (see below). It is unclear whether this will still be the case under this Fiscal Framework, though it is stated that further detailed operational arrangements will be agreed between the governments. Annual draw-downs from the Wales Reserve will be limited to £125 million

for resource spending and £50 million for capital spending.

The agreement states that **the resource borrowing powers of the Welsh Government will remain unchanged** from those under the Wales Act 2014. The Welsh Government will be able to borrow up to £200 million each year (which together with resource reserves draw-down means up to £325 million – if reserves are utilised – to support resource spending), up to an overall limit of £500 million, if tax revenues are lower than forecast. Under this arrangement, any resource borrowing will have to be repaid within 4 years.

When considering the level of resource borrowing powers (and potential draw-downs) which would be appropriate for revenue volatility management, recall the critical role the BGA mechanism will play in insulating the Welsh Government from the budgetary impact of revenue shocks. As explored in the first report in this series, this can be illustrated by analysis of historical data. Had tax devolution been in place, the Welsh Government's devolved revenues would have fallen by more than £233 million between 2007-08 and 2009-10. However, because equivalent UK government revenues in E&NI also fell during these years (reducing the BGA) the Welsh budget would have faced a cut of approximately £36 million.

This illustrates one key factor that will determine the Welsh Government's future need for resource borrowing powers: the correlation between Welsh devolved revenues and the equivalent revenues in E&NI, which determine changes in Wales' BGAs. The strong positive correlation in Welsh and E&NI revenues (meaning that when Welsh revenues rise, E&NI revenues are likely to rise in a similar way, and vice versa) means that shocks to Welsh revenues will, in most cases, be largely offset by changes to the BGAs, insulating the Welsh Government from most revenue volatility. It is only shocks which hit only Wales (or hit Wales disproportionately) that the Welsh Government will have to manage via its borrowing or reserves policy.

The other key factor is the relatively small scale of tax devolution, at least compared with Scotland. The larger the proportion of the Welsh budget funded by own taxes, the larger the potential budgetary impact from asymmetric revenue shocks. In 2021–22, devolved revenues from income tax, SDLT and landfill tax are forecast to be around £2.7 billion (with total devolved revenues including business rates forecast to be £3.8 billion). An annual borrowing limit of £200 million therefore represents 7.3% of newly devolved revenues (or 5.2% of all devolved revenues, including business rates). The combined limit for borrowing and reserve draw-downs of £325 million represents 12.8% of newly devolved revenues (or 9.1% of all devolved revenues, including business rates). The tools available to the Welsh Government would therefore allow it to smooth unexpected (temporary) falls in its newly devolved revenues relative to revenues in E&NI of up to around 10% of total devolved revenues.

But although the magnitude of the borrowing and reserves limits outlined in this Agreement appear to offer sufficient scope for volatility management, the rules and restrictions governing the use of such mechanisms are also of central importance in evaluating the new arrangements.

The Agreement proposes rules that are relatively simple but more restrictive than for Scotland. The rules for resource borrowing will be the same as at present: the Welsh Government will be able to borrow (up to its limits) if revenue receipts are lower than forecast. However, unlike in Scotland, the Welsh Government will not be able to borrow for forecast shortfalls in Welsh revenues, which result from a Welsh-specific shock to revenues. This avoids any complex definition of what constitutes a 'Welsh specific shock'.[17] However, it also means that the Welsh Government will only be able to utilise reserves (and not borrowing powers) if it is forecast to be subject to a temporary fall in revenues relative to E&NI (due to an economic shock expected to have a disproportionate impact on Wales, for instance). This implies that paying into such reserves may be relatively more important to the Welsh Government than the Scottish. The limit on annual draw-downs from resource reserves (£125 million) is equal to around 5.1% of initial devolved revenues (or 3.6% including business rates). Given the very high correlation of revenue growth in Wales and E&NI this would be expected to provide enough scope for revenue smoothing. However, the Welsh Government's potential ability to smooth forecast

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17 The Scottish Fiscal Framework agreement defines a "Scotland-specific economic shock" as an event when "onshore Scottish GDP is below 1% in absolute terms on a rolling four quarter basis and one percentage point below UK GDP over the same period". When this is observed or forecast, the Scottish Government will be able to borrow up to £600 million to address observed or forecast shortfall in revenues or increase in welfare expenditure.

shocks to Wales' relative revenues is clearly substantially less than its potential to smooth *unforecast* shocks via resource borrowing.

Given these limitations, it would seem sensible for the periodic review of Wales' fiscal framework (see Section 4) to review both borrowing and reserve rules and limits. Consideration should be given to indexing limits to the level of devolved revenues: as it stands, these limits are fixed in cash terms, but inflation and economic growth are likely to increase devolved revenues (and therefore the cash at risk over the course of the agreement).

5. Policy spill-overs, disputes and institutional arrangements

Given that tax devolution represents a major step change to Wales' current funding system, a number of institutional arrangements, compensatory transfers and dispute resolution mechanisms will need to be put in place for the first time. These aspects covered in the agreement will play a major role in the success (or otherwise) of the new system.

Compensatory transfers for policy spill-overs

When different tiers of government (such as the UK government and Welsh Government) are responsible for different but interrelated areas of policy, the decisions of one government may impact the other's spending or revenues. The Welsh Government's new tax powers, and the interactions with the tax and spending powers that remain reserved to the UK government, lead to a number of potential spill-overs. For example, if the Welsh Government increased its income tax rates, then it might increase eligibility for Universal Credit, which is based on after-tax income. This would increase the UK government's spending on this benefit in Wales. It could also change the behaviour of Welsh taxpayers who may choose to work less in response for example, influencing the reserved taxes they also contribute to, and the benefits they receive from, the UK government. Given that it is not possible to directly observe the counterfactual scenario where the Welsh Government did not increase its tax rates, identifying and measuring such spill-over effects is not a straightforward task.

The agreement makes a distinction between different types of spill-over effects. **All 'direct' spill-over effects will be accounted for**. These effects are described as the financial effects that "directly and mechanically exist as a result of a policy decision (before any associated change in behaviour)". An example of this would be the immediate increase in Universal Credit eligibility in Wales resulting from an increase in Welsh Government income tax rates.

Meanwhile, financial spill-over effects that result from people changing **behaviour following policy decisions, or behavioural spill-over effects, will only be accounted for in exceptional circumstances**. An example of such effects would be people working less as a result of UK government cuts to Universal Credit work allowances, which would reduce the Welsh Government's income tax revenues. Another example would be taxpayers moving across the Welsh-English border as a result of the Welsh Government changing its tax rates away from 10p (and hence creating differential rates of income tax between Wales and England). Under the agreement, these effects will only be subject to compensatory transfers if they are "material and demonstrable", and both governments agree that transfers would be appropriate.

The agreement provides no definition as to what level of financial spill-over would be classed as "material". As was the case in the Scottish Fiscal Framework, this decision appears to be pragmatic response to the difficulty in calculating the magnitude of behavioural effects. However, this could open the door to dispute between both governments, especially because the occasions where behavioural spill-over effects are likely to be large will also be the occasions where there will be most uncertainty and scope for disagreement. The much more limited taxation powers being devolved to Wales (both in terms of total revenues and usability) imply that there will be less scope for large behavioural effects in Wales than in Scotland. However, the more densely populated border area between Wales and England may lead to greater cross-border effects from policy changes.

Second round effects, which encompass wider economic impacts that may result more indirectly from policy decisions – such as changes in the level of aggregate demand in the economy – **will not be accounted for.**

Plans to account for first-round behavioural responses only in exceptional circumstances, and to ignore second round effects completely, are clearly designed to reduce the extent to which controversial

assumptions are required, and to limit the potential for disagreements between the governments. However, by ignoring such spill-over effects, the incentives for policymakers may be skewed. For example, if an increase in the Welsh rate of income tax led to a reduction in how much people work, and if the Welsh Government did not have to compensate the UK government for the reduction in revenues from the UK government's share of income tax and National Insurance contributions, the Welsh Government would not be facing the true costs of its policy decisions. **This could skew its incentives towards tax rises and away from tax cuts**.

For all spill-over effects, assessment of causality and scale of financial impacts will be based on a "shared understanding of the evidence", and any transfer relating to a spill-over will have to be jointly agreed by both governments. But a complicating factor – and the next area addressed by this report – relates to the question of how agreement will be reached if the governments do not agree.

Disputes

The Fiscal Framework agreement sets out a process for resolving any disputes relating to the implementation or operation of the agreement. In the first instance, disputes will be considered and discussed by officials, initially at working level and then by the Joint Exchequer Committee (Wales) (Officials). If no agreement is reached then the matter will be considered by the finance Ministers at JEC (Wales). If no agreement can be reached between Ministers, then the dispute will fall, and no outcome will result from it.

The agreement states that discussions over disputes may be informed at any stage by seeking the view of independent bodies. This would be similar to the dispute resolution mechanism described in the Scottish Fiscal Framework agreement, where technical input will be sought from the OBR and the Scottish Fiscal Commission. The Welsh Government's Cabinet Secretary for Finance Mark Drakeford described this independent oversight as an "important departure from the normal way that business is conducted".[18]

Forecasting responsibilities

Since 2014, the UK Office for Budget Responsibility has been producing forecasts for revenues that will be devolved to Wales. The agreement states that the Welsh Government will be able to decide whether to continue to use the OBR's forecasts or put in place alternative independent forecasting arrangements. It can also draw on its own forecasting capacity in the first instance.

Periodic review

The block grant adjustment arrangements contained in the Scottish Fiscal Framework will only apply until the end of 2021. Arrangements beyond 2022 will be subject to a formal review and renegotiation between the Scottish and UK governments. In contrast, the Welsh Fiscal Framework will not be reviewed and renegotiated before a set date. The two governments have however agreed that the framework should be subject to periodic review.

The agreement states that the first review will take place before the end of the block grant funding transitional period, although as explored in section 3, this period may last for decades. Importantly, either government will be able to request a review, with the intention that arrangements will not be reviewed more than once during an Assembly or Parliamentary term.

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18 Transcript available at: http://senedd.assembly.wales/documents/s500003348/11%20January%202017.pdf

6. Conclusions

As illustrated by the projections presented in this report, the Fiscal Framework agreement between the Welsh and UK governments will likely lead to larger Welsh Government budgets than under the present funding arrangements. As it represents a good financial deal for the Welsh Government, it made it more likely that Assembly Members would pass a Legislative Consent Motion for the Wales Bill on 17 January 2017, which was required for the agreement to come into effect. But looking beyond its purely financial effects, there are strengths and weaknesses to the new system of devolved public finance being introduced in Wales.

For the first time, the Welsh Government budget will be significantly and directly linked to what happens to tax revenues collected in Wales. The relative performance of the Welsh economy will have a bearing on the amount ministers have to spend on public services, and political parties will also be able to present competing policy packages of Welsh taxes and public services at Assembly elections. This addresses what the Holtham Commission identified as one of the main weaknesses of the existing devolution funding settlement.

Although the Welsh Government will begin to bear the risks and rewards of tax base growth in Wales, the new system (specifically the BGA mechanism) should provide relatively strong protection against macro-economic shocks that affect the whole of the UK. This means the UK Government will continue to bear responsibility for smoothing much of the volatility in Welsh revenues - perhaps a key strength of Wales' new funding system compared with other countries internationally.

Almost all countries with sub-centralised tax systems undertake some element of revenue equalisation (i.e. provide grants to compensate sub-central governments with a weaker tax base, so that differences in their spending power per person are reduced). In the first year of tax devolution, there will effectively be full equalisation of Wales' lower tax capacity, because the amount deducted away from Wales' block grant will be based on the amount of revenue raised in Wales in that year. However, as the 'comparability factors' in the BGA mechanism will remain fixed, the level of equalisation will not be updated to reflect changes to Wales' tax capacity. This is somewhat unusual in an international perspective; most systems have some form of ongoing, responsive equalisation of tax capacity in place. The flip-side of this risk is that the Welsh Government is fully incentivised to grow the Welsh tax base and reap all the rewards. Although perhaps some responsive revenue equalisation mechanism may have been prudent, another important consideration is that the degree of fiscal devolution to Wales will be rather limited compared to other countries. Under the new system, devolved revenues will eventually only equate to around a fifth of the Welsh budget, compared with almost a half of the Scottish budget when assigned revenues (from VAT) are taken into account. As explored in section 2.1, another protection against Wales' lower tax capacity is provided by the creation of separate BGAs for each band of income tax. This means that what happens to incomes in the higher tax bands in E&NI will have less of an impact on the Welsh budget.

As suggested by projections in this report, future growth in the Welsh Government's devolved revenues is likely to lag behind the growth in the BGAs made to account for tax devolution. Some of this shortfall will result from factors largely outside the Welsh Government's control, such as Wales' slower growing population. This is perhaps a weakness of the agreed Fiscal Framework, in that it will make it difficult to evaluate the relative revenue performance and decisions of the Welsh Government. As described in box 1 of this report, the budgetary information published by both governments will be essential in boosting public understanding of why and how Welsh budgets change from year to year. An increase in transparency on block grant funding arrangements will be necessary to enhance the financial accountability of the Welsh Government.

As a result of this agreement, the system of allocating grants to the Welsh Government will for the first time account for Wales' higher level of need for public spending, addressing the other main weakness

of the existing system identified by the Holtham Commission. The inclusion of the need-based factor in the Barnett formula will slow future convergence in relative funding per person between Wales and England, and will likely ensure that relative funding per person will not fall below a 115% of the level in England. However, as the funding formula will still determine changes in Wales' block grant, rather than its actual level (as is most common internationally), relative funding per person in Wales will still be influenced by a mix of historical accident, trends in relative population growth, and the rate of growth in spending in England.

Internationally, a number of decentralised fiscal systems factor relative spending needs in determining grant allocations. However, Wales' fiscal framework will again be slightly unusual in that no arrangements have been made for reassessing relative need in future. Even at the point of introduction, the 'needs-based' element of the funding formula will be based on a decade old assessment of relative need. Most countries either conclude that measuring spending needs is too complex and contentious, or decide upon a framework for ongoing assessments of relative need. As the needs assessment underpinning the needs-based factor will be fixed in time, the Welsh Government will ultimately bear the risks (and rewards) of Wales' relative need changing in future.

This is likely to become a source of tension, if it emerges that Wales' relative need is changing. It is fair to say the agreement kicks that particular can down the road. Therefore, although the agreement is described as "fair, sustainable and coherent", it is unlikely to end debate around Wales' fiscal framework. Indeed, the Cabinet Secretary for Finance and Local Government, Mark Drakeford, has already noted that "a more root and branch revisiting of the way funding flows through the UK" remains the long-term objective of the Welsh Government.[19]

Looking across the UK as a whole, the arrangements in place look increasingly asymmetric, reflecting the ad-hoc way in which devolved public finances are being reformed. There will in future be significant differences in the scale and composition of devolved and reserved taxes across each country; in how their block grants are determined, allocated and adjusted over time; and in the borrowing and budget management capacity of each devolved government. This is slightly ironic given HM Treasury's professed penchant for simplicity. Perhaps expectedly, each funding settlement reflects particular political circumstances in each country during negotiations.

The fact that HM Treasury were willing to concede a generous financial deal for Wales (even as funding per person in Wales remains well above 115% of England) may suggest it has one eye on the renegotiation of the Scottish fiscal framework, set to take place after the 2021 Scottish Parliamentary elections. The initial Scottish agreement implemented the Scottish Government's preferred method of BGA (Per-Capita Indexed Deduction), which will insulate the Scottish Government from population-related revenue risks. That the Welsh Government has agreed to the Treasury's Comparable model provides some precedent for the Treasury to take into the renegotiation. However, as devolved revenues are more than five times greater in Scotland, the population-related revenue risk would be much greater for the Scottish Government, especially since slower population growth is a much more entrenched and persistent phenomenon in Scotland. On current projections, moving from the Per-Capita Indexed Deduction method to the Comparable model (the Welsh system) after 2021-22 would cost the Scottish Government £380 million per year after just five years, growing to £740 million per year by 2031-32.[20] There has also been little call or rationale for a need-based element to determine Scottish block grant changes, which would mitigate these losses, as will be the case in Wales. What will probably be a good financial deal for Wales may not be so good for the Scottish Government.

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19 Transcript available at: http://senedd.assembly.wales/documents/s500003348/11%20January%202017.pdf
20 See page 32 of Bell, D., Eiser, D., and D., Phillips (2016). *Scotland's Fiscal Framework: Assessing the Agreement.* IFS Working Paper W16/05.