

Finance Committee

Meeting Venue:

Committee Room 2 – Senedd

Meeting date:

Wednesday, 22 October 2014

Meeting time:

09.00

Cynulliad
Cenedlaethol
Cymru

National
Assembly for
Wales



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Agenda

1 Introductions, apologies and substitutions (09:00)

2 Best Practice Budget Processes Inquiry Part II: Evidence Session 3 (09:00– 10:00) (Pages 1 – 9)

FIN(4)–19–14 paper 1

Research Brief

Professor Max Munday – **Director of Welsh Economy Research Unit**, Cardiff
Business School

3 Best Practice Budget Processes Inquiry Part II: Evidence Session 4 (10:00–11:00) (Pages 10 – 26)

FIN(4)–19–14 paper 2

Research Brief

Mike Usher – Sector Lead, Health & Central Government, Wales Audit Office

4 Motion under Standing Order 17.42 to resolve to exclude the public from the meeting for the following business: (11:00)

Items 5, 6 & 7

5 Best Practice Budget Processes Inquiry Part II: Consideration of evidence received (11:00–11:15)

6 Planning (Wales) Bill: Financial Implication of the Bill (11:15–11:30)

(Pages 27 – 34)

FIN(4)–19–14 paper 3

7 Welsh Government Draft Budget 2015–16: Consideration of key issues (11:30–12:30)

FIN(4)–19–14 paper 4

Provision of Economic Data and Modelling in Wales

Dr Andrew Crawley*[^] & Professor Max Munday*,

*Welsh Economy Research Unit, Cardiff Business School.

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28th May 2014.

Introduction

The use of economic modelling is a critical component for the assessment of economic policy for any Government. Robust models are a necessity for any legislative body considering alterations to taxation. To date, there have been limits on the extent to which economic models of Wales have been used to inform policy. This contrasts with the situation in Scotland where for well over two decades there has been significant economic data gathering and interrogation done, first by academics but then by the Scottish Government, to inform both basic and more complex models of the Scottish economy. Scotland benefits from better details of the economic links between regional industries, government and households, and has official Input-Output tables (see below) detailing these links. Added to this is the significant economic modelling work conducted at Strathclyde and Heriot Watt Universities, where sophisticated macroeconomic models for Scotland have utilised this data, delivering unique policy insights.

For Wales there has been a conflation of two problems, the first is having greater **Data** and the second is the ability to produce and run **Economic Models**. Each of these are inherently important for Wales but having one without the other will be of little use. What is required is a fundamental change with which “economic intelligence” is gathered, analysed and disseminated.

Data

The biggest challenge presently is the collection and provision of disaggregated Welsh economic data. There are two primary blocks of data required to build an economic model capable of analysing tax changes. First micro or agent level information including i) Consumption, ii) Labour Market Composition and well as Dynamics and iii) Earning, Saving and Investment information. Second, macro including aggregate regional accounts of output and inputs.

Presently there is little (agent level) data collected specifically for Wales, the National Survey for Wales is run by the Welsh Government and contains a great deal of information of which some would support development of economic models for Wales. However with few adjustments a specific economic behaviour module could be included cheaply and efficiently improving the usefulness of this source for modelling purposes. Another important source is the Integrated Household Survey conducted at a UK level. With a Welsh booster this would be a particularly valuable resource for developing agent level data for use in economic models of Wales.

Macro data would include: i) Trade Flows ii) Aggregate Tax Receipts iii) Project Government Expenditure. This macro/aggregate data presents somewhat more of a challenge. To this point there exists no formal Welsh accounting programme whereby components of supply and demand are decomposed into inputs and outputs. This macroeconomic information provides the backbone of understanding how Wales's economy works.

The simplest accounting mechanism that could be adopted quickly would be an official Input Output (IO) account formed from a supply and use matrix as well as the detailed information on the components of final demand.

Although not official an IO account for Wales has been in existence since 1995 constructed by the Welsh Economy Research Unit (WERU) at Cardiff University. But this accounting data has only been updated incrementally through projects supported by agencies and Government Departments in Wales. The monetary cost of producing official input-output tables for Wales would not be high, and the supporting statistical framework is already in place. Development could be achieved quickly and efficiently. Looking at both micro and macro data requirements, existing surveys and work in Wales already provides the base for more in-depth information to be collected. The Welsh Government might recognise that investing in the foundation capacity through which to develop more complex economic models, could reap dividends when tax changes are debated in the future.

Economic Modelling

Economic modelling builds a framework for applying logic, statistics as well as mathematics to independently assess and test the consequences of changes to economic outcomes. Economic models do not give definitive answers but can provide likely outcomes of changes in policy. This in turn provides powerful tools for critique of changes before they are actually implemented. Models usually fall into two classes **Impact**, to assess short run changes or a set of specific individual actions and **Forecast** for understanding trends across time particularly in aggregate data. Whichever class of model is used the output is very much limited by the accuracy and quantity of its initial input data.

Likely Models suitable for Wales for assessing tax changes are an i) Econometric Input Output (EIO) and ii) Computable General Equilibrium (CGE) model. To date there have been some attempts to build and run models for Wales however these have been limited by the quality of data available.

Led by a team in Scotland utilising the AMOS (A Macroeconomic of Scotland) framework, a CGE model for Wales has been developed and has been used to assess the economic and environmental consequences of industrial change. Dr Andrew Crawley from WERU has been leading a European-funded project, INTERIM¹ (Integrating Regional Economics Impact Models) the goal of which is to develop new approaches to the development of economic impact models. Working with a world-class team in the United States, one of the test regions will be Wales. The output from this research will be a new Wales Econometric Input Output model.

Both of these examples show how modelling has been utilised for Wales but both of which are academic in nature and have been constrained by limited information. Similar to the discussion of data in the previous section the examples of existing models provide a useful starting point for developing robust tools for the assessment of tax changes as well as other policy assessments.

Importance for Wales

If any tax raising powers were to be devolved, there would need to be sufficient economic models and data available in Wales to inform the debate over the consequences of such actions. There is currently no official disaggregated macroeconomic model for Wales, and estimates of tax change consequences will at this stage likely have to be sought from the UK Treasury based upon UK models.

Having an independent Welsh model(s) provides the ability to construct policy scenarios using robust methods explicitly built for understanding Welsh specific consequences.

¹ <http://business.cardiff.ac.uk/research/projects/integrating-economic-regional-impact-models>

By virtue of paragraph(s) vi of Standing Order 17.42

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Date: 7th May 2014
Our ref: HVT/2145/fgb
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FINANCE COMMITTEE INQUIRY INTO BEST PRACTICE BUDGET PROCESSES

Thank you for your letter of 28 March 2014, inviting me to provide written evidence to the Finance Committee to assist you with your inquiry into Best Practice budget processes. The 'call for evidence' covers a wide range of ground and I trust that my comments will be of assistance to the Committee.

Before addressing each of the specific questions set out in the call for evidence, I thought it would be useful for me to set out some general observations.

The new financial powers that are to be devolved to Wales under the Wales Bill represent both real opportunities and significant challenges for the National Assembly and the Welsh Government. This will be the first time that tax-raising powers have been devolved to Wales, and it will be imperative that the associated risks are fully understood and well-managed. I think that both the Finance Committee and also the Public Accounts Committee will have important roles to play in scrutinising the new arrangements, both during their development and also once they come into operation from 2018.

The Committee will be aware that I am keen to ensure that, wherever possible, I and the staff of the Wales Audit Office provide real-time input and commentary on significant public sector developments in Wales. Whilst I need to ensure that my independence as the statutory external auditor is safeguarded at all times, it is obviously better for us to seek to ensure that public bodies 'get it right first time' rather than simply issue retrospective audit reports criticising their shortcomings. I am therefore pleased that the Welsh Government has invited a senior member of my team to participate as an observer on their 'Welsh Treasury Implementation Programme Board', and also to attend meetings of the Finance Minister's 'Welsh Tax Forum'.

More generally, it is encouraging to see that senior Welsh Government officials are adopting an inclusive approach to wider stakeholder engagement from the outset of their implementation programme. This includes establishing productive lines of communication with their counterparts in the Scottish Government, who are currently grappling with similar challenges regarding devolved taxation powers within their own context.

My responses to each of the specific questions posed within the call for evidence are set out below.

Part 1 of the Inquiry

Question 1: International best practice – What are the principles of fiscal accountability? How do other countries achieve devolved financial accountability while retaining central fiscal control?

Response:

I have not undertaken any specific audit work to date in this area. However, I commend to the Committee's attention the draft '*Principles of Budgetary Governance*' that were recently published¹ by the Organisation for Economic Co-operation & Development (OECD), as these will be of significant relevance to the Committee's consideration of this topic.

The ten principles identified by the OECD are that:

- i. Fiscal policy should be managed within clear, credible and predictable limits;
- ii. Top-down budgetary management should be applied to align policies with resources;
- iii. Budgets should be closely aligned with government-wide strategic priorities;
- iv. Budgets should be forward-looking, giving a clear medium-term outlook;
- v. Budget documents should be open, transparent and accessible;
- vi. The budget process should be inclusive, participative and realistic;
- vii. Budgets should present a true, full and fair picture of the state of the public finances;

¹ <http://www.oecd.org/gov/budgeting/Draft-Principles-Budgetary-Governance.pdf>

- viii. Performance, evaluation and value for money should be integral to the budget process;
- ix. Longer-term sustainability and other fiscal risks should be identified, assessed and managed prudently; and
- x. The integrity and quality of budget forecasts, fiscal plans and budgetary implementation should be promoted through rigorous, independent quality assurance.

I note that these OECD principles have a particular resonance within the Welsh context, given that the Government of Wales Act 2006 places a statutory duty on the Welsh Government to promote sustainable development. Since 2009, the policy of the Welsh Government (as set out in *'One Wales, One Planet'*) has been to make sustainable development² the central organising principle of Government.

This long-standing duty and policy commitment is likely to be strengthened by a new set of sustainable development duties under the Future Generations Bill, when this is published later in the summer. In my response³ to the White Paper consultation on a sustainable development bill, I noted the central role that budget-setting plays in the delivery of public sector policy. It would therefore appear sensible for the National Assembly to evaluate the Welsh Government's eventual proposals for implementation of the devolved taxation powers against both the OECD's principles and also its own sustainable development duty. I suggest that the Committee may also wish to seek an early assurance from the Welsh Government that these principles are being embedded into policy development.

² **Sustainable development** means enhancing the economic, social and environmental well-being of people and communities, achieving a better quality of life for our own and future generations in ways which:

- Promote social justice and equality of opportunity; and
- Enhance the natural and cultural environment and respect its limits – using only our fair share of the earth's resources and sustaining our cultural legacy.

Sustainable development is the process by which we reach the goal of sustainability.'

'One Wales, One Planet', Welsh Government, 2009

³ www.wao.gov.uk/sites/default/files/download_documents/SD_White_Paper_response_final.pdf

Question 2: Are the devolved powers tailored to the Welsh devolution settlement – as the powers in the Wales Bill are based on those in the Scotland Act, does this create unforeseen problems in Wales?

Response:

There are some real advantages to the fact that the powers in the Wales Bill are based on those in the Scotland Act, in that Wales is approximately two years behind Scotland in terms of implementation plans. This provides significant opportunities for all those engaged on the devolution of financial powers to Wales to learn from the experiences of those currently engaged in the Scottish project.

Early indications are that this process of observation, discussion, comparison and reflection is getting underway well, with officials in both Cardiff and Edinburgh exchanging views and sharing their learning. I think it will be important that this dialogue continues throughout the project and that all transferable learning (whether key success factors or potential pitfalls) is captured and evaluated as early as possible.

One important issue that will certainly impact differently on the Welsh arrangements is geographical, as around 60 per cent of the Welsh population live within one hour's travel from the border with England, compared with just 10 per cent in Scotland. This means that the 'cross-border' fiscal risk factors associated with unintended macro-economic consequences (in either direction) between Wales and England are likely to be significantly higher than those faced by Scotland.

These cross-border factors will play out in different ways for each of the taxes that are expected to be devolved to Wales, but their expected impacts will need to be carefully evaluated on each occasion when any differentiation in taxation rates is proposed between Wales and England.

Question 3: Linking budgets to outcomes. What new budget procedures are needed to improve the links between policies, spending programmes and outcomes? How would outcomes generated by the UK Government and the global economy be identified separately from those generated by local Welsh Government policies?

Response:

It is undoubtedly important to see that links are made wherever possible between policies, spending programmes and outcomes. This maxim holds true under the existing financial settlement, whereby the Annual Budget Motion focuses almost entirely upon the Welsh Government's spending plans, but it will become even more important once an element of fiscal devolution is in place for Wales from 2018 onwards.

However, in practice a note of caution is required here, as I think that it is generally hard and often impossible to identify outcomes generated by the UK Government and the global economy separately from those generated by local Welsh Government policies.

Whilst outputs can in some cases be used as reasonable proxy measurements of outcome, the measurement of outcome itself (which is often qualitative, rather than quantitative) is generally fraught with difficulty. In particular, causative economic effects are notoriously hard to tease out individually, and the Welsh economy is so closely integrated into the wider UK and global economies that isolating any single specific outcome as being the result of a single specific cause is highly problematic.

Part 2 of the Inquiry

Question 4: Tax and borrowing issues identified in the Holtham Report; e.g. the impact on the block grant and the 'indexed method' for adjustments; the basis of the devolved taxes; the lack of a needs based floor; no clear resolution of 'convergence' issues; what is the tax yield and what borrowing could be made against this income; what would be the basis of any new taxes and will they be governed by principles or rules?

Response:

As Auditor General, it would be inappropriate for me to offer views to the Committee on what are, essentially, policy matters for the Welsh and UK Governments. However, one factual observation I should like to make is that the nature of the taxation base is a key predictor of the Welsh Government's ability to borrow against the expected tax yield.

Importantly, each of the specific taxation powers being devolved to Wales contains a significant degree of inherent volatility, even before any changes in existing rates of tax are contemplated. For example:

- the level of revenue raised annually from non-domestic rates and from landfill tax is driven by fluctuations in economic activity; and
- the level of revenue raised annually from stamp duty land tax (or from any Welsh replacement property tax based on transactions, rather than equity value) is driven by the historically highly variable volume of annual transactions within the Welsh residential housing and commercial property markets.

Similarly, any proposed changes to the rates at which individual Welsh taxes are levied will drive further potential volatility in the forecasts for the revenue that will be raised. This element of uncertainty will be particularly hard to model accurately in the early years of the devolved powers, in the absence of an established trend history for Welsh fiscal policy.

All of this suggests to me that the ability of Welsh Ministers to borrow against future revenues from devolved taxation powers (as set out in the Wales Bill) may be significantly constrained in practice, especially in the first few years beyond 2018.

Question 5: Managing budgetary risk - what additional budgetary risks are introduced by the new powers and how will these be monitored and managed (e.g. how are shortfalls in revenue managed)?

Response:

As I have indicated in my response to Question 4, I suggest that the ability of the Welsh Government accurately to anticipate volatility in its future revenue streams will be the key additional budgetary risk that is introduced by the new powers.

To manage this risk effectively, the existing capacity of the Welsh Government for economic modelling and forecasting may need to be reviewed and enhanced, as the existing focus on expenditure funded by the Welsh block will only form part of the overall picture post-2018. Modelling changes in population behaviour (and addressing both intended and unintended consequences, including likely avoidance/evasion rates), will be an important element of understanding the likely revenue impact of proposed changes in individual tax rates etc.

I also note that the full devolution to Wales of non-domestic rating (NDR) represents a risk transfer from Westminster to Wales, as the current pooling and reallocation of NDR receipts at the UK level will be discontinued. Fluctuations in Welsh NDR receipts will therefore in future be borne solely by the Welsh Government, whereas currently these are mitigated by the smoothing effect of a UK-wide pooling arrangement via the Welsh block. The potential benefit to Wales is that any future increase in the generation of Welsh NDR receipts will be retained in Wales, but the downside is of course that the opposite case also applies.

Shortfalls in revenue can take one of two forms: planned or unplanned. Any planned or expected reductions in future revenue can be managed via robust budget setting, assisted by access to planned borrowing. However, unplanned or unexpected in-year revenue shortfalls will need to be swiftly identified and appropriate mitigating action taken. In the latter case, the existing arrangements for reducing (or deferring) planned in-year expenditure will of course continue to operate, but the Welsh Ministers will also have the option to increase in-year revenue income and / or to extend the use of their new borrowing powers within the limits approved by the UK government.

In any event, robust scrutiny of any proposed amendments to the annual Budget approved by the National Assembly, whether in respect of taxation, borrowing or expenditure, will be essential.

Question 6: How can the new budget processes be made transparent and understandable to all stakeholders, and how can stakeholders engage and participate in the budget process.

Response:

I would encourage the Committee to adopt a broad definition of the term 'stakeholder' when considering this aspect of the new financial powers. Welsh taxpayers, whether individuals or companies, can be expected in future to take a heightened interest in how their taxes are to be used by the Welsh Government, and other stakeholders will include the UK government and potential investors in Wales. This will especially be the case in the event that referendum approval is sought for the devolution of Income Tax-varying powers to Wales.

Transparency and understandability will therefore be important in all aspect of the budget-setting, approval and financial reporting processes. This in turn could be expected to stimulate greater stakeholder engagement and participation, and is also relevant in the context of the proposed Future Generations Bill.

I therefore suggest that consideration should be given to the publication of an annual 'Whole of Government of Wales Account' (WGWA) from 2018-19, equivalent to the existing set of Whole of Government accounts that is currently prepared at the UK level by HM Treasury. This could provide both the National Assembly and Welsh taxpayers with a comprehensive picture of the Welsh finances, both income and expenditure, and a coherent understanding of total assets, liabilities and future spending commitments. (I note that statutory authority for the preparation and audit of a WGWA already exists under Section 141 of the Government of Wales Act 2006, subject only to agreement with HM Treasury.)

Unlike the existing Welsh Government annual consolidated resource account, a WGWA would also include those elements of the Welsh public sector that are not under the direct ownership of the Welsh Government, including local government, the Welsh Government Sponsored Bodies and the NHS Trusts. Together with enhanced reporting to the National Assembly of the Welsh Government's taxation, borrowing and expenditure intentions, in my view this could facilitate greater transparency and enhance the ability of Assembly Members to scrutinise the executive.

In this regard, I entirely endorse a recent statement by my colleague the Auditor General for Scotland, who said that:

"Comprehensive, transparent and reliable public sector financial reporting...helps decision-making, by providing evidence about the long-term consequences of different options. It ensures public bodies can be held to account for their decisions and helps encourage confidence, so public and investors trust in the decisions of government".

I also strongly suggest that Wales, and the scrutiny function within the National Assembly itself in particular, will need input from the UK's Office for Budget Responsibility (OBR), or from an equivalent new Welsh body in terms of independent, expert commentary and analysis of the macro-economic implications of the Welsh Government's fiscal, borrowing and expenditure plans. In particular, this would provide assessments of the likely revenue effects of any specific proposals to move away from UK-wide taxation rates etc.

I understand that the UK Government has already indicated that the OBR will be asked to provide an initial forecast of the revenues from each of the taxes to be devolved to Wales. However, the availability of specialist OBR-type support on a continuing basis would greatly assist Assembly Members in assessing long-term fiscal sustainability and performance against fiscal and expenditure targets, and would provide both capacity and expertise well beyond that which could reasonably be expected from the Members' Research Service.

Question 7: UK budget planning - how does the Assembly work with Welsh Government, UK government and other public bodies under the new arrangements; how should the budget process be timetabled to meet Welsh and UK Government requirements (e.g. UK spending reviews)

Response:

I am aware that some preliminary work is already underway within the Welsh Government to identify the key timetable issues, including the various 'critical path' dependencies that exist in respect of HM Treasury's information requirements and the Westminster Parliamentary timetable. All of these factors will need to be mapped and then addressed as part of the Welsh Treasury implementation programme.

This is necessarily a complex process, and I would urge that the final arrangements are kept as streamlined as possible to minimise bureaucracy, whilst ensuring that sufficient time is allowed at each stage of the consultation and approval process for robust scrutiny of budget proposals.

In my view, the key to success will be the provision by the Welsh Government of budgetary information to both the UK Treasury and to the National Assembly in a clear and consistent manner and at an appropriate level of detail to allow timely challenge and scrutiny without unnecessary delay.

Question 8: Implementation – *how does the Assembly formally implement the devolution of the financial powers; how does the Assembly scrutinise, approve and monitor the Welsh Government's annual tax, borrowing and expenditure requirements; how does Welsh Government seek approval for new tax and borrowing powers from HM Treasury, and what role should the Assembly have in agreeing such changes.*

Response:

These remain essentially policy matters at present but, as with the issues covered under Question 7, the mechanical arrangements for scrutiny, approval and monitoring of the Welsh Government's fiscal, borrowing and expenditure proposals will require careful consideration alongside the development in due course of the Welsh Government's own detailed arrangements for the production of those proposals.

The existing arrangements within the Westminster Parliament, and the arrangements currently being developed for the Scottish Parliament certainly both offer reasonable starting points for the development of arrangements for Wales, but it will be equally important not to slavishly replicate what happens elsewhere if that is unsuited to the specific Welsh context.

My staff will be working closely with both Welsh Government and National Assembly officials to provide an external audit perspective on the robustness of whatever is developed, and I would certainly wish to alert both the Finance Committee and the Public Accounts Committee should we identify any unresolved concerns during that process.

If you would like any further information in respect of the material contained in this response, please do let me know.



HUW VAUGHAN THOMAS
AUDITOR GENERAL FOR WALES

cc Ms Bethan Davies, Committee Clerk

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