

## **Response from the Welsh Government to the Finance Committee report: Borrowing Powers and Innovative Approaches to Capital Funding.**

**August 2012**

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The Welsh Government welcomes this report from the Finance Committee and its recommendations. Overall, the report represents a considered approach to the issues of borrowing and innovative finance, and is a timely contribution to the ongoing debate on these issues.

The funding of capital and infrastructure investment has become particularly challenging for the Welsh Government in an environment of substantially reduced budgets. Borrowing and innovative finance are mechanisms for matching Wales' capital and infrastructure investment needs with funding, in the absence of adequate capital budgets. Work is ongoing in both the pursuit of new borrowing powers and in the development of innovative approaches to funding capital and infrastructure investment.

Borrowing serves a number of purposes and would enable the Welsh Government to undertake functions it is currently prevented from exercising. Large infrastructure projects that are otherwise unaffordable, but which can deliver significant benefits to Wales over the medium term, can be facilitated through borrowing. Borrowing, particularly at the historically low interest rates currently available, can increase the level of this investment at an effective cost and support the economic recovery.

Along with the purely economic rationale for borrowing, there are constitutional issues raised by the lack of a borrowing function for the Welsh Government. The extra flexibility provided would improve the ability of the Welsh Government to manage Welsh resources in line with Welsh priorities. The lack of a borrowing function also places Wales at odds with the other devolved administrations, with Northern Ireland already able to access borrowing and Scotland gaining access to borrowing through the Scotland Act 2012. Wales, being a sub-national government unable to exercise borrowing powers, is also an anomaly from an international perspective.

The Welsh Government has been seeking a fairer funding settlement, including access to borrowing powers, through discussions with the UK Government since the publication of the report from the Independent Commission on Funding and Finance for Wales (also known as the Holtham Report). This report included a number of recommendations on financial reform for Wales, including recommending that Wales be given the ability to access borrowing.

Innovative financial models provide another mechanism for maintaining necessary capital or infrastructure investment with reduced capital funding. Using a revenue commitment to leverage in private sector investment can deliver infrastructure assets, which would be otherwise unaffordable within present capital budgets. Medium to long term revenue commitments of this

kind do have implications for future budgets, so it is important to consider very carefully what the appropriate level of commitment of revenue funding to finance capital or infrastructure investment is at any point in time.

In the past year, a dedicated team has been established to investigate and implement innovative financial solutions where investment needs can not be met within capital budgets.

**Detailed Responses to the report's recommendations are set out below:**

The Committee recommends that:

1. The Welsh Government should be granted the power to borrow, without negative impact on the Welsh block grant, for the purpose of financing capital spending.

**Response: Accept**

Capital investments tend to have budgetary impacts over a number of years, and often require large lump sums in the initial stages. Currently, larger capital projects are often deemed unaffordable initially, and undesirable by virtue of budgetary impacts lasting well past the spending review periods. This is the case even for projects with very high benefit cost ratios. Borrowing for the purpose of financing capital spending would provide greater financial certainty over longer time periods. In order for the benefits of such borrowing to be realised it is essential that there is no negative impact on the Welsh block grant, as this would negate the extra resources brought forward via borrowing.

**Financial Implications** – There will be no impact on overall capital resources as borrowing facilitates a re-profiling of expenditure, increasing capital spending in early years, at a revenue cost over the borrowing period. This revenue cost comes in the form of repayments on the borrowing. There are also resource implications for the Welsh Government of running a borrowing programme. The administration of the borrowing will require expertise and dedicated staff resource. The magnitude of these costs is as yet uncertain, given the existence and form of borrowing are unresolved. These administrative resource issues are pertinent to any recommendations on the Welsh Government progressing new borrowing powers.

The Committee recommends that:

2. Capital borrowing powers for the Welsh Government should, if granted, be put on to a firm legislative footing.

**Response: Accept**

The Welsh Government has the power to borrow under current legislation, although HM Treasury rules prevent these powers from being used to

practical effect. The Welsh Government does not want the introduction of new legislation to delay the process of making effective use of existing powers. However, placing Welsh Government borrowing powers on a firmer legislative footing could ensure that the Welsh Government will not be unduly restricted in utilising these powers. The Welsh Government does accept that some restrictions on borrowing are appropriate such that it operates within a framework that enables the UK Government to deliver its fiscal mandate.

**Financial Implications** – None.

The Committee recommends that:

3. If borrowing powers were granted to the Welsh Government, a control framework should be negotiated between the Welsh government and HM Treasury which provided the Welsh Government with maximum flexibility to use borrowing effectively to respond to investment needs. The negotiated framework should be reflected in the *Statement of Funding Policy*.

**Response: Accept**

4. In order to maximise flexibility for the Welsh Government if it were granted borrowing powers, and respect HM Treasury's fiscal and macroeconomic responsibilities, a protocol should be negotiated between the Welsh Government and HM Treasury to enable a national borrowing limit to be agreed, if required by economic circumstances.

**Response: Accept**

For borrowing powers to be used effectively there must be responsiveness to investment needs. However, some controls on borrowing are appropriate to ensure that they operate within a framework that enables the UK Government to deliver its fiscal mandate. A protocol reflecting these needs could be included in the *Statement of Funding Policy*.

A borrowing limit is one constraint that can ensure the sustainability of borrowing. The form that such a limit might take should be considered jointly by the Welsh and UK Governments. A prudential framework, which allows the level of borrowing undertaken to reflect the capacity of the Welsh Government to hold and finance debt, could be an efficient mechanism. In practice, however, the Welsh Government acknowledges that the precedent of a nominal cap, as in Scotland, is likely to be followed should the Welsh Government be granted new borrowing powers. If that is the case, it is essential that the cap should be set at a level that provides sufficient headroom to establish an effective ongoing borrowing programme.

**Financial Implications** – None immediately. However, see the provision in response to recommendation 1 for potential future impacts.

The Committee recommends that:

5. If the Welsh Government were granted borrowing powers, proposals for upper limits for its borrowing requirements, demonstrating affordability, sustainability and prudence, should be presented to the Assembly within the budget motion.

**Response: Accept in Principle**

The Welsh Government accepts that borrowing should be affordable, sustainable and prudent, and that the Assembly should be able to exercise its oversight and scrutiny roles in relation to borrowing as it does with other financial activities of the Welsh Government through the budget process and other mechanisms. However, the most appropriate mechanism for actually achieving these objectives cannot yet be determined given that neither the principle of Welsh Government borrowing nor its framework have yet been established.

**Financial Implications** – None.

The Committee recommends that:

6. If borrowing powers were granted to the Welsh Government, a protocol should be negotiated with HM Treasury to ensure that the Welsh Government would be notified sufficiently early of any proposed or planned movements in National Loan Fund or Public Works Loan Board rates.

**Response: Accept**

Given the long term nature of capital investments, any movement in interest rates can have long lasting effects. For planning, business case, and assurance purposes, it is important that the most accurate estimate of costs is available. Borrowing decisions should be made on the basis of value for money assessments which take account of interest rates currently available in the market. There could be a risk of market distortion from a pre-announced change in rates, through the timing of borrowers' investment decisions. However, the Welsh Government will seek an open and transparent relationship with the National Loan Fund and Public Works Loan Board, including financial elements of the relationship such as interest rates.

**Financial Implications** – None.

The Committee recommends that:

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

**Response: Accept**

The Welsh Government should be able to exercise borrowing powers on the basis of value for money assessments regardless of the instrument being used to borrow. Based on past experience, the most cost-effective source of borrowed funds is likely to be the National Loan Fund or Public Works Loan Board. There are likely to be high fixed costs to issuing bonds. Specialist experience and dedicated resource would be required to run a program of bond issuance. However, the relative cost of different borrowing instruments can vary over time. For example, in October 2010, the Public Works Loan Board rate increased to 100 basis points above a benchmark gilt rate. In March 2012, a 'certainty rate' was introduced which reduced the rate by 20 basis points in certain circumstances. Given such fluctuations it is possible that at some point bond issuance may become the most cost effective debt instrument, and therefore should not be ruled out.

**Financial Implications-** The specialist resource required to manage a bond issuance programme is not currently available within the Welsh Government and would be an additional cost of a bond issuance programme.

The Committee recommends that:

8. The Silk Commission should consider whether the devolution of tax varying powers is a pre-requisite for the granting of borrowing powers to the Welsh Government, or whether the focus should be on whether borrowing is affordable, prudent and sustainable, regardless of tax varying powers.

**Response: Accept in Principle**

The Silk Commission is currently considering the devolution of new fiscal powers to Wales. The Welsh Government's view is that tax devolution should not be a pre-requisite for the use of borrowing powers. We look forward to considering the Silk Commission's proposals in this area in due course.

**Financial Implications – None.**

The Committee recommends that:

9. The Welsh Government should undertake exploratory discussions with HM Treasury about the possibility of drawing forward future capital budgets where appropriate, particularly in relation to large scale infrastructure projects.

**Response: Accept**

As an initial step bringing forward future capital budgets is conceptually similar to borrowing, although the mechanism could be different. The Welsh Government agrees that greater flexibility in allocating capital budgets over time would allow closer matching of investment with Welsh needs. The Welsh Government will continue to explore a variety of approaches that will enable the matching of investment needs with the capacity to undertake that investment.

**Financial Implications** – None. If budgets brought forward were fully offset by reductions in budgets available in future years then this would just be a change in the profile of budgets. The overall level of finance over the whole period would remain the same.

The Committee recommends that:

10. The Welsh Government should be able to switch its departmental expenditure limit budget allocation from resource to capital in year without requiring HM Treasury approval.

**Response: Accept**

The Welsh Government believes that the UK Government should not place undue restrictions on the ability to switch provision between resource and capital budgets, provided spending remains consistent with the UK Government's fiscal mandate. The HM Treasury *Statement of Funding Policy* provides that the Welsh Government, as well as being free to allocate capital and resource budgets, "may also switch provision from resource DEL to capital DEL". Currently, switches are put to HM Treasury along with other changes made in year for inclusion in the "Supplementary Estimate". While some of these changes require approval, switches from revenue to capital do not.

**Financial Implications** – None, the overall spending level would remain unchanged.

The Committee recommends that:

11. In its discussions with HM Treasury, the Welsh Government should negotiate modifications to the Budget Exchange System, including the removal on the cap on the level of underspends which can be carried through, with a view to increasing budgetary flexibility.

**Response: Accept**

The current Budget Exchange System was agreed in July of last year following discussions between Treasury and the three Devolved Administrations. This agreement allows the Welsh Government to carry forward unspent resources from one year to the next up to an agreed cap and provides much greater flexibility than the original proposals that were put forward by the UK Government in March 2011. Welsh Government will continue to make a strong case for Wales to receive a fair funding settlement, including greater flexibility to manage our resources effectively. It is more important than ever that we maximise expenditure in line with our priorities, and to this end the revised Budget Motion provides us with increased flexibility to manage our position especially towards the end of the financial year. Given the ongoing real terms reductions in budgets and the resulting challenge of managing expenditure pressures, in the short term the existing cap on the level of underspends which can be carried forward is not a major issue as the Welsh Government does not anticipate accruing underspends above the level of the cap. However, this type of financial management control is not appropriate for devolved Governments.

**Financial Implications** – None immediately. However, the ability to carry forward all of any underspend would increase the overall level of funding available to the Welsh Government over time, compared with a situation in which a proportion of underspend was retained by the UK Government.

The Committee recommends that:

12. In light of reductions in its capital budgets, the Welsh Government should consider using revenue financed models, including Non-Profit Distributing models, as an alternative source of financing for capital investment, subject to robust value for money assessments. Account should be taken of the discrediting of the approach to traditional Private Finance Initiative value for money assessment.

**Response: Accept**

We are currently looking in to a number of models for revenue financing infrastructure investment. This includes Non-Profit Distributing models. We are also investigating the optimal amount of this type of investment and the mix of models to apply. There are already examples of achievements so far. The Local Government Borrowing Initiative, for instance, which has allowed Local Authorities to expand their investment in highways improvements and the Ely Mill Development Company has been established to deliver additional affordable housing. There are also innovative finance solutions being used in the Waste Programme. The innovative finance solutions being pursued will ensure that undesirable features of traditional PFI deals are avoided.

**Financial Implications** – With the implementation of innovative finance solutions comes a demand on revenue budgets. At present, the demand on revenue from these programs is a very small proportion of the total revenue budget.

The Committee recommends that:

13. The Welsh Government should take account of the outcomes from the business rates review, and lessons which could be learned from Tax Incremental Financing pilots elsewhere in the UK, and consider the merits of undertaking pilot projects in Wales.

**Response: Accept**

Tax Incremental Financing (TIF) has not been discounted, and is one option in a range of innovative finance solutions. This option is available to be used by Local Authorities in Wales. At the moment there are no examples of TIF being used in Wales, although there is some potential to learn from other parts of the UK. The Business Rates Task and Finish Group also recommend “that the Welsh Government monitor the progress of the implementation of Tax Increment Financing in England and Scotland”. Consideration will be given to whether TIF will provide a robust value for money approach.

**Financial Implications** – None. Under a successful TIF programme, the increased business rates from the investment cover the unitary charge needed to fund the investment.

The Committee recommends that:

14. The Welsh Government should consider whether its departments have the right mix and standard of the skills and capabilities required to develop, design and make use of innovative finance models and undertake borrowing, if it were granted the powers to do so.

**Response: Accept**

Having sufficient capacity and capability in appropriate areas will be vital to driving the success of innovative finance projects. There is now a dedicated team undertaking work on innovative finance, supported by an external expert advisor. Also the development potential and experience gained from the implementation of the Waste Programme and other innovative finance initiatives is a valuable resource.

**Financial Implications** – Increasing capacity and capability in these areas will need to be achieved within existing resources.

The Committee recommends that:

15. Taking account of lessons which could be learned from the establishment of a centre of expertise in Scotland, the Welsh Government should consider putting in place arrangements to ensure that the whole Welsh public sector has access to a central source of expertise which complements existing capability and capacity. It would be essential that the costs of these arrangements did not outweigh the benefits.

**Response: Accept**

The Welsh Government is currently considering the extent to which these functions should be centralised, and as part of this, investigating ways to further develop the relevant expertise. The potential costs and benefits of establishing a centre of expertise in addition to existing capacity form part of this investigation. Consideration is also being given to the circumstances which will affect these costs and benefits.

**Financial implications** – The establishment of a centre of expertise would only proceed if the savings and efficiencies driven by the establishment were expected to exceed the running costs. However, specifically the consideration of lessons to be learned from Scotland has no financial implications.

The Committee recommends that:

16. The Welsh Government should commission an independent assessment of the quality of asset management across the public sector in Wales, with a specific focus on reviewing the systems in place to ensure investment needs are robustly challenged. Subject to the findings of such an assessment, the Welsh Government should consider lessons which could be learned from Scotland on the role of an independent body to challenge the assessment of investment need by public bodies.

**Response: For further Consideration**

Whilst the Welsh Government agrees with the Committee that quality asset management is essential it believes that an independent review is not appropriate at this time. The annual State of the Estate Report provides an assessment of the performance of the administrative estate against key benchmark indicators and the Property Division within the Welsh Government has made significant progress in strategic asset management, implementing a number of initiatives to improve the efficiency of public sector asset management across Wales. The Welsh Government Location Strategy Programme is already delivering savings while work continues with the public sector organisations in Wales to improve co-ordination and collaboration in Asset Management, which is being led by the Public Service Leadership Group.

**Financial Implications** – There would be a cost incurred were an independent body commissioned. At present, there are Departmental Running Costs being incurred as the Welsh Government is devoting resource to the assessment and improvement of asset management across the public sector.

17. The Welsh Government should consider lessons which could be learned from Scotland on the role of an independent body to co-ordinate asset management planning and decision making across multi-agency boundaries.

**Response: Accept**

The National Assets Working Group is working with public service partners to identify and address common themes, issues and trends and build responses to them. For instance, a Land Transfer Protocol has been established, along with an All Wales Public Sector Land and Property Database. Lessons from this experience can be considered alongside information on the experience in Scotland.

**Financial Implications** – Were an independent body to undertake this work on an ongoing basis, the running costs would be carried forward. At present, there are Departmental Running Costs being incurred as the Welsh Government is devoting resource to improving the co-ordination of asset management across the public sector.