

The Advantages and Disadvantages of the Barnett Formula

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<https://www.e-ir.info/2012/12/12/evaluate-the-advantages-and-disadvantages-of-the-barnett-formula-for-the-financing-of-devolved-government-and-public-services-in-wales-what-differences-would-a-needs-based-formula-a/>

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Evaluate the Advantages and Disadvantages of the 'Barnett Formula' for the Financing of Devolved Government and Public Services in Wales. What Differences would a Needs-Based Formula and/or Devolution of some Tax Powers make?

Introduction

With the referendum on independence scheduled in Scotland for Autumn 2014, devolution has once again come to the fore in the media. International relations discourse is extending to IR contained within our own joint nations. Funding devolution is obviously a big and contentious issue, with the economy perhaps being decisive in the vote for independence; can Scotland sustain its economy without the current generous arrangements of funding from the central UK government. The current arrangements benefit Scotland, but here in Wales they are seen as less than generous. Huge issues relating to the current arrangements being dependent on population not need have big weight in Wales, the poorest of the UK nations. A government initiated commission on devolution, the Silk Commission are due to publish their findings on funding devolution in early November 2012. This leads us to consider Wales; how best do we finance Welsh devolved government and public services?

The Barnett formula was introduced in 1978 as a temporary method of determining public expenditure in Scotland leading up to the 1979 referendum. Now, almost 35 years later Barnett's formula is used to finance devolved government and public services in the devolved administrations, including Wales. The block grant accounts for about 50% of public spending in Wales with the rest from the UK government on non-devolved functions.[1]. The formula allocates a proportion of comparable spending within England in relation to a population index. Barnett may have survived 35 years, but according to many the current method of financing the devolved administrations utilised by the UK government is unsustainable.[2][3][4]

In recent years the debate over how the devolved administrations should be funded has become more contentious. Before 2007 the devolved administrations were seen to have it relatively easy. There was party symmetry throughout multi-level governance, and the age of austerity had not yet struck. With the SNP's electoral victory in 2007, the previous levels of party symmetry was lost. The party too came with calls for moves towards fiscal autonomy embroiled in its calls for independence from the UK[5]. This is not without impact for Wales. Five years later, the political and financial context differs greatly. We are in a time of recession, which has led to much debate over whether any Barnett reform would be ill fated at this point[6]. Additionally Scotland has an upcoming referendum on independence. From a UK government standpoint, any Barnett reform would most likely reduce the allocation in Scotland, a bad move politically. Wales has often been seen to be getting the rough deal from Barnett, with its ill account of need. The Holtham commission published its final report in July 2010; easily the most cohesive assessment of funding in a devolved Wales. It ultimately recommended that Barnett was not sustainable in the long run and a shift to a needs-based formula with supplementation from some tax devolution was the way forward. These suggestions do not seem to have changed the rather stagnant discourse on the subject from either the Welsh administration or the UK government. The UK government's coalition agreement of 2010 established a commission

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similar to Calman to look into devolution in Wales, a remit that will include financial accountability.[7]

This essay will give a comprehensive analysis of the current status quo; looking at the present arrangement of the Barnett formula, and then move on to discuss options for the future. Firstly the relative advantages of Barnett will be assessed. This system of block grant allocation has lasted 35 years; is its durability reliant on a lack of alternative that all parties are willing to agree on? Disadvantages of the Barnett formula will then be assessed. Barnett is widely criticised by elements of all parties. Nobody agrees the status quo is ideal. Barnett in particular is criticised within Wales for its reputedly 'unfair' allocation of funds in comparison with needs indexes and the higher levels of funding allocated to Scotland. Assessment will then turn to the alternatives to Barnett often suggested, and expressly discussed within the Holtham reports. Firstly a needs-based formula will be studied to see what difference implementing this form of allocation would make. Areas of potential tax devolution will then be identified and the effects of this will be discussed. This essay will attempt to identify whether any of these systems offer a preferable format for the financing of devolved government and public services in Wales. It is additionally important to acknowledge that these methods of financing may not be independent of each other. Holtham's final report recommended a needs-based formula with some tax devolution.[8] Would this be preferable to the status quo? One of the reasons that the Barnett formula has been in such an unhappy but perpetual existence is that there is no quick ideal answer for funding devolved government and services within Wales. The options for funding each have pros and cons; a choice between the simple, equity and accountability. The arrangements for funding devolution are often more political than they are financial, and these contextual factors will be highlighted within this essay. It says a lot that it is only since Welsh Labour have lost the power to do anything about Barnett, after the 2010 UK election, that Labour politicians have been seen to slander the system.[9]

Advantages of the Barnett Formula

With the bad press that the Holtham formula has gathered over the years, it would be easy to assume that Barnett's positive attributes are limited, yet its durability speaks for itself. There are relative advantages for each party. As discussed in the introduction, contextually we have been lucky. If the first eight years of devolution had not been characterised with political party symmetry of the Labour party, more issues over funding inequality may have been raised by the devolved administrations earlier on. A lot of the perceived benefits of Barnett are definitely to the advantage of the UK government. For the Treasury it's easy to administer, and more importantly in the current context is favourable to Scotland. In terms of easy administration, the Barnett formula is very easy to calculate, relying on the initial 1978 baseline, and calculating any changes relating proportional changes to an administrations population, with changes on functions deemed as comparable to England. As well as being easy to administer, this system is cheap, and an infrequent worry to the Treasury, with the consequentials calculated in three year blocks.[10] With regards to Scotland, the context of an impending referendum on independence is an opportune time to be overfunding the country from the perspective of the UK government. The current arrangements of Barnett allow this to happen with a projected overfunding amount of £4.5bn per year.[11]

With regards to a Welsh perspective, it seems that Barnett has been good to the nation, if not good enough. There are many advantages to this simple formula. Flexibility has been identified as a key advantage of the Barnett formula for the devolved administrations.[12] This relates to the fact that the block grant given to the administrations by the Treasury, minus the running costs of the Welsh Office, is non-hypothecated, meaning that Wales has substantial freedom in what it chooses to do with the grant itself. This has led to some of the more divergent policies in Wales; tuition fee subsidies, the Foundation Phase, free prescriptions. Secondly, it is undeniable that to some the fact that the amount of money raised by taxes within Wales has no impact on the amount of block grant received is a relief. Wales can also be relatively confident in the amount of block grant it will receive giving it increasing stability.[13] Overall, the Barnett formula can be said to have the advantage of being stable, simple for the UK government, which allows the Welsh government to make the most of a situation that does not entirely suit their needs.

Disadvantages of the Barnett Formula

The Barnett formula has been vastly criticised.[14][15] Wales undoubtedly suffers in comparison to its devolved partners.[16] Yet, it is not merely questions of equity that have been hinted at, that call into question the efficiency

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and adequacy of the Barnett formula. By its very nature Barnett is seen as an unsuitable formula for the funding of devolved government and public services in Wales. Holtham's reports concluded that the Barnett formula "has no objective justification and has survived for 30 years solely for reasons of political and administrative convenience".[17] Additionally, the entire formula rests on a baseline established thirty five years ago; a baseline that some claim is fundamentally inadequate.[18] After the referendum that brought devolution to Wales in 1997, no review was made of the pre devolution Barnett funding allocations. Put simply Barnett was never intended to carry Wales financially through devolution.

It has been said that "essentially devolved administrations are not much more than spending agencies".[19] Wales has limited responsibility for raising its taxes; the allocations given by the block grant are not accountable to the levels of tax raised within the administration. Wales does not share the discourse of accountability that Scotland emphasises in their proposals for fiscal autonomy. Accountability in Wales in relation to Barnett appears to be a political game; with rhetoric on the matter exclusive to when ministers are quite sure that there is no immediate potential for change. While supporting the same borrowing powers for Wales that are about to be devolved to Scotland, the First Minister insists on a referendum if the same were to be considered for Wales, begging the question of whether the problem of lacking accountability for Wales in terms of its devolved funding can be remedied?[20]

A vast criticism highlighted by Holtham in the commission's final report is that the Barnett formula's allocation to Wales is not based on need. In 1979, with the run up to referendums on devolution in Scotland and Wales, the Treasury commissioned a needs assessment study to assess the levels of relative need within the areas to be devolved. With the rejection of the referendum in both administrations, this needs assessment study was abandoned.[21] Subsequent attempts have been made to commission further studies; a 1986 report recommended 'corrective action', and a 1993 study's results were never published.[22] Therefore Barnett is not based on need, merely population, "the Barnett formula makes little effort to align budgetary allocation with the need of public services.[23] This lack of need-based fund allocation puts Wales in an increasingly disadvantaged position. Wales currently receives around 112% of comparable spending for England.[24] The Holtham report when considering its proposals for a needs-based formula for financing devolved services in Wales estimated that Wales should be receiving around 114-115% of spending on England in relation to its relative needs. Indeed, Holtham calculated that Wales currently receives less than it would if the same formula that applies to funding within England was applied in Wales.[25]

The Barnett squeeze is becoming an increasing feature in the discourse of devolved funding within Wales. An intentional feature of the implementation of the Barnett formula was that it should over time create a convergence to levels of public spending per head by the nations within the UK, meaning that the higher levels of funding we see per head in the devolved administrations currently, should gradually align with the levels of funding seen in England.[26] It is a concerning threat to Wales due to the different levels of needs that Wales consistently has. "Unless needs converge there is no mechanism to drive convergence of spending in English regions, but there's exactly that for Scotland, Wales and Northern Ireland".[27] This has caused the issue mentioned above wherein Wales now gets less than its equivalent regions based on an English needs formula. As Holtham describes "It is in effect being penalised for being devolved".[28] The intriguing thing about this particular disadvantage of Barnett is that it can be easily remedied by the Treasury and not at the expense of Scotland. In the interim period between now and when any Barnett reform or change is considered, a 'safety net' type floor could be implemented stopping Welsh allocations going further under that of English comparative allocations preventing further convergence.[29] In terms of a UK government perspective, it too is an easy fix; cheap and would not require extra spending from them, merely a floor under relative public spending dropping more. Yet, the likelihood of the Barnett floor being introduced is diminishing. Jane Hutt, the current Minister for Business and Budget in the Assembly indicated in January 2011 that Danny Alexander, Chief Secretary to the Treasury was supportive of a method of halting any convergence that would leave public spending in Wales dipping below 112% of English relative public spending.[30] Talks since 2011 though, do not seem to have seen any progress in the implementation of the Barnett floor or such a mechanism.

This dominance from the Treasury is becoming more apparent as devolution becomes more entrenched, with Wales' powers increasing after the referendum of 2011. Indeed, "all key decisions regarding the working of the formula and

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the block grant and formula system are taken by HM Treasury”.[31] The dominance from the Treasury in terms of funding devolved public services has been particularly evident of late in relation to the controversial identification of consequentials for the Olympic Games in London. The decision by Andy Burnham, former Chief Secretary to the Treasury, to exclude the regeneration of the Olympic area in London from the list of English consequentials and apply it to the UK spending as a whole remit caused much controversy on this matter. Normally, ‘regeneration funding’ is classed as English spending, thus triggering consequentials, but this decision was tactical so as to avoid over spending, after the calculations for Barnett consequentials were left out in error when establishing the budget for Olympic spending.[32] This goes to further demonstrate how the Welsh government’s hands are tied in relation to the allocation the Barnett formula. The Barnett formula can be easily manipulated by the Treasury’s interpretation of the consequentials. In legal terms ‘on every funding decision the Treasury is judge in its own cause.’[33]

What Difference would a Needs-Based Formula make?

The disadvantages of the Barnett formula, we have established, far outweigh the advantages. This is consistent with the very public calls for reform of the methods of funding devolved government and public services in Wales. The question is thus; what should replace Barnett? This section of the essay will consider the difference that the oft suggested needs-based formula would make. The likelihood of utilisation will also be considered; to truly make a difference to the current dispensation of funds via the Barnett formula the solution has to be realistic.

The final Holtham report ultimately recommended devolution of limited powers over certain taxes and borrowing adjustment mechanism.[34] The influential report from the Lords Select Committee also recommended a turn to a needs-based system of funding.[35] The discourse within funding devolved public services in Wales seems to be focussing on the needs-based model as the answer to Barnett’s inadequacies. It is widely understood that a needs assessment of Wales infers that the nation is relatively underfunded. Need is not an absolute entity as Holtham makes clear.[36] Yet, identifiers of need can be easily assessed. Wales is traditionally a poor region with a GDP of between 78-85 to the UK’s 100.[37] It has a high dependency ratio too, as assessed by Holtham of around 65%, higher than 15 years ago.[38] This is the highest of all regions in England and Wales except the South West of England. Additionally Holtham identified that sparsity was a factor in delivery of public services meaning that cost of delivery is indeed higher in Wales.[39] In terms of deprivation, Wales has a high index, and one that has been climbing over the first ten years of devolution. Unemployment too is higher in Wales than in many English regions with a current employment rate of 68.3% as of February 2012, with the UK average at 70.4% for those between 16-64.[40] The Barnett formula for this financial year allocates £112 for every £100 spent on comparable functions within the English regions.[41]

Holtham calculated need by utilising the same formula applied to English regions. “If spending in England is allocated on the basis of geographical units via a needs-based formula and if data limitations allow, the formula has been applied directly to Wales”.[42] This ultimately recommended a ‘top down’ approach to a needs-based formula, also utilised in the recommendations by the Lords select committee. These two recommendations proffer the simple identification of areas that affect the cost of public services and take into account the mitigating factors identified in the section above; unemployment, dependency ratios, demographics, health.[43] In terms of the difference a needs-based formula would make, the Holtham report calculates as opposed to the existing indices of 112 currently employed in this financial year to calculate proportional funding to Wales in comparison with England, a projected needs indice would be 114 to 115 for Wales. Thus the change in the calculation of funding should be providing, on a needs calculated basis, £114-5 per head for every £100 spent in England in the devolved comparable services. In terms of making a real difference, Holtham calculated that over the next decade, with the rate of convergence as it stands, Wales will lose out on “£8.5 billion, even allowing for a period of low growth over the next 3 year spending review period. This is equivalent to £2,900 per resident of Wales”.[44] A needs-based formula would not only prevent this from happening, but would increase at the point of implementation (assuming that £114-£115 per £100 for England still accounted for variables in need at the time of implementation) spending on devolved government and public services by £2 to £3 for every £100 spent on comparable costs in England. This, using the 2010-11 figures for reference equates to a total increased amount of about £400million.[45]

In an idealistic world the move to a needs-based formula would make a huge difference to equity in funding devolved

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government and public services in Wales. In reality though, despite these regular calls for a serious consideration of a move to a needs-based formula the UK government will not comprehend such a move. The fundamental reason is thus; Scotland.[46] Scotland does better out of Barnett. Scottish public expenditure is around £1,600 per head more than England.[47] On a basis of comparison with Wales too, Scotland should be receiving less of a block grant than Wales. According to McLean Scotland is overfunded £4.5bn per year.[48] In a needs-based assessment it is calculated that Scotland should be given around £105 for every £100 spent on the relative areas in England.[49] If a needs-based overhaul of the financing system were to be introduced, the impact to Scotland would be huge. According to McLean "in a world of fiscal autonomy it might be possible to make up the shortfall through tax increases, unfortunately would mean increasing income tax by more than a third".[50] Not only is it not economically feasible to introduce a needs-based formula for allocating funding to the devolved administrations but it would be political suicide for a UK government intent on keeping Scotland within the union. Not only is there a referendum on independence in Scotland scheduled for 2014, but even upon its rejection a needs-based formula would not offer any option for further devolution, a key feature of the SNP's programme for government.[51] Trench also makes the point that a move to a needs-based formula would inhibit the Treasury's spending, something that they would definitely not intentionally inflict upon themselves.[52] Needs-based reform of the Barnett formula thus, while suiting Wales in its rhetoric of equity, in reality would not make a difference as it has too many disadvantages for the other parties involved in the funding of devolved administrations to be implemented in the near future. The "combination of strong political opposition, lukewarm support and bureaucratic opposition makes it hard to see how such changes could be realised".[53]

What Difference would Devolution of some Tax Powers make?

The referendum of 2011 in Wales has left the Welsh Government in a strange situation. Constitutionally, they are now endowed with primary legislative powers, yet they lack the financial accountability normally associated with such powers. Currently, the performance of the Welsh economy has scarce impact on the amount of block grant it receives via the Barnett formula. This protects the weaker Welsh economy from the pressures of a competitive market, but fails to act as a method of incentive for good economic performance too. In terms of accountability, the status quo is poor, yet Carwyn Jones's line on this is not exactly radical.[54] Elements of tax devolution would thrust Wales into an arena of financial accountability but many think that this would be unsustainable. In a recent poll it was found that a 24% of respondents agreed that 'The Welsh Assembly should have the power to increase or reduce all taxes in Wales', with 31% believing that 'The Welsh Assembly should have the power to increase or reduce some taxes in Wales within limits agreed with the UK Government in Westminster'. 34% of respondents thought that 'The Welsh Assembly should not have any powers to increase or reduce taxes in Wales'.[55] In terms of broad support, these figures are not ground breaking, but they demonstrate that elements of tax devolution are not overwhelmingly rejected theoretically by the public. Academics too are sceptical. "Despite accepting the principle of tax devolution, we are sharply aware that the practical challenges of implementing it in the Welsh context are substantial".[56] This section of the essay will therefore attempt to identify which elements of tax could happily be devolved, what difference this would make, and whether this is a realistic potential for a new method of financing devolved government and public services.

The highly integrated nature of the Welsh and English economies and geographies is often cited as one of the reasons that identifying taxes to be devolved is so complex.[57] The proportion of the populations who live within 50 miles of the border amounts to 30% of England and Wales. 90% of the Welsh population live within 50 miles of the border.[58] In terms of any variance via a set of devolved taxes, this complicates matters due to two very integrated economies. "The potential for economic distortions and tax avoidance as a result of tax devolution is therefore of greater concern in the case of Wales than Scotland".[59] Additionally, the Welsh tax base does not yield quite enough as it stands, to sustain itself solely; in 2007-8 the total identified spending was £6 billion more than the tax receipts in Wales had yielded.[60] While this is commonplace, in this particular administration it is partially because of this that partial tax devolution, not full fiscal autonomy is being suggested at this point, supplemented by a needs-based formula funded by the central UK government. The levels of integration of the two economies of England and Wales support this; it is difficult to identify how Wales could implement fiscal divergence via taxation, without it being seen as a haven for tax avoidance, for those businesses and individuals so close to the border.

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The process of devolving tax is seen by many as complex, but in Wales it would be relatively simple. If tax devolution were to take place, it would essentially operate as a 'swap' style of funding, i.e. a tax would be devolved and the portion of the existing block grant that includes that particular tax would be removed. In an ideal scenario, the block grant would be needs-based so reflect relative need even after individual tax devolution.[61] So if some taxes were selected to be devolved, supplemented by the needs-based formula as seems most likely, which taxes would they be? Income tax is the obvious candidate for devolution. In Wales income tax accounts for 30% of total tax revenue.[62] Fundamentally though devolution of income tax would provide the accountability much needed by the Welsh Government. Corporation tax too, has been suggested as viable for devolution within Wales. This in particular, if utilised in the correct manner, could improve economic performance by competing with England, as utilised by the Northern Irish government in terms of their corporation tax devolution to compete with the Republic of Ireland.[63] Land based taxes are often identified as viable; taxes on things in other words that do not move. This includes; stamp duty on land tax and landfill taxes. An interesting proposal too, is whether the Welsh Government could instigate new taxes via 'Financial Competence Orders' similar to the LCO process implemented in part 3 of the Government of Wales Act 2006.[64] It must be noted though that each tax if it were to be devolved would most likely be considered individually. Thus, specific socio economic conditions within Wales would have to be considered.[65] The needs-based formula would again help with this process, in terms of providing a smooth transition for the Welsh economy.

With tax devolution borrowing powers could also be utilised. Elements of this could be introduced now with increased access to 'end of year funds' meaning that if budgets are not spent in their allocated year, the excess could roll over to the next, as a first move to lessen the restrictions currently places on the budget of the Welsh administration. The case for borrowing powers would be helped by the devolution of some taxation powers. Currently in place are limited conditions where borrowing by the Welsh Government could occur. These conditions mean the government can borrow from the Secretary of State for a 'temporary excess' but only up to £500 million.[66] Holtham recommended that "limited powers to borrow in order to finance capital expenditure should be devolved to the Assembly Government" with a borrowing framework agreed between the Welsh Government and the Treasury.[67] The effect of the borrowing powers would mean that any issues arising from a projected devolution of income tax could be offset easier, and would also provide a good base for financing capital expenditure; again it too would drastically improve the accountability of the Welsh executive.

With an assessment of the candidates for tax devolution above, we now see that while tax devolution can certainly not be the only answer, it can be part of the remedy for the disadvantages presented by the existing Barnett formula. Yet, projections put an earliest implementation at 2015.[68] Public support as we have seen is not overtly high. Neither, we could say, is domestic political support here in Wales. Carwyn Jones is adamant that any devolution of taxation powers is constitutional and requires a referendum.[69] Additionally a group set up to monitor the workings of the Silk Commission are calling for a reform of Barnett as a pre requisite for any talks on tax devolution within Wales.[70] This demonstrates how unserious debates on tax devolution actually are; as we have learnt from the assessment of the Barnett formula above it is impossible that the Treasury will consider Barnett reform with an impending Scottish referendum on independence looming. Talks on tax devolution are thus unserious, but do have serious potential for increasing the Welsh government's accountability with its electorate. In terms of making a difference economically, only if teemed with a needs-based formula would tax devolution increase revenue, unless new forms of taxation are employed, or corporation tax levy's provided a real draw for businesses coming to Wales.

Conclusion

To conclude, no option for the funding of devolved government and public services in Wales is perfect. The status quo of the Barnett formula seems likely to endure, but ultimately fails to account for the needs of the Welsh population. It is unfair to claim that Barnett has no advantages; its durability speaks for itself. Barnett is flexible, cheap and easy to administrate. The Treasury themselves have few complaints. But fundamentally, the status quo does not provide Wales with the accountability or equity a legislator fundamentally needs. Barnett is adequate in its discomfort. The Lords Committee report undertaken in 2008 had noted the former Chief Secretary to the treasury as claiming that the formula was "fair enough" and did "a pretty good job".[71] The rhetoric appears to be that just because the Barnett formula has lasted it should endure.

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There are feasible alternatives for change, but too often politics has gotten in the way. A needs-based formula for calculating funding for devolved government and public services in Wales is almost universally agreed on as the best method. The Barnett formula significantly overfunds Scotland, while underfunding the economically underperforming Wales. A needs assessment undertaken by the Holtham commission recommended that the current 112% of English funding provided to Wales needs to be increased to 114-5%.[72] This would ensure that Wales receives the same level of funding affording to the English regions according to its needs. Unfortunately mitigating factors have so far halted any plans for a needs assessment and Barnett reform to be utilised. The UK government has said that it cannot reform Barnett until it has dealt with the current large budget deficit.[73] Additionally, the Treasury refuse to act for political reasons. With the impending Scottish referendum, now is not the right time to reform Barnett and potentially remove £4.5 billion of Scotland's block grant per year.

Tax devolution has been identified as a feasible companion for a needs-based formula for funding devolved government and public spending in Wales. Key taxes can be identified with calculations on suitability and an identification of mitigating socio economic factors. Income tax in particular is a good candidate, coupled with corporation tax to provide a good tax base and high levels of accountability for the Welsh administration. The government in Wales though do not seem to be seriously considering any potential imminent tax devolution. While they would like to obtain borrowing powers Carwyn Jones insists on yet another referendum before any moves to devolve tax could be undertaken.

Funding of devolved government and public services in Wales is suffering from the current arrangements, yet there are no real demands to change this. The Silk Commission's first report, due out later this year may identify some short term changes as well as long term recommendations. It may too be more radical than anticipated, and genuinely cause calls for reform. Ultimately, it is too early to say. The implementation of a Barnett floor could be a useful tool in halting the rate of convergence that is slowly increasing the inequalities in the funding system. So too could the increased accessibility of end of year flexibility funds which would essentially mean that any funding surplus could be rolled over. There are options for this administration; feasible options that do not require excessive political or legal manoeuvrings, yet there appears to be a lack of appetite for fairness and accountability on all sides of the funding arrangements for a devolved Wales.

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[51] SNP, p8.

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Date written: May 2012

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