

Funding The Northern Ireland Assembly: Assessing The Options

**Professor David Heald with
A Statement by the Economic Council**

NORTHERN
IRELAND
ECONOMIC
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Funding the Northern Ireland Assembly: Assessing the Options

by

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Aberdeen**

with

A Statement by the Economic Council

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ABBREVIATIONS USED

AFFF	Agriculture, Fisheries, Food and Forestry
AME	Annually Managed Expenditure
CAP	Common Agricultural Policy
CGC	Commonwealth Grants Commission
CMS	Culture, Media and Sport
CSR	Comprehensive Spending Review
DARD	Department of Agriculture and Rural Development
DE	Department of Education
DEL	Departmental Expenditure Limit
DETI	Department of Enterprise, Trade and Industry
DETR	Department of the Environment, Transport and the Regions
DFP	Department of Finance and Personnel
DHFETE	Department of Higher and Further Education, Training and Employment
DHSSPS	Department of Health, Social Services and Public Safety
DRAG	Domestic Rate Aid Grant
DRD	Department for Regional Development
DSD	Department for Social Development
EPF	Executive Programme Fund
ERDF	European Regional Development Fund
EU	European Union
EYF	End- Year Flexibility
GDP	Gross Domestic Product
GERS	Government Expenditure & Revenue in Scotland

Abbreviations Used

HPSS	Health and Personal Social Services
LOPS	Law, Order and Protective Services
NAO	National Audit Office
NAV	Net Annual Value
NEE	Needs and Effectiveness Evaluation
NHS	National Health Service
NIAO	Northern Ireland Audit Office
NIEC	Northern Ireland Economic Council
NIHE	Northern Ireland Housing Executive
NIO	Northern Ireland Office
OECD	Organisation for Economic Cooperation and Development
OES	Other Environmental Services
OFMDFM	Office of the First Minister and Deputy First Minister
OFWAT	Office of the Water Regulator
ONS	Office for National Statistics
PESA	Public Expenditure: Statistical Analyses
PFI	Private Finance Initiative
PSA	Public Service Agreement
R&T	Roads and Transport
RA	Resource Accounting
RAB	Resource Accounting and Budgeting
RB	Resource Budgeting
RCA	Rate Collection Agency

Abbreviations Used

RRI	Reinvestment and Reform Initiative
SIB	Strategic Investment Board
SR	Spending Review
SS	Social Security
SSA	Social Security Agency
TES	Total Expenditure on Services
TME	Total Managed Expenditure
TIEE	Trade, Industry, Energy and Employment
VFM	Value For Money

FOREWORD

For many years, the Council has expressed its concern over the ongoing need to increase the resources allocated to public service provision within Northern Ireland. Under Direct Rule administration these resources were determined within the confines of the Block grant allocation to the Secretary of State for Northern Ireland by HM Treasury. The re-establishment of devolution created an expectation that local politicians would be able to prioritise public expenditure in accordance with the genuine needs of the local population. The reality of devolution has resulted in this expectation being tempered by an appreciation of HM Treasury's mechanical process of allocating funds to the devolved countries.

The application of the Barnett Formula by HM Treasury is an incredibly complex process. The process appears to be intelligible to only a few individuals in the public expenditure arena – achieving a status similar to a 'black art'. The Council believes this to be unacceptable in the new devolved context. In line with its remit, the Council commissioned Professor David Heald (University of Aberdeen), an acknowledged expert in this area, to undertake an overview of how the devolved administrations are funded by Westminster and to highlight the opportunities and threats that the Barnett Formula poses.

Professor Heald, in this comprehensive study, clarifies how the funding system actually operates and sets out the drawbacks associated with the Barnett Formula, eg convergence. He then goes on to give careful consideration to a possible alternative to the Barnett Formula and the resulting implications for Northern Ireland.

The Council believes it is imperative that local politicians are fully appraised of these funding issues. The fundamental issues discussed within this paper form the cornerstones upon which successful devolution will be built. An appreciation of how resources are allocated to Northern Ireland will shape deliberations about the standard of public services that can be provided locally – with consequent debate on the appropriateness of other funding options, such as increasing local property rates or water charges.

The Council would like to thank Professor Heald for producing this comprehensive and rigorous study.

JANET M TREWSDALE OBE
Chairman

COUNCIL STATEMENT

The Economic Council has, for many years, maintained a close interest in the public funding arrangements that apply to and within Northern Ireland. Many years of Direct Rule from Westminster resulted in HM Treasury allocating public expenditure to the Secretary of State for Northern Ireland to allow him/her to meet a wide range of priorities – the highest of these, unfortunately, being Law, Order and Protective Services for obvious reasons.

The annual publication of the Financial Statement* highlighted the poor state of public finances within Northern Ireland – with a substantial shortfall between public revenue generated and expenditure allocated. This funding deficit, termed the ‘subvention’, regularly equated to a double-digit share of regional Gross Domestic Product (GDP). During the period of Direct Rule there was little public discussion about how Northern Ireland should be funded and how the funds might be raised. There was notionally a commitment by HM Treasury to allocate public expenditure to Scotland, Wales and Northern Ireland on the basis of the Barnett Formula during the 1980s and 1990s. However, this formula, which sought to allocate expenditure to the regions on the basis of population share and comparability in expenditure programmes, did not substantially bring about the equalisation of expenditure that the formula was designed to do. There was, too frequently, an allocation of expenditure to the regions that was not determined by the mechanics of the Barnett Formula. This ‘Barnett Bypass’ helped to ensure that public expenditure per capita in Northern Ireland remained substantially higher than that experienced in England.

It could be argued that the Comprehensive Spending Review (CSR), initiated by the Chancellor of the Exchequer in 1998, triggered the first, robust application of the Barnett Formula. In subsequent biennial Spending Reviews (2000 and 2002) the HM Treasury has allocated public funding to the devolved countries in accordance with its Statement of Funding Policy for the Devolved Administrations (July 2000 and 2002). This Statement, published for the first time in July 2000, set out in a very transparent manner the mechanics of the Barnett Formula. It left very little room for negotiation with HM Treasury in seeking additional Barnett Bypass.

The publication of the Statement of Funding Policy and the stricter adherence to Barnett will, undoubtedly, result in greater convergence in expenditure per capita levels between the four countries. This will generate greater attention within the regions on how they are funded and how they might be expected to deliver public services within their jurisdictions over the coming years.

In the context of the devolved administration the Council considered it was an appropriate time to undertake a review of how the Northern Ireland Assembly might be funded over the coming years and how it might obtain sufficient resources to achieve the policy targets as set out in its Programme for Government. There has been growing concern expressed in the local media by devolved Ministers and Assembly Members that the application of the Barnett Formula is, in some way, inappropriate and iniquitous. There appears to be a growing desire for a more equitable and fair funding mechanism.

* Published annually by the Department of Finance and Personnel (DFP) up to 1998/99.

Accordingly, the Council, in September 2001, invited Professor David Heald of the Centre for Regional Public Finance at the University of Aberdeen, to undertake a systematic study of public expenditure (and revenue generation) in Northern Ireland. This study, jointly funded by the DFP, provides a rigorous assessment of how Northern Ireland's public spending was financed in the past; looks at recent United Kingdom public expenditure policy and trends; assesses the impact of devolution on funding arrangements; considers the local revenue generation effort; and, finally, considers alternative funding arrangements that might replace the Barnett Formula.

The first observation that needs to be made about this study is that it exposes how complex the underlying issues are for any debate about public financing in the devolved context. The mechanics of the Barnett Formula will, undoubtedly, bring about per capita convergence with English levels if recent expenditure growth rates continue. While HM Treasury may declare this acceptable and fair on the basis of population share within each of the expenditure programmes, the Council has grave reservations about the Barnett Formula's failure to capture the differences in prevailing expenditure *need* within the programme areas. This issue is central to concerns over Barnett – there has to be some acknowledgement of differing socio-economic characteristics within the devolved regions. For example, seeking to equalise per capita health expenditure between Northern Ireland and England is wholly unacceptable when health standards (both prevention and care) in Northern Ireland are already substantially below those prevailing in England.

Local politicians may be able to advance an argument that relative need within Northern Ireland is greater than England across a wide range of expenditure programmes, but care must be exercised before formally requesting that HM Treasury commission a Needs Assessment. As Professor Heald highlights, requesting a Needs Assessment is a complex task and local politicians should be fully apprised of the consequences of such a request. In addition to the possible objections of other devolved administrations, there are a host of technical questions about who conducts the assessment and what methodology should be employed. In the past, HM Treasury retained control of such exercises and there might be a reluctance to engage in a more objective and transparent way. Local politicians should also be alert to the fact that HM Treasury would, undoubtedly, commission a wide-ranging assessment of need across all areas of public expenditure within Northern Ireland – not just the notable areas that exhibit greater need. The final outcome might be the aggregation of shortfalls in expenditure in some areas (eg, health) and surpluses elsewhere (eg, industry, trade and employment) resulting in little overall difference from actual public expenditure at the total Block level to that determined by a needs model.

Approaches to HM Treasury for recognition of greater levels of need will also be undermined by comparisons on regional fiscal efforts. This refers to the ability of regions to generate public receipts that may be retained by the devolved administration for re-allocation as public expenditure. In the case of Northern Ireland, the main source of public receipts is the Regional Rate revenue. The revenue generated from collection of rates is re-allocated by the Assembly on mainstream public services. HM Treasury can legitimately point out that the rates revenue generated within Northern Ireland is significantly less than households in England are required to pay. In this context the questions will arise about the implementation

of water charges within Northern Ireland – a fact to which HM Treasury will, undoubtedly, refer when devolved administration politicians question expenditure allocations.

Consequently, the case for additional funding above and beyond that provided through Barnett inevitably must include consideration of the regional fiscal effect. The Reinvestment and Reform Initiative (RRI) agreed in May 2002 by the Prime Minister, Chancellor of the Exchequer and the First and Deputy First Ministers explicitly linked additional funding with a requirement to improve the local revenue effort. Additional revenues generated through phasing out rate relief on vacant and industrial property and the introduction of water charges will increase the resources available to the devolved administration. There may, however, be knock-on effects in terms of increasing the overall levels of need within Northern Ireland. These charges will reduce the disposable incomes across all sectors within Northern Ireland. They may lead to increased hardship for some – probably those who live just above the benefits assistance thresholds who cannot avail of various reliefs.

Therefore, there appears to be a route defined for the devolved administration in terms of how it should increase the level of public expenditure available to it. Unfortunately, it could effectively mean increasing the taxation burden that its population faces. Only by so doing, can a case be made for approaching HM Treasury for additional aid. It is reasonable to highlight that the higher relative need reflects a history of under-investment and neglect when resources were skewed towards law and order requirements. The backlog in under-investment in physical infrastructure alone was recently estimated to be £6bn. Approaches to HM Treasury should focus on this aspect.

Any approach to HM Treasury should be taken with the utmost care. The mechanics of the Barnett Formula need to be fully understood before engaging in criticisms of its application. With the publication of the Statement of Funding Policy, the resource allocation process between Westminster and the devolved regions is now fully transparent. All parties understand the rules. Triggering a formal Needs Assessment is fraught with danger and everyone should be aware that it may be a double-edged sword. As Professor Heald suggests, it is more important to appreciate absolute changes in expenditure allocations to Northern Ireland rather than be concerned about relative changes vis-à-vis England.

Research Monograph

**FUNDING THE NORTHERN IRELAND
ASSEMBLY: ASSESSING THE OPTIONS**

by

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Sole responsibility for the content of this Report belongs to the author, and the views expressed should not to be attributed to either the Northern Ireland Economic Council or other organisations.

PREFACE

None of the technical discussion in this Report is particularly complex, but much material is only accessible to those who know their way around a wide range of official and other published sources. The problem has been accentuated in Northern Ireland by the absence of a local democratic element in the 1972-99 period, which clearly contributed to a lack of debate on public expenditure issues.

This Report therefore has a double purpose: first, to make a contribution to future public expenditure policy-making in Northern Ireland, taking positions on certain controversial issues; and, second, to render the subject matter more accessible to all those who wish to contribute to the debate. The remit of the Report is restricted to the funding of the Northern Ireland Assembly, thereby excluding Northern Ireland Office expenditure. Although the fact of devolution is common to Scotland, Wales and Northern Ireland, there is a differential coverage of devolution in terms of functions and institutions. Nevertheless, some of the discussion necessarily relates to Northern Ireland public expenditure as a whole, rather than just to that which is currently devolved.

This Report draws upon work funded by a project (L219 25 2017) on the financing of UK devolution, which is part of the Devolution and Constitutional Change Programme of the Economic and Social Research Council. The author is Professor of Accountancy, and Director of the Centre for Regional Public Finance, at the University of Aberdeen. The views expressed are his own and should not be attributed elsewhere.

1 INTRODUCTION

This Report takes as its starting point that the devolved Assemblies in Northern Ireland and Wales and the Scottish Parliament will be durable institutions of devolved government, and that there will be no return to administrative devolution under three territorial Secretaries of State. In terms of financial mechanisms, there has been a great deal of continuity bridging the pre-devolution and post-devolution periods. However, devolution in the political sense changes the context in which such financial mechanisms operate.

Fiscal decentralisation is on the world-wide policy agenda, as evidenced by the revival of the academic literature (Oates, 1972; 1999) and by the huge amount of attention now paid to it by the International Monetary Fund (2000) and the World Bank (Burki and Perry, 2000). When a country faces difficult policy choices, it is important to remember that other countries may confront similar issues; the apparent insolubility of certain problems should not lead to disheartenment or disillusionment. There is no magic box of ready-packaged solutions, but a thorough understanding of technical issues is a prerequisite for good policy development. The remarkably varied experience of other countries shows how much is historically and culturally rooted; we need a map from where we are, not from where we would like to have started (Gray et al, 1993).

It is essential to set developments in Northern Ireland within the context of constitutional evolution across the United Kingdom. There is enormous practical significance in there now being elected devolved bodies in all three territories;¹ for example, a Scottish Parliament on its own would have been much more vulnerable to interventions from Westminster and Whitehall. Indeed, there is plenty of evidence that isolation was a fundamental problem for the 1921-72 Stormont system. Despite different forms of devolution in Scotland, Wales and Northern Ireland, the common feature of elected territorial bodies alters the calculus of electoral competition; a UK political party which alienated all three territories could only win a UK General Election on the back of a landslide majority in England. Consequently, a broad swathe of political opinion will seek to make the new institutions work. Furthermore, political parties and voters in Great Britain will adapt to the direct and indirect consequences of proportional representation in non-European Union (EU) elections. This gives an opportunity for the new constitutional arrangements to mature organically; they will not necessarily be frozen as they stand after the 1998 bout of constitutional legislation. Indeed, they should be expected to develop and change.

One issue for Northern Ireland will be whether the existing assignment of functions between central and devolved government, still much influenced by the legacy of the *Government of Ireland Act 1920*, remains appropriate. For example, there might in time be more symmetry with Scotland, some now-reserved functions being devolved and perhaps other functions passed back to the UK level.

¹ There is much political sensitivity in labelling the component parts of the United Kingdom: for example, 'nation' and 'region' may be seen to carry implications for the nature of governance. When discussing England, Scotland, Wales and Northern Ireland, the Treasury's current practice of describing these as 'countries' (Treasury, 2001e) is followed. Formerly, it used the term 'territories'. In this Chapter, the term 'territories' is applied collectively to Scotland, Wales and Northern Ireland. The internal components of England are described as 'regions'. The analysis of public expenditure by country and region is referred to as 'territorial analysis'.

Accordingly, what is happening in Northern Ireland is partly a product of highly specific circumstances (ie the Peace Process) (Gay and Morgan, 1997) and partly a product of the Blair Government's UK-wide constitutional agenda (Hazell, 1999). If the Peace Process holds, the position of Northern Ireland will probably more closely mirror that of Scotland than was traditionally the case. Carmichael (1996) explained how the governmental arrangements in Northern Ireland had evolved before the 1997 Blair reforms on the mainland. He emphasised that the 1990-97 Major Government viewed devolution in Northern Ireland as part of the solution to problems of legitimacy and consent, whereas it viewed devolution in Scotland and Wales as a threat to the Union. This illustrates that similar institutional proposals can be interpreted differently, contingent upon context and time.

Devolution to Scotland, Wales and Northern Ireland impacts not just in those territories, but draws attention to existing and new asymmetries within the United Kingdom, notably concerning electoral representation and public money (House of Lords Select Committee on the Constitution, 2003). Much that has hitherto been unknown, or deemed irrelevant, has come under the glare of greater transparency and also of sensationalised media reporting. The language of 'anomaly' and 'crisis' has been extravagantly overworked, with such descriptors attached to any policy divergence or disagreement between tiers of government, including those of a kind regarded as everyday in federal countries.

The politics surrounding territorial public expenditure have intensified. Even though per capita expenditure by the Devolved Administrations is considerably higher than comparable expenditure in non-devolved England, the political pressure in the devolved territories is to find ways of spending more. Devolution has taken place in those parts of the United Kingdom with higher public spending and lower relative Gross Domestic Product (GDP). This is in marked contrast to the situation in several other EU countries. It is often the higher relative GDP areas that are demanding greater political and fiscal autonomy, for example Flanders in Belgium, Lombardy in Italy, and the Basque Country and Catalonia in Spain. Keating (1996, p.36) has described this process as 'the revolt of the rich'. A rich region in a relatively poor EU member state can be a large net contributor to national redistribution, when the same region would be a recipient if it were located in a richer member state. The language of debate has changed significantly over the last 20 years: rich regions confidently want to keep what they have 'earned on merit' just as individual citizens may do. As with interpersonal redistribution, territorial redistribution is now more contested. There is spectacular inconsistency in public attitudes, magnified in the way these are reflected in the media: for example, increased inequality is deplored whilst even modest policy responses are lambasted, thereby encouraging governments to resort to measures of subterfuge or stealth.

In contrast to the UK assumption (at least in the devolved territories) that devolution would facilitate more public spending, one of the internationally proclaimed benefits of devolution is that the shedding of functions downwards from the centre to financially weaker governments reintroduces hard budget constraints, which are in turn likely to limit public expenditure.

The United Kingdom as a whole has to adjust to a more explicit form of asymmetrical government (Keating, 1998). The irony is that asymmetry has long existed, but few outside

the territories ever noticed. The extent of economic and social imbalances within the United Kingdom is admirably captured by MacKay and Audas (1997, p. 23):

Where government is has economic as well as political effects. In a centralised State, career structures develop which require location in or close to the national capital. That capital draws strength from the atmosphere of centralised culture and power. In the UK, there are few fields of endeavour where it is possible to scale the commanding heights without being close to the national capital.

Looking at existing public expenditure, taxation and GDP data is therefore only part of a much broader picture.

2 UK PUBLIC EXPENDITURE POLICY

2.1 UK Public Expenditure Context

The Devolved Administrations are principally financed by transfers from the UK government. It is therefore essential to locate them within the wider UK public expenditure context in which they are embedded. In the last quarter of the twentieth century, public expenditure was controlled in the United Kingdom more strictly than in most other (what are now) EU countries. Heald (1997) concluded that, in terms of its public expenditure/GDP ratio, the United Kingdom had become detached from other EU countries, resembling non-EU members of the Organisation for Economic Cooperation and Development (OECD) rather than continental Europe.

For reasons of electoral strategy, the Labour Opposition in 1997 committed itself to keeping to the 1997/98 and 1998/99 public expenditure plans which it would inherit from the outgoing Conservative Government. This led to restrictions on public spending, probably tighter than those which would actually have occurred under a re-elected Conservative Government. The immediate context of devolution was thus one of very strict aggregate control of public expenditure, leading to an expectation of resource shortage in the early years of the Devolved Administrations (Heald and Gaughan, 1998).

Given this background, the scale of the increases in public expenditure announced in the 1998 Comprehensive Spending Review (CSR) (Treasury, 1998c), even allowing for gross exaggeration of the numbers through aggressive spinning at the time, and in Spending Reviews (SR) 2000 (Treasury, 2000c) and 2002 (Treasury, 2002a) was not expected. Moreover, the Chancellor of the Exchequer (Gordon Brown) established fiscal rules and a substantially different control framework for public expenditure management (Heald and McLeod, 2002c, Treasury, 1998f). This new system of Departmental Expenditure Limits (DEL) and Annually Managed Expenditure (AME) would require time for budget participants to learn the new rules, especially relating to extremely generous End-Year Flexibility (EYF). Further changes would take place in 2001/02 (first stage implementation of Resource Accounting and Budgeting (RAB)) and in 2003/04 (full implementation of RAB).²

The sharp increase in planned expenditure brought with it the unexpected problem of the underspending of public expenditure allocations.³ Like Whitehall itself, the Devolved Administrations recorded significant underspending. In 2001/02, the Northern Ireland Departments underspent by 4.67% against the final DEL, and the Northern Ireland Office

² It should be noted that the new expenditure planning system does not entail three-year rolling programmes; there was initially (CSR 98) a three-year horizon for DELs (1999/2000, 2000/01 and 2001/02). Naturally, the time horizon successively shortened as these years arrived. In July 2000 (SR 2000) and 2002 (SR 2002), new sets of three-year plans were promulgated for 2001/02 to 2003/04 and 2003/04 to 2005/06 respectively. These plans are now expressed in 'resource' terms, rather than in cash, as a result of the implementation of RAB. Whereas non-cash items such as capital charges and depreciation were, in SR 2000 plans, left in AME, they were transferred to Department DELs in SR 2002 (Treasury, 2002a). The relevance of these changes to territorial funding is discussed in Section 4.5.

³ The precise reasons for this are not yet clear. Possible explanations include: a lack of capacity to launch capital schemes, after historically low levels of spending; the difficulty of managing exceptional bursts of expenditure growth, without taking on insupportable future commitments; and labour shortages, particularly in London and the South East, though now manifesting themselves more generally. The constraint on public services may not now be inadequate budgets, but an inability to command real resources (eg skilled personnel).

(NIO) underspent by 10.89%. Underspending was greater than in both Wales (0.55%) and Scotland (2.89%) (Treasury, 2002e). The extent to which such underspending is a new problem is demonstrated by the following pattern for Northern Ireland: 1997/98, 0.75% underspend; 1998/99, 0.77% overspend; 1999/2000, 2.28% underspend (Northern Ireland Departments) and 4.03% underspend (NIO); and 2000/01, the first full financial year of devolution, 3.87% underspend (Northern Ireland Departments) and 3.85% underspend (NIO) (Treasury, 1998e; 1999b; 2000b; 2001d).⁴

The immediate financial problem of the Devolved Administrations has been in spending their Assigned Budgets. This contrasts markedly with public perceptions, and with loud complaints, sometimes encouraged by all the Devolved Administrations, that they are underfunded.

2.2 UK Public Expenditure Trends

There are important preliminaries before discussing the numbers. A great deal of obfuscation is caused in discussions of public expenditure by a failure to distinguish changes in levels from changes expressed relative to some other figure. Public expenditure can be expressed in relation to some macroeconomic aggregate, for example public expenditure/GDP (Heald and McLeod, 2002c, para 487). Quite often, it is convenient to express per capita identifiable public expenditure in Northern Ireland relative to per capita identifiable public expenditure in the United Kingdom, with the result expressed as an index, UK = 100.⁵ When such distinctions are not respected, there can be claims that a territory or a public service is being impoverished because its expenditure is falling relative to some other territory or public service, when, in fact, the level of expenditure is growing rapidly.

Another source of confusion is the failure to specify the price basis of any comparison. Expenditure levels can be expressed in: nominal terms (ie amounts spent at the time); real terms (ie amounts spent adjusted by a measure of general inflation, usually the GDP deflator); or volume terms (ie amounts spent adjusted by a service-specific deflator). The third basis has fallen into disuse, on the grounds that it is too permissive of cost inflation in the public sector, particularly in relation to pay settlements. However, systematic data are still prepared for the National Health Service (NHS) in England. Even when inflation is at low levels, quite different pictures will emerge according to whether attention is paid to nominal or real terms.

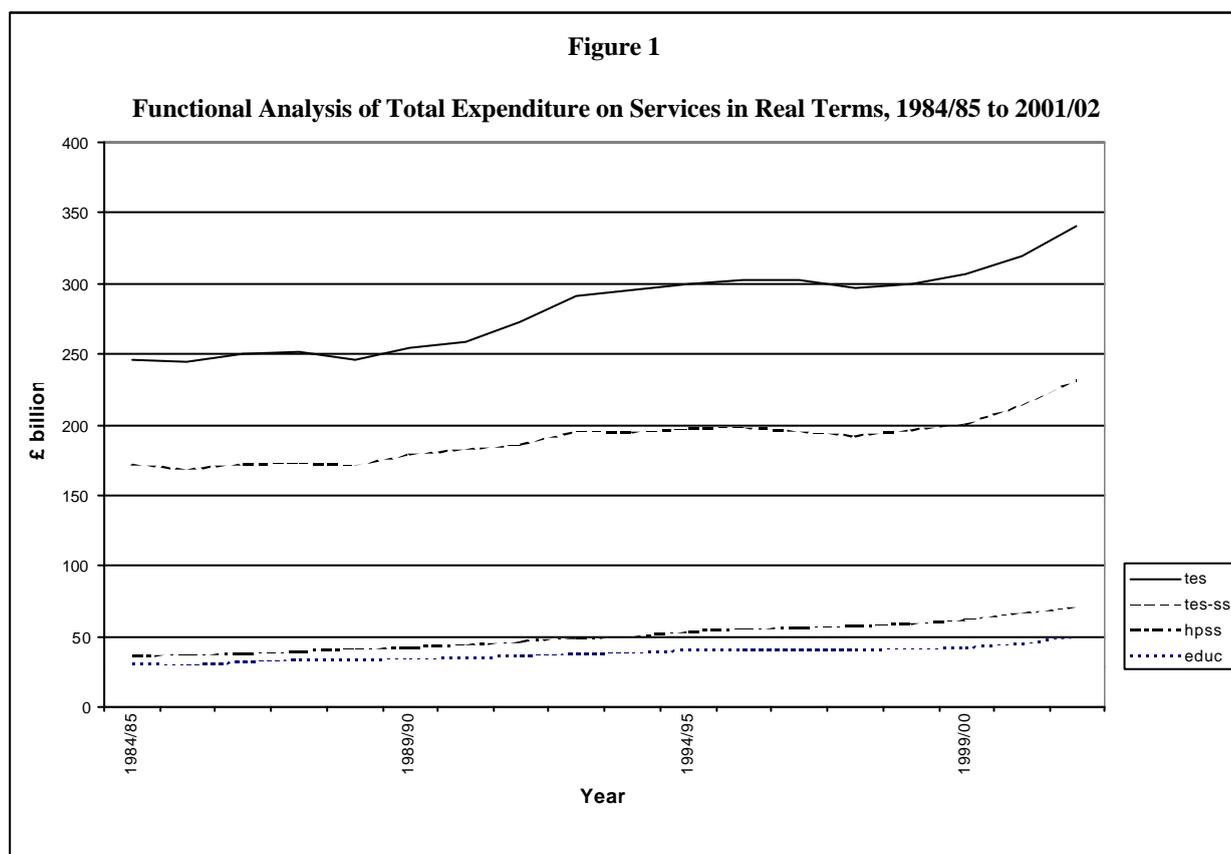
Taking data from *Public Expenditure: Statistical Analyses 2002-03* (PESA) (Treasury, 2002f), Figure 1 plots the evolution in real terms of certain components of UK public expenditure over the period 1984/85 to 2001/02.⁶ The functional analysis is only published on

⁴ These figures are not strictly comparable through time due to the implementation of RAB.

⁵ It is essential to check in any particular comparison whether the index is expressed relative to UK = 100 or England = 100.

⁶ The aggregate which is plotted is 'Total Managed Expenditure' (TME), converted to real terms using the GDP deflator in use at the time of publication of *PESA 2002*.

this basis for past years because it includes spending by local authorities; it is support to local authorities, not its functional distribution, which is planned, and outturn figures depend crucially on the decisions of individual authorities.⁷ Because such a diagram becomes unintelligible if there are too many lines, only four plots are made: Education (Educ); Health and Personal Social Services (HPSS); Total Expenditure on Services (TES); and Total Expenditure on Services less Social Security (TES-SS). The path of Social Security (not plotted) was certainly affected by the cyclical behaviour of the economy; it is therefore useful to have the two aggregates (TES and TES-SS).



Source: Treasury (2002f, Table 3.4)

Figure 1 shows some interesting patterns. Aggregate control of public expenditure was tough in the period 1984/85 to 1988/89 (a period of strong economic growth), during which there was virtually no growth in real terms in either aggregate. The same effect occurs between 1993/94 and 1998/99 (another period of strong economic growth), at the end of which real-terms expenditure was just below the level in 1993/94.

⁷ Although local authorities in Northern Ireland are relatively unimportant in public expenditure terms, this is not the case in the rest of the United Kingdom. In 2002/03 plans, UK local authorities account for 25% of TME (Treasury, 2002f, Table 1.14).

In between these two periods, Figure 1 shows that there was an upward shift in public expenditure in the early 1990s: from 1988/89 to 1993/94, TES increased in real terms by 20.1% (TES-SS by 14.0%). It is not until 2000/01 that a new shift can be detected: TES registered a 4.5% real-terms increase (TES-SS, 6.6%).⁸ When attention focuses on TES-SS (a rough form of adjustment to reduce cyclical effects), two conclusions emerge. First, there was a sudden loss of control of public expenditure in the run-up to the 1992 General Election, an event which was observed at the time (Heald, 1991). Following the reassertion of control, TES-SS was below its 1992/93 level in 1998/99. Second, different functional areas have contrasting experiences. Education has a higher growth rate than HPSS in only four years out of 17; it was relatively static in real terms from 1994/95 to 1998/99, though HPSS increased by 10.0%.

When examining the underlying data behind Figure 1, two points should be noted. First, UK government does not explicitly plan real-terms expenditure, and differences between forecast and outturn GDP deflators will have an effect. Second, care has to be exercised at this level of aggregation, not least because there will have been efficiency gains over the period, and also the GDP deflator adjustment does not reflect experience at service level (in some years, the Relative Price Effect might have been positive, in others negative).

2.3 The Territorial Margins

Traditionally, what happened in Scotland, Wales and Northern Ireland was of peripheral interest to the mainstream of UK political debate. Controversies about devolution and about territorial funding have begun to change this. One manifestation is the intense controversy about the Barnett formula, used since 1979/80⁹ to determine the allocation of changes in certain categories of public expenditure. The formula was named after Joel Barnett, Chief Secretary to the Treasury in the 1974-79 Labour Government (Twigger, 1998).

The crucial point is that the Barnett formula takes existing levels of expenditure by the Devolved Administrations as given, and determines increases in their expenditure ceilings by applying population-based percentages to changes in comparable programmes in England.¹⁰ Although the detailed analysis of the predicted effects of the Barnett formula is postponed to Section 4.1, a brief overview is now provided.

The Barnett formula provides that changes in public expenditure in Scotland, Wales and Northern Ireland for specific services within the territorial blocks are determined according to the formula consequences of changes in comparable expenditure in England. Under the original population proportions of 10:5:85, Scotland received 10/85ths and Wales 5/85ths of

⁸ This continued in 2001/02, with TES registering a 6.5% real-terms increase and TES-SS an 8.0% increase. However, the reported percentage increases in 2001/02 may be overstated if outturn expenditure is less than the estimated outturn expenditure reported in *PESA 2002*. Revised data on a comparable basis will not be available until *PESA 2003*.

⁹ In 1979/80, the formula was only used for Scotland, being extended to Wales (1980/81) and Northern Ireland (1981/82).

¹⁰ More detailed explanations are provided in Heald (1994, 1998).

the change in England. A parallel formula then allocated 2.75% of the change in comparable expenditure in Great Britain to Northern Ireland. The essential distinction is between base expenditure (whose current levels are carried forward) and incremental expenditure (which is determined by the formula). Under this arrangement, block expenditure indexes would in the long run converge on the England per capita level, though it was never the intention to drive expenditure indexes below (unmeasured) needs indexes. In practice, convergence has been substantially frustrated by formula bypass¹¹ and, in the case of Scotland, by continued relative population decline.¹² In 1992, the formula was recalibrated (10.66:6.02:100.00, and Northern Ireland 2.87%); this took place at a time of major changes in the UK public expenditure planning system and shortly after the results of the 1991 population census. With effect from 1999/2000 (the first year to be affected by the results of the Labour Government's CSR 1998), the formula proportions were to be updated annually, in line with revised estimates of relative populations. On the first implementation, in July 1998, the revised proportions (based on mid-1996 population estimates) were 10.45:5.95:100.00, and Northern Ireland 2.91%. With effect from SR 2000, Northern Ireland's formula consequences were determined in relation to changes in comparable expenditure in England. The formula proportions used in SR 2002 were: 10.23% (Scotland); 5.89% (Wales); and 3.40% (Northern Ireland)¹³ (Treasury, 2002b).

Given the centralised organisation of UK departments around Whitehall, the territorial departments which preceded the Devolved Administrations were an exception to the functionally oriented structure. Even taken together, the three territories account for only 16% of the UK population, and what happened there was something of a mystery, and of little interest, in London. The territorial departments were able to exploit the situation to their own advantage, profiting from being unimportant. Midwinter (1997) has argued that one reason why the territorial programmes were not more vigorously challenged was that spreading any alleged 'excess' expenditure across England would have a small impact relative to the political controversy this provoked. Although their financing could be viewed in London as a relatively minor add-on to English developments, decisions were viewed in Edinburgh, Cardiff and Belfast as vital to the economies of the territories. There was much more incentive in the territorial departments to devote resources to managing the relationship with London than there was for London to invest in its relationship with the territories.

Each year, in PESA, the Treasury publishes a territorial analysis of public expenditure, by country and also by English region. The figures published in Treasury (2001e) significantly improved on those in previous years; the hitherto separate 'territorial' and 'regional' (ie English regions) exercises have been unified.

¹¹ Formula bypass refers to increases in expenditure, on services within the block (Assigned Budget), which are allocated to the territories on a basis other than the formula proportions.

¹² The implications of relative population change are discussed in Section 4.1.

¹³ Expressing Northern Ireland as 3.40% in relation to England is equivalent to expressing it as 2.92% in relation to Great Britain.

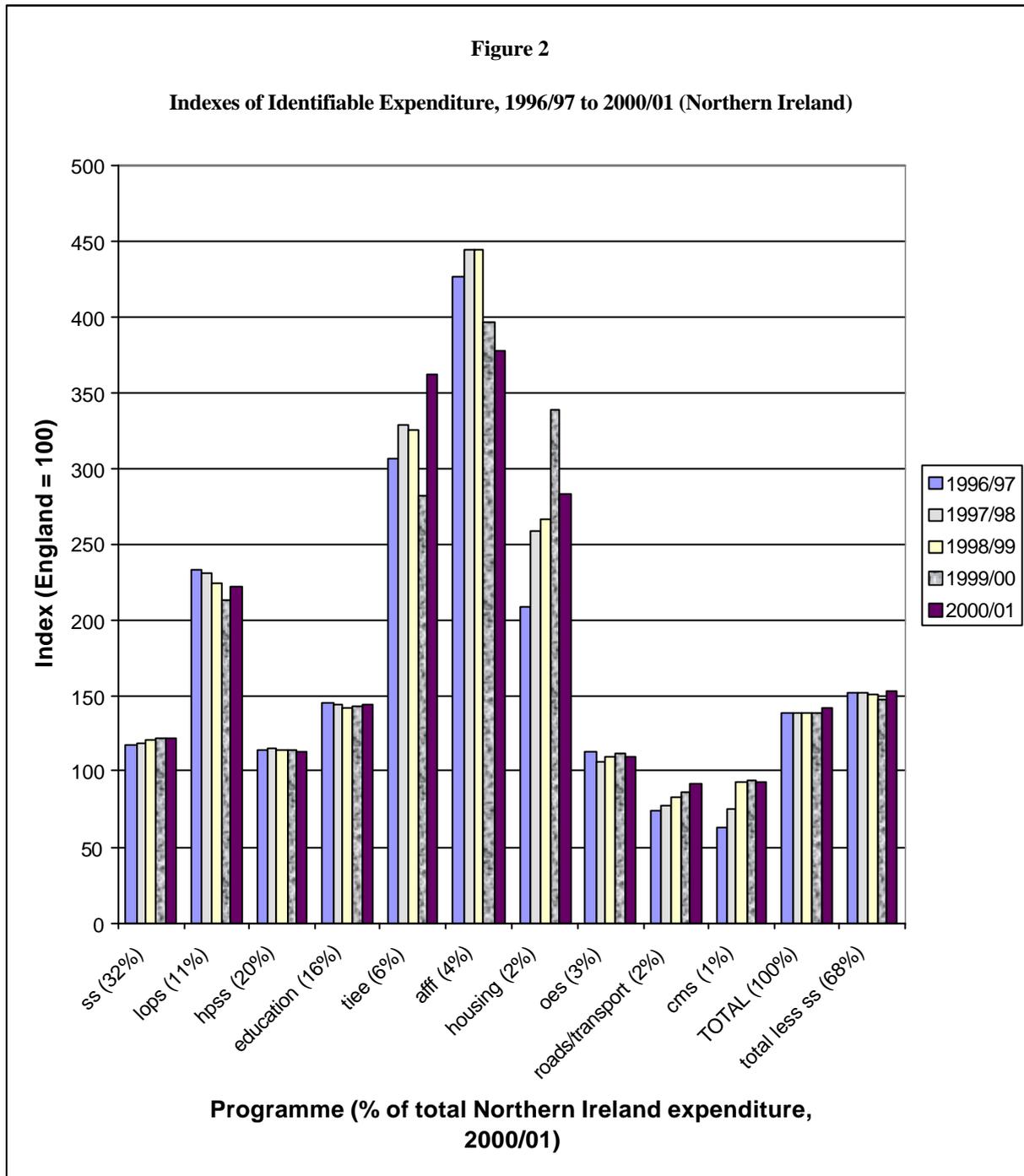
Figure 2 presents summary data for Northern Ireland, covering the years 1996/97 to 2000/01.¹⁴ For each programme in each year, the Northern Ireland index of per capita expenditure (England = 100) is indicated by its own column in the histogram. The sequencing of programmes in Figure 2 has been deliberately chosen: Social Security (SS), 32% of the total in 2000/01, is outside devolved financial arrangements, except for expenditure on administration. Similarly, Law, Order and Protective Services (LOPS), accounting for 11%, is mostly not devolved.¹⁵ Next follow the large devolved programmes, namely Health and Personal Social Services (HPSS) (20%) and Education (16%). The percentage contribution of these two programmes would increase to 35% and 29%, respectively, if both SS and LOPS are excluded from the calculation. Together, HPSS and Education account for approximately two-thirds of that public expenditure in Northern Ireland which is both identifiable and devolved.

The indexes are generally well above 100, the exceptions being the small Roads and Transport (R&T) and Culture, Media and Sport (CMS) programmes. There is a band of programmes where the Northern Ireland index is massively higher: Trade, Industry, Energy and Employment (TIEE) (ranging from 282 to 363); Housing (209 to 339, though housing indexes need to be treated with caution); and Agriculture, Fisheries, Food and Forestry (AFFF) (377 to 444, where the EU dimension is dominant). The index for total identifiable expenditure in 2000/01 is 42 points above that for England, increasing to 53 points above if SS is excluded. There is some year-on-year fluctuation on individual programmes, though the overall pattern is clear.

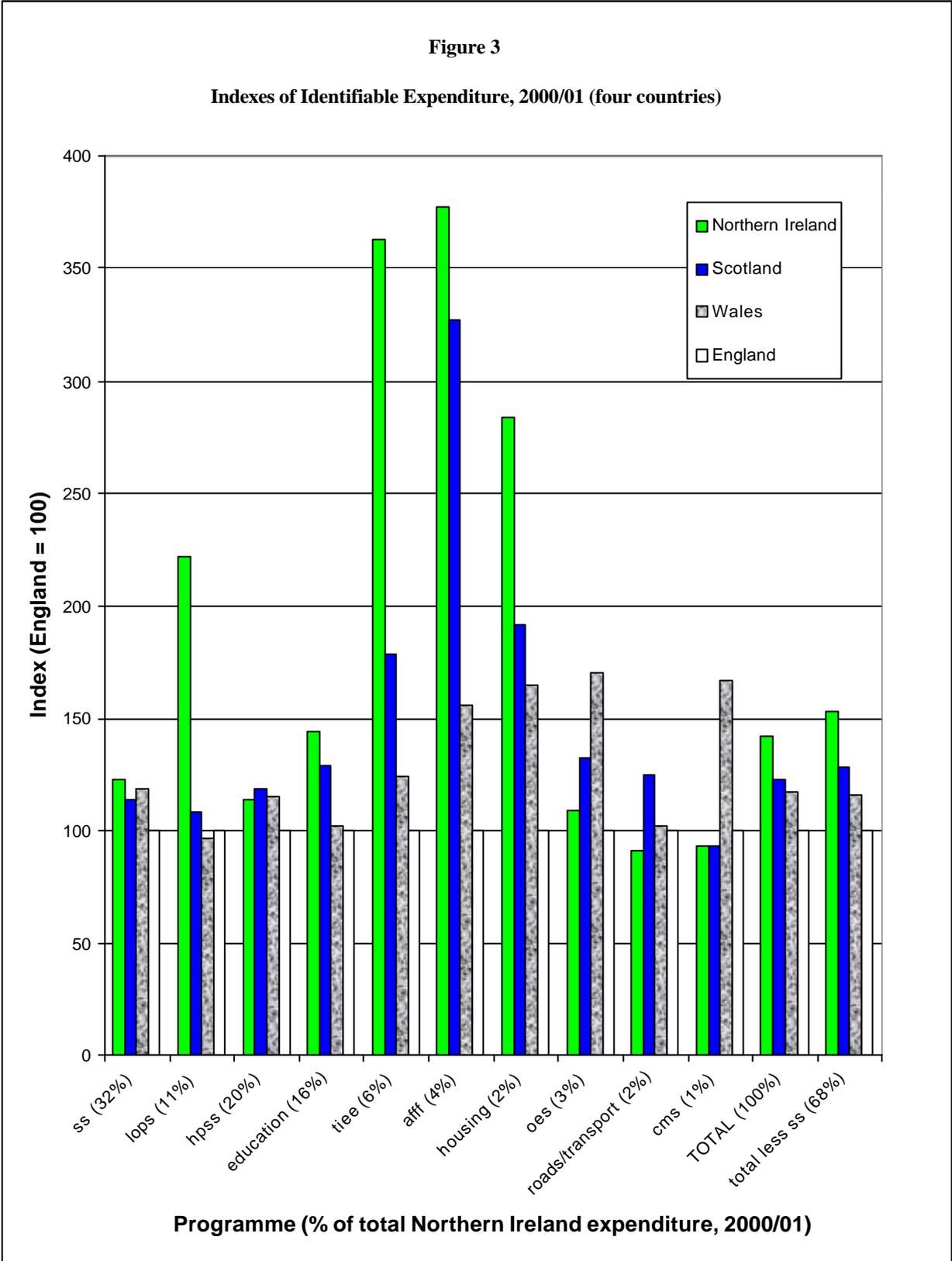
Figure 3 is derived from the same source, plotting, for each programme in 2000/01, the indexes for Northern Ireland, Scotland and Wales. The index for England, by definition always 100, is also plotted for each programme. With regard to both total identifiable expenditure and total identifiable expenditure less SS, there is a consistent ordering: Northern Ireland, Scotland, Wales, England. On the large devolved programmes, the Education index for Northern Ireland is above that for Scotland, with the converse applicable for HPSS; this is exactly what might be expected given the relative demographics. Northern Ireland is much higher on TIEE and Housing, and – like Scotland – higher than Wales on AFFF. Unsurprisingly, Northern Ireland is an outlier on LOPS. With regard to SS, Northern Ireland is the highest, but Wales is also considerably higher than Scotland.

¹⁴ At the time of completing this Report, the 2000/01 data in *PESA 2002* (Treasury, 2002f) are the latest available.

¹⁵ This adjustment is an approximation, as the Fire Service (devolved and part of the Department of Health, Social Services and Public Safety) is classified by the Treasury within LOPS.

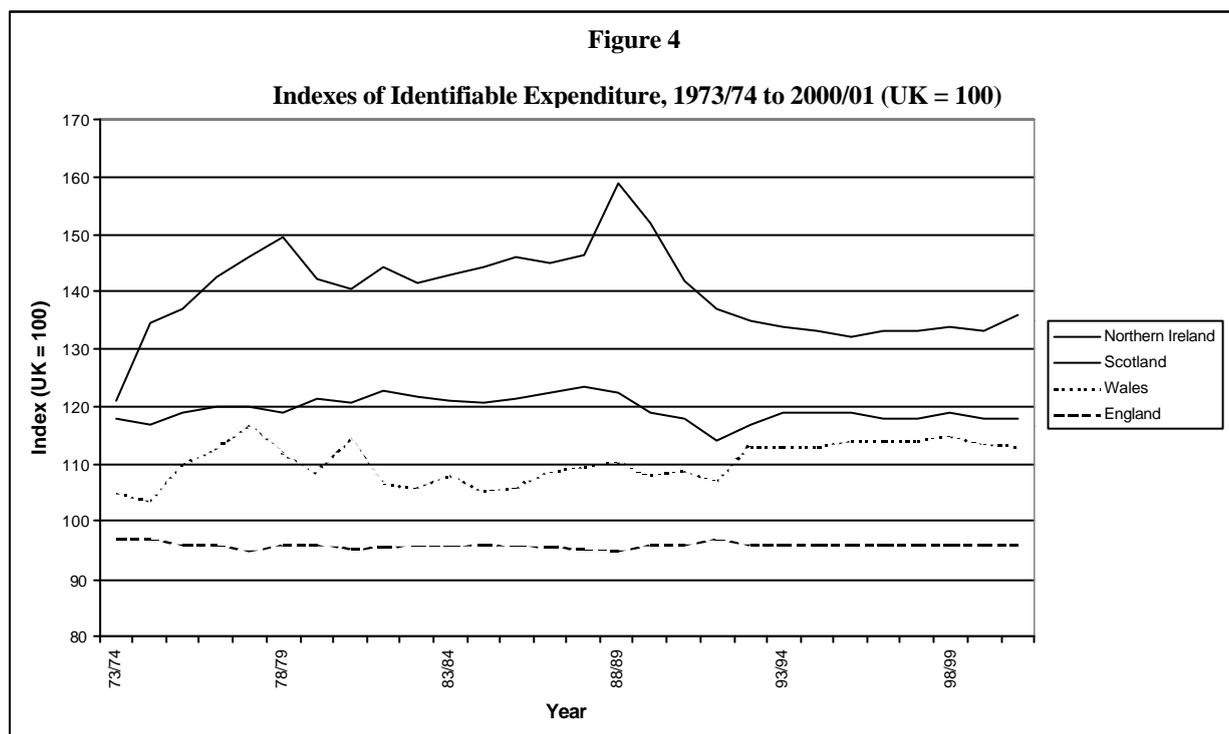


Source: Treasury (2002f), Tables 8.2b to 8.6b



Source: Treasury (2002f), Tables 8.2b to 8.6b

Figure 4 is drawn with UK = 100 because the original data were published on this basis.¹⁶ Too much attention should not be given to small year-on-year changes because of data issues affecting the plotting of Figure 4. The only territorial data of reasonable quality on a reasonably consistent basis through time are those for identifiable public expenditure. This includes Social Security benefit expenditure (outside the Barnett formula arrangements) and public expenditure, like Defence, which the Treasury views as being for the benefit of all UK residents, irrespective of where that expenditure is physically incurred.



Source: See Table 1.

This is not the level of data at which statements can be made about whether or not the Barnett formula is bringing convergence. The component of territorial public expenditure controlled by means of the Barnett formula is only one component of the identifiable figure, and there have been shifts, largely into formula-controlled expenditure, through time.¹⁷ Despite these

¹⁶ To rebase on England = 100 would require going back to the numerous source documents; doing this from rounded indexes would lead to unacceptable rounding errors.

¹⁷ There is no published account of changes in the coverage of the Northern Ireland 'managed block' (see Section 3.3). Significant transfers into the block in Scotland seem to have been in areas, such as agricultural, education and industrial expenditure, where the territorial indexes have been particularly high. There were further, fairly minor, additions at the time of devolution, for example some ports and waterways. Railways were brought in later, when responsibility was executive devolved. Agriculture in its entirety remained outside the block until devolution, when the purely Scottish elements, such as the agricultural and biological research institutes and the Scottish Agricultural College, were brought in. Such changes through time in the coverage of the block add to the difficulty in looking for evidence of convergence.

qualifications, one would expect to detect some convergence at the identifiable level. However, one needs to be careful about the effect of the economic cycle; the territorial share of Social Security expenditure can be expected to increase during the boom, and fall during the recession: London and the South East fluctuate more in both directions than do the territories.

Some limited conclusions can be drawn from Figure 4. The Northern Ireland index rose markedly in the 1970s (from 121 in 1973/74 to 149.5 in 1978/79).¹⁸ In the early 1990s, it fell sharply (from 159 in 1988/89 to 137 in 1991/92). Despite some fluctuation, the Scotland index remains almost unchanged. The index for Wales is closer to that of Scotland in the 1990s than previously, though still considerably below it. Since the economic recovery from the early 1990s' recession, the indexes for Scotland, Wales and Northern Ireland look fairly stable.

The graphical presentation in Figure 4, though helpful in conveying the overall picture, is not a suitable way of reporting the data for individual years. Table 1 reports, for each year, the Northern Ireland indexes of identifiable expenditure per capita (UK = 100) for the period 1973/74 to 2000/01. As well as the numbers reported in successive Treasury publications, Table 1 also shows the median used for plotting the Northern Ireland line in Figure 4.¹⁹

Table 2 shows indexes of identifiable expenditure per capita, analysed by country, region and function, for the year 2000/01. The adjustment of excluding Social Security from the identifiable figures has the marked effect of increasing the 2000/01 index for Scotland (from 118 to 122) and Northern Ireland (from 136 to 146), whilst decreasing the index for Wales (113 falls to 111). This differential effect of excluding Social Security also occurs when the analysis is extended to English regions. Table 2 shows that the London index is markedly affected by the exclusion of Social Security: rising from 108 to 115. In contrast, the same adjustment reduces the North East index from 109 to 102, and also has a marked impact on the North West (down five points). However, the index for Eastern is unchanged.

¹⁸ The identifiable public expenditure series began in 1973/74, though some authors have linked this to earlier data series. Rhodes (1988, p. 66) provided a linked series from 1960/61 to 1980/81 for the four countries. Northern Ireland is reported as 99 (UK = 100) in 1960/61; 106 in 1967/68; and 127 in 1972/73. The earlier data are derived from King's (1973) research for the Kilbrandon Royal Commission on the Constitution.

¹⁹ The territorial analysis of public expenditure is undertaken annually by the Treasury as a stand-alone exercise, drawing upon its public expenditure database. There can be significant definitional and measurement changes through time in Treasury practice (Heald, 1995). Consequently, the data published in one year are not necessarily consistent with those published in the following year. The Treasury practice is to publish, each year, five years of territorial data on the expenditure conventions of that year. The plotting points for Figure 4 are the median for each year of the index. For further discussion, see Heald and Short (2002).

Table 1											
Indexes of Identifiable Public Expenditure per capita, 1973/74 to 2000/01 (Northern Ireland)											
	73/74	74/75	75/76	76/77	77/78	78/79	79/80	80/81	81/82	82/83	83/84
17 January 1979, cols 781-93	121	135	137	143	142						
26 November 1979, cols 507-520		134	137	143	147	152					
26 March 1981, cols 415-424			136	142	146	149	142				
8 December 1981, cols 384-96				141	145	148	142	139			
1 February 1983, cols 84-96					147	150	144	139	147		
No data located for 1984											
22 February 1985, cols 606-616							143	142	142	141	144
12 March 1986, cols 502-512								144	143	142	143
16 December 1986, cols 488-498									146	145	146
23 October 1987, cols 896-906										141	142
25 October 1988, cols 120-129											143
No data located for 1990											
February 1991, Cm 1520											
January 1992, Cm 1920											
January 1993, Cm 2219											
February 1994, Cm 2519											
February 1995, Cm 2821											
March 1996, Cm 3201											
March 1997, Cm 3601											
April 1998, Cm 3901											
March 1999, Cm 4201											
April 2000, Cm 4601											
April 2001, Cm 5101											
April 2002, Cm 5401											
Median value used in Figure 4	121	135	137	143	146	150	142	141	144	141	143

84/85	85/86	86/87	87/88	88/89	89/90	90/91	91/92	92/93	93/94	94/95	95/96	96/97	97/98	98/99	99/00	00/01
146																
146	148															
142	143	143														
143	144	144	143													
	148	149	148	160	155											
		147	147	159	152	143										
			146	158	151	141	137									
				159	152	142	137	135								
					152	142	137	133	134							
						142	137	135	135	132						
							137	135	134	133	132					
								134	134	133	133	135				
									135	133	133	135	135			
										129	129	132	132	134		
											131	133	133	135	133	
												133	133	134	133	136
144	146	145	147	159	152	142	137	135	134	133	132	133	133	134	133	136

There is a further point to make about the differential context of the territories, a factor that has bridged the pre-devolution and devolved arrangements. Quite apart from formula feeding of the territorial blocks by means of Barnett, the territorial Secretaries of State enjoyed far-reaching expenditure-switching powers within those blocks. Limited use appears to have been made of these powers for strategic, rather than expenditure management, purposes: Midwinter et al. (1991) attributed this partly to the membership of these Secretaries of State for Scotland of UK Cabinets with a clear sense of ideological direction. In the case of Northern Ireland, Direct-Rule Secretaries of State were preoccupied with security matters and did not consider themselves to have the legitimacy to embark on policy innovation.

Table 2
Indexes of Identifiable Expenditure per capita, by Country, Region and Function, 2000/01 (UK = 100)

	UK weight	Scotland	Wales	Northern Ireland	England				
Education	15.0%	124	99	129	96				
Health and personal social services	24.7%	116	112	110	97				
Roads and transport	2.2%	122	100	90	90				
Housing	1.2%	124	141	242	96				
Other environmental services	2.4%	124	160	102	94				
Law, order and protective services	7.2%	104	92	212	96				
Trade, industry, energy and employment	2.7%	154	109	214	97				
Agriculture, fisheries, food and forestry	1.9%	251	120	200	77				
Culture, media and sport	2.0%	90	141	90	97				
Social security	26.0%	110	116	120	97				
Miscellaneous expenditure	1.1%								
Total	100%	118	112	127	96				
Total excluding social security	73.9%	122	114	146	95				
	North East	North West	Yorkshire/ West Midlands	East Midlands	West Midlands	South West	Eastern	London	South East
Education	100	100	90	94	100	90	92	102	90
Health and personal social services	102	102	90	90	92	92	97	110	90
Roads and transport	114	95	79	92	94	90	105	125	97
Housing	91	121	96	46	29	29	20	227	11
Other environmental services	124	112	96	99	90	94	74	106	91
Law, order and protective services	99	100	92	94	90	96	94	124	94
Trade, industry, energy and employment	90	92	94	96	97	92	96	97	96
Agriculture, fisheries, food and forestry	51	56	100	106	94	94	126	29	67
Culture, media and sport	117	92	156	77	100	90	92	110	77
Social security	122	112	101	95	101	95	97	94	92
Miscellaneous expenditure									
Total	100	104	90	94	95	92	99	100	95
Total excluding social security	102	99	90	99	92	99	99	115	96

NOTES:

An index of miscellaneous expenditure is not calculated since the administration costs of departments other than in the territories are not separated from functional expenditure. Such an index would be misleading. Indexes for the English regions are not published in *PESA 2002-03* but are calculated from data contained therein. In the case of the countries, in instances where the results of such calculations differ from the published figures due to rounding, the PESA number is shown.

Source: Treasury (2002f), Tables 8.6B and 8.12.

Devolution brings much greater opportunity for policy variation. Moreover, the Assigned Budget arrangement has protected the Devolved Administrations from the outbreak of centralism which is afflicting Whitehall.²⁰ In contrast, Whitehall departments, responsible predominantly for England, are constrained by funding through separate programmes and channels. They are increasingly controlled by the Treasury, through mechanisms such as Public Service Agreements (PSAs). In turn, they increasingly control the bodies that financially depend upon them, using funding mechanisms targeted at specific issues. The contrast between block (spending envelope) and blowpipes (many fragmented channels) is pronounced, and is enormously to the advantage of the Devolved Administrations.

UK public expenditure control systems change relatively frequently, sometimes because they are judged no longer to achieve desired policy objectives and sometimes as a means of reasserting Treasury control over the government machine (Heald, 1995, Thain and Wright, 1995). The 1998 changes, introducing DEL and AME, were significant in themselves but also important because they coincided with devolution. The most important component of the budgets of the Devolved Administrations is their DELs (Heald and McLeod, 2002c).

Table 3 is derived from *PESA 2002*, which covers three outturn years, one estimated outturn year and two plan years. The DELs for Scotland, Wales, Northern Ireland Executive and NIO are shown for each of these years, together with a subtotal for the territorial component. The rest of the Table shows 'Other DELs' (ie all DELs other than the territorial ones), and then several budgets centrally held by the Treasury. There is an allowance for shortfall for the estimated outturn year (2001/02), and a DEL Reserve for the plan years.

It is easier to understand what has been happening by examining Table 4, which has converted the nominal figures in Table 3 to a real-terms index.²¹ This is clearly a period of very strong public expenditure growth: total DELs show an index of 112.2 (2001/2002 = 100) in 2003/04. There is also strong growth in the territorial DELs: Wales (111.7 in 2003/04); Scotland (109.5); and the Northern Ireland Executive (107.6). In contrast, the NIO DEL is planned at 87.4 in 2003/04. This clearly reflects the profiling of the LOPS expenditure for which it is responsible. At this level of aggregation, there is always a danger of comparing like with unlike, because there are major differences in functional composition, even among the Devolved Administrations. The operation of the Barnett formula would be expected to deliver higher percentage increases in Wales than in Scotland, and higher in Scotland than in Northern Ireland. This expected ordering of percentage increases in planning years is shown in Table 4. For these years, Wales is higher than Scotland which is higher than Northern

²⁰ Centralism can also derive from the Westminster Parliament. During the passage of the *Scotland Act 1998*, the UK Government resisted a sustained effort by the Chairman of the Public Accounts Committee (David Davis MP) to incorporate powers for the Comptroller and Auditor General to audit the Assigned Budget, as well as the payment of the Assigned Budget from the Scotland Office Vote into the Scottish Consolidated Fund. The expenditure of the Scottish Executive is audited by the Auditor General for Scotland, who heads Audit Scotland (Heald and McLeod, 2002c).

²¹ Indexes cannot be calculated when there is no expenditure in the base year. Accordingly, care has to be exercised when using these indexes.

Ireland (as predicted given the Barnett formula and the expenditure indexes). However, the expected relationship is not consistently supported by data in Table 4 for outturn years.²²

Table 3						
The Territorial Component of DEL, 1998/99 to 2003/04 (current prices, £ million)						
	1998/99 outturn	1999/2000 outturn	2000/01 outturn	2001/02 estimated outturn	2002/03 plans	2003/04 plans
Scotland	13,030	13,812	14,568	16,497	17,775	18,939
Wales	6,820	6,914	7,583	8,543	9,287	10,005
Northern Ireland Executive	4,426	4,646	4,978	5,737	6,131	6,472
Northern Ireland Office	986	982	952	1,125	1,152	1,031
Subtotal	25,262	26,354	28,081	31,902	34,345	36,447
Other DELs	145,034	151,119	162,942	181,929	194,347	209,591
Welfare to Work	533	775	1,371			
Invest to Save Budget					30	44
Capital Modernisation Fund					338	778
Policy Innovation Fund					40	40
DEL Reserve					400	2,100
Allowance for Shortfall				(2,013)		
Departmental Expenditure Limits	170,829	178,248	192,394	211,818	229,500	249,000

Source: Treasury (2002f), Table 1.2.

Table 5 provides a similar analysis to Table 3, but of AME rather than DEL. Changes to AME are outside the scope of the Barnett formula (see Section 3.4.2). Following Treasury practice since SR 2000, AME is divided into the Resource Budget Departmental AME and Non-Cash Departmental AME.²³

Again, the transformation to a real-terms index, as shown in Table 6, is much easier to interpret than the unadjusted figures. The index Resource Budget Departmental AME is planned to be 102.7 in 2003/04, whilst the Non-Cash Departmental AME has a value of

²² This confirms the need, vigorously argued throughout this Report, for more transparent data about the numerical operation of the Barnett formula. Outturn can be affected by many factors, including different degrees of underspending and transfers in and out of DEL.

²³ The accounting issues are not important here and will be discussed in Section 4.5.

114.3. The corresponding Northern Ireland Executive indexes are 107.4 and 118.0. Given the heterogeneity of AME, such comparisons are much less informative than in the case of DEL.

One of the conclusions emerging from Tables 3 to 6 is that the evolution of Northern Ireland programmes is a more complex phenomenon than simply applying the Barnett formula percentage, which is applicable only to the Assigned Budget component of the DEL. Much of the commentary which has forecast extremely rapid convergence has missed this important consideration.

Table 4						
The Territorial Component of DEL, 1998/99 to 2003/04 (index of real terms)						
	1998/99 outturn	1999/2000 outturn	2000/01 outturn	2001/02 estimated outturn	2002/03 plans	2003/04 plans
Scotland	84.7	87.7	90.4	100.0	105.1	109.5
Wales	85.6	84.7	90.9	100.0	106.1	111.7
Northern Ireland Executive	82.7	84.8	88.8	100.0	104.3	107.6
Northern Ireland Office	94.0	91.4	86.6	100.0	99.9	87.4
Subtotal	84.9	86.5	90.1	100.0	105.0	109.0
Other DELs	85.5	87.0	91.7	100.0	104.2	109.9
Welfare to Work	n/c	n/c	n/c			
Invest to Save Budget					n/c	n/c
Capital Modernisation Fund					n/c	n/c
Policy Innovation Fund					n/c	n/c
DEL Reserve					n/c	n/c
Allowance for Shortfall				100.0		
Departmental Expenditure Limits	86.5	88.1	93.0	100.0	105.7	112.2
NOTE:						
The underlying real terms series is expressed at 2001/02 prices. Where there is no expenditure in 2001/02, n/c indicates that an index is not calculable.						
<i>Source: Treasury (2002f)</i>						

Table 5						
The Territorial Component of AME, 1998/99 to 2003/04 (current prices, £ million)						
	1998/99 outturn	1999/2000 outturn	2000/01 outturn	2001/02 estimated outturn	2002/03 plans	2003/04 plans
Resource Budget Departmental AME						
Scotland	1,559	1,546	1,764	1,864	1,961	2,080
Wales	677	689	649	1,098	1,139	1,152
Northern Ireland Executive	3,489	3,590	5,069	5,507	5,717	6,196
Northern Ireland Office	(34)	87	(57)	100	86	117
Subtotal	5,691	5,912	7,425	8,569	8,903	9,545
Other Departmental AME	118,737	125,942	132,940	135,443	139,437	145,519
Total Resource Budget Departmental AME	124,428	131,854	140,365	144,012	148,340	155,064
Non-Cash Departmental AME						
Scotland	826	1,002	1,127	1,214	1,378	1,402
Wales	319	341	303	718	778	792
Northern Ireland Executive	74	85	1,466	1,588	1,666	1,964
Northern Ireland Office	54	179	(60)	52	51	66
Subtotal	1,273	1,607	2,836	3,572	3,873	4,224
Other Departmental AME	18,612	20,802	26,574	19,804	22,292	23,773
Total Non-Cash Departmental AME	19,885	22,409	29,410	23,376	26,165	27,997
<i>Source: Treasury (2002f), Tables 1.7 and 1.8.</i>						

Table 6						
The Territorial Component of AME, 1998/99 to 2003/04 (index of real terms)						
	1998/99 outturn	1999/2000 outturn	2000/01 outturn	2001/02 estimated outturn	2002/03 plans	2003/04 plans
Resource Budget Departmental AME						
Scotland	89.7	86.8	96.9	100.0	102.6	106.5
Wales	66.1	65.7	60.5	100.0	101.2	100.1
Northern Ireland Executive	67.9	68.3	94.2	100.0	101.3	107.4
Northern Ireland Office	(36.5)	91.1	(58.3)	100.0	83.9	111.6
Subtotal	71.2	72.2	88.7	100.0	101.4	106.3
Other Departmental AME	94.0	97.4	100.5	100.0	100.4	102.5
Total Resource Budget Departmental AME	92.7	95.9	99.8	100.0	100.5	102.7
Non-Cash Departmental AME						
Scotland	73.0	86.4	95.0	100.0	110.7	110.2
Wales	47.6	49.7	43.2	100.0	105.7	105.2
Northern Ireland Executive	5.0	5.6	94.5	100.0	102.4	118.0
Northern Ireland Office	111.4	360.4	(118.1)	100.0	95.7	121.1
Subtotal	38.2	47.1	81.3	100.0	105.8	112.8
Other Departmental AME	100.8	110.0	137.4	100.0	109.8	114.5
Total Non-Cash Departmental AME	91.2	100.4	128.8	100.0	109.2	114.3
<i>Source: Treasury (2002f).</i>						

3 NORTHERN IRELAND PUBLIC EXPENDITURE

An analysis of public expenditure policy in Northern Ireland is inescapably entwined in geography and history. Northern Ireland is a geographically detached part of the United Kingdom, representing 2.87% of the population on Census 2001 figures (Office for National Statistics, 2003) and 5.85% of the land area (WorldAtlas.com, 2002). It is the only part of the United Kingdom with a land border with Euroland; this permeable international frontier extends for 499 kilometres. Issues of fiscal disparities and volatile exchange rates are inevitably more important than on the mainland.

Historically, Northern Ireland was the only devolved territory of the United Kingdom from 1921-72. The period of Direct Rule (1972-99) exhibited both similarities and differences from the administrative devolution under a Secretary of State in the UK Cabinet already established for Scotland and Wales. During that period, Northern Ireland nevertheless retained much of the administrative apparatus of devolution.

With devolved government restored to Northern Ireland in 1999, it now enjoys the company of Devolved Administrations in Scotland and Wales – an immense advantage compared to the previous exceptionalism. Nevertheless, there remain important differences. Most particularly, Northern Ireland remains exceptional in a political sense, since its party system bears no relationship to that on the mainland, isolating it at the informal levels which are so influential. Its proximity to Euroland brings both opportunities (riding on the back of the Celtic Tiger) and problems (certain fiscal disparities²⁴ with the Republic of Ireland are likely to survive because of the UK-wide repercussions of changes). The theoretical opportunities to customise policy to Northern Ireland circumstances and needs were not taken, either under devolved government or under Direct Rule, for reasons which were then held to be persuasive by relevant decision-makers.

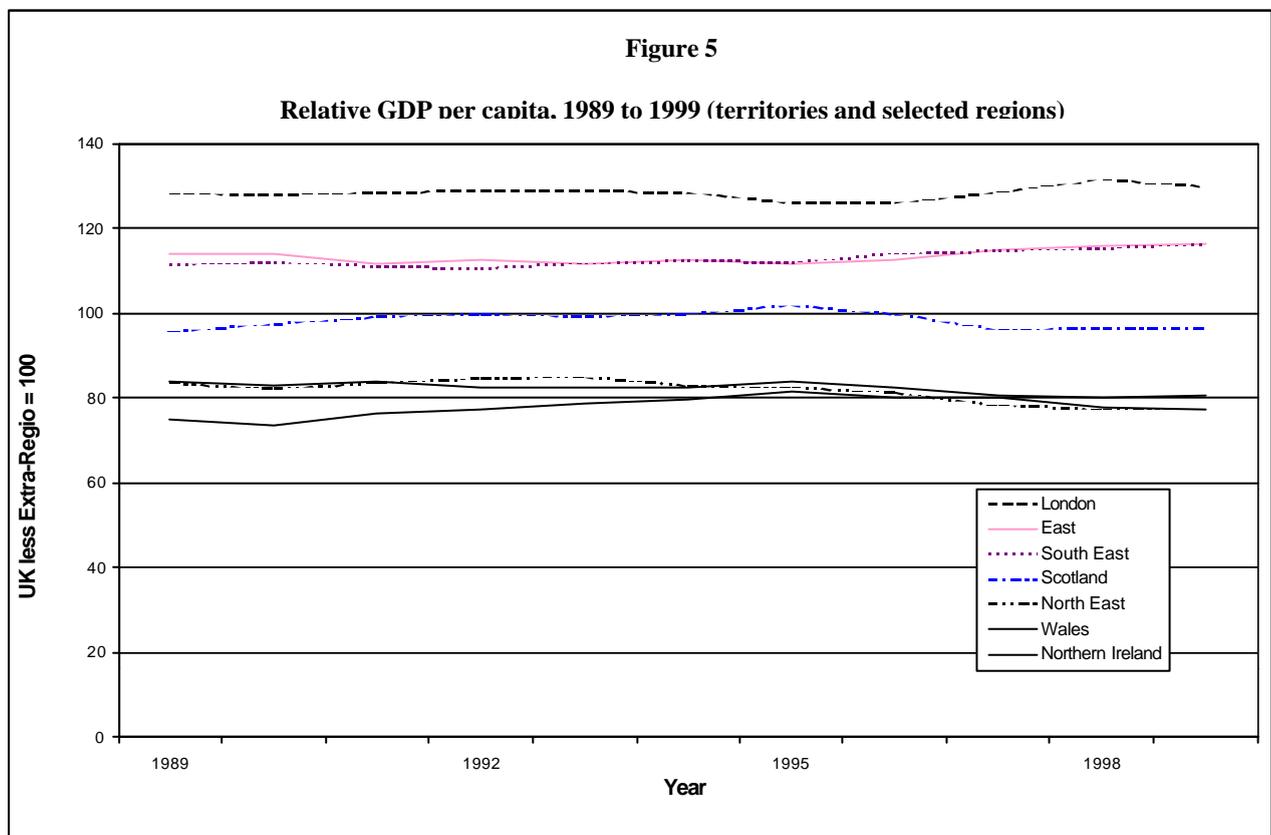
Care has to be taken with Northern Ireland economic data. Northern Ireland is comparatively small to be treated as an economic region. There have clearly been economic incentives to exploit fiscal, subsidy and exchange rate differences, leading to substantial economic distortions near the border and hence problems with economic statistics. Adjustments for the estimated importance of the black economy are made in the UK national accounts to the individual components of GDP at the UK level, but not at the regional level. Casual empiricism suggests that the black economy might be more extensive in, say, London and Northern Ireland than elsewhere. Regional economic data must always be treated with a degree of caution.²⁵

²⁴ Those in relation to petrol duties and corporation tax are much discussed.

²⁵ The Office for National Statistics (ONS) Regional Accounts were withdrawn in November 2002 because ONS found errors in the Annual Business Inquiry after publication of revised data to 1999. The re-revised figures are expected to be published by ONS in spring 2003.

3.1 Northern Ireland Context

Figure 5 plots indexes of regional GDP per capita for Scotland, Wales, Northern Ireland and certain English regions;²⁶ the England index is consistently just over 100 and is not shown. On this measure, Northern Ireland is one of the poorest UK regions, but it has not experienced a fall in its index comparable to that of Wales (from 84.0 in 1989 to 80.5 in 1999) and the North East (from 83.1 to 77.3). By far the strongest UK regions are London, East and South East. There has to be care in interpreting changes in an index over relatively short periods because the spread of the index widens during periods of strong economic growth and narrows in periods of recession.

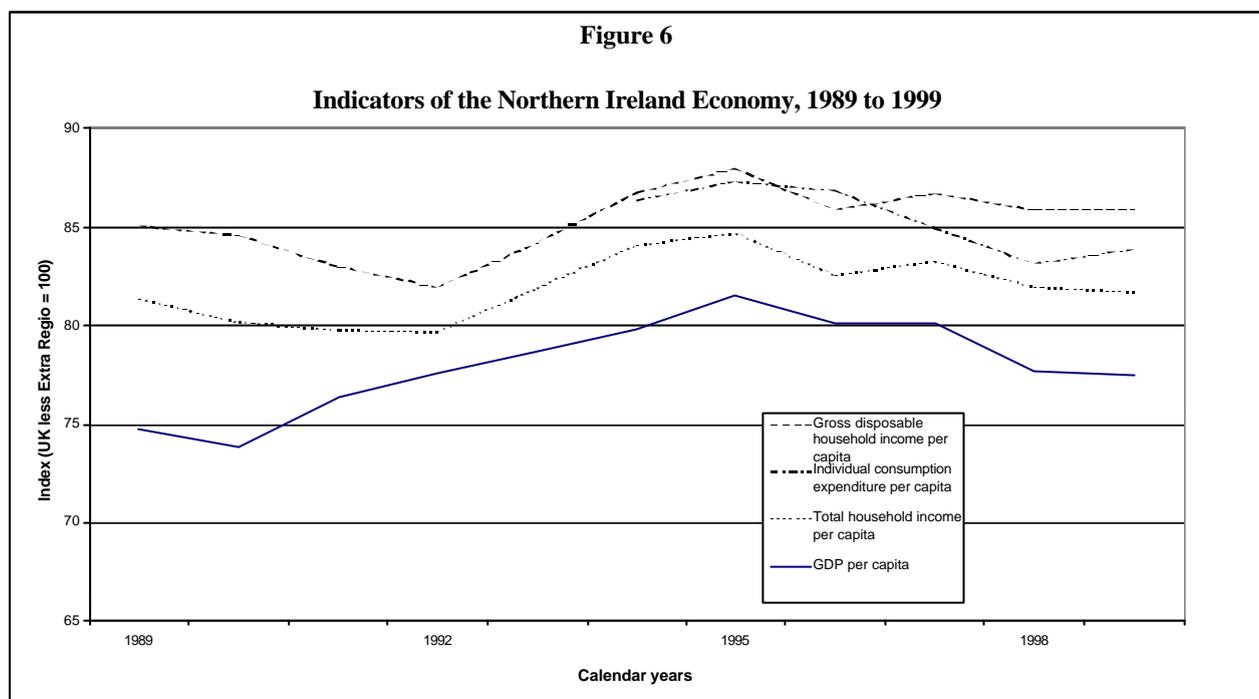


Source: Office for National Statistics (2002), Table 12.1.

Figure 6 concentrates exclusively on the relative position of Northern Ireland. The most striking point is that the indicators closer to household welfare (gross disposable income per

²⁶ The United Kingdom consists of four countries, one of which (England) consists of eight regions, plus the notional 'Extra-Region'. The contribution to GDP of UK embassies abroad and UK forces stationed overseas is included in Extra-Region, along with the element of GDP relating to activities taking place on the continental shelf. As these cannot be assigned to specific regions they are assigned as "Extra-Region GDP" (Clifton-Fearnside, 2001, Background Note 13). Consequently, the United Kingdom is not the sum of the countries and regions.

capita and individual consumption expenditure per capita) are markedly higher than the GDP index. The gap between gross disposable income per capita and GDP per capita was 10.4 percentage points in 1989, and 8.4 percentage points in 1999.



Source: Office for National Statistics.

There is no necessary connection between relative GDP per capita and the relative need for public expenditure per capita, whether measured as ‘identifiable’ or ‘devolved’. For example, Scotland’s relative improvement on GDP per capita (its ranking among regions rather than its index) is often used as an argument that Scotland is over-funded for public services under the Barnett formula system. This argument is fundamentally misguided, particularly at the level of devolved expenditure. Three kinds of item dominate devolved expenditure: health; education; and (what is in Great Britain) support for local government expenditure (which includes primary and secondary education). Relative needs for such services are weakly related to relative GDP, and strongly related to demography (eg Northern Ireland has more schoolchildren per thousand population) and participation rates in publicly provided services (eg there is much less middle-class exit from publicly provided health and education outside London and the South East). Accordingly, a region with expensive demographics and high participation rates will exhibit a high level of relative need, irrespective of its relative GDP ranking.

There has been a dearth of recent work on public expenditure in Northern Ireland, symptomatic of a more general lack of applied economics research on its economy. This is

somewhat surprising given the excellence of some earlier work (Birrell and Murie, 1980, Lawrence, 1965) and the obvious importance of public expenditure to the economy and society of Northern Ireland. For example, there was no public expenditure chapter in the proceedings of the important 1996 British Academy conference, assessing 'Ireland North and South' (Heath et al, 1999).

The recent literature that does exist on Northern Ireland public expenditure is fragmentary and occasional. One of the difficulties confronting authors, especially when invited to contribute on Northern Ireland public expenditure to conferences or books, is that they have to start largely from scratch, as there is no ongoing systematic work. Examples of such writings are those by: McAlister (1994); Roper (1995); Smith (1996); Barnett and Hutchinson (1998); and Heald (1998). Northern Ireland public expenditure data were published in an obscure form; for example, the operation of the block system was less clear in the NIO Departmental Report than in the counterpart Scottish and Welsh documents.

Northern Ireland data have been traditionally more difficult to interpret than the Scottish data. Probably this reflects more vigorous probing by the Scottish Affairs Committee at Westminster (Heald and McLeod, 2002c, para 530). Moreover, the residual framework of the *Government of Ireland Act 1920* meant that some of the published material was liable to mislead rather than help. Another problem was terminology. Unlike in Scotland and Wales, what was described as the NI block was much broader than the formula-controlled block over which expenditure discretion could be exercised. Confusing presentation therefore hampered research and debate, though there were obviously inhibitors other than poor data.

3.2 The Legacy of History

In comparison with the process of establishing devolved government in Scotland and Wales, Northern Ireland has possessed some advantages and some disadvantages. Both, ironically, were rooted in institutional and financial history. On the positive side, Northern Ireland already had much of the necessary financial framework and institutional infrastructure, for example a separate Estimates system and the Northern Ireland Audit Office (NIAO), headed by the Comptroller and Auditor General for Northern Ireland. In retrospect, not having to build a new Parliament building was also a much greater advantage than it seemed before the Scottish and Welsh projects went hopelessly over cost, fully chargeable against their Assigned Budgets. On the negative side, the frozen inheritance of provisions contained in, or originating from, the *Government of Ireland Act 1920* had created something of a time warp. In particular, a gulf had developed between the formal financial system and the reality of expenditure planning, which had increasingly become more like that in Scotland and Wales. This effect had been reinforced by the suspension of 'normal politics' (for 27 years decisions were taken by Direct-Rule ministers with no 'local' accountability), rendering the financial system opaque and little discussed. Indeed, an inquiry by the House of Commons' Northern Ireland Affairs Committee (1998a, 1998b) into Northern Ireland expenditure programmes explored ground that Scotland began traversing in 1980 (Committee on Scottish Affairs, 1980).

The financial history of Northern Ireland is therefore important to an understanding of the present. The financial system of the *Government of Ireland Act 1920*, involving extensive revenue devolution and an Imperial contribution to Westminster, rapidly disintegrated under financial pressure (Gibson, 1996). The reality of a highly secretive system was that the 'parity' principle removed most of the financial autonomy statutorily guaranteed to the Stormont Parliament. Effectively, Northern Ireland was underwritten by the UK Treasury, provided that it matched UK changes to taxes and expenditure. From 1943 until 1972, the concept of 'leeway' (ie the need to catch up) was added to that of parity. Nevertheless, these principles were implemented in an ungenerous manner, with the inevitable result that public services in Northern Ireland continued to lag behind those in Great Britain.

Under the *Government of Ireland Act 1920*, the Stormont Parliament was to pay an Imperial contribution to the Westminster Parliament for reserved services. However, rather than the flow being from Northern Ireland to Westminster, the true direction was in time reversed (Gibson, 1996, Lawrence, 1965). The 1921-72 Stormont period clearly demonstrated the problems inherent in operating a revenue-based system, on an asymmetric basis and without systematic provision for equalisation.

Simpson (1984) remarked that what 'might be seen initially as an over-ambitious model' became 'a very fettered model of devolution'. This observation led on to two conclusions with continuing validity: first, that extensive devolution on a revenue-based system is doomed to failure in the absence of a secure scheme of fiscal equalisation, unless large disparities in public service provision would be tolerated; and second, that a strong case can be made in the UK setting for a block grant system:

... where the main taxes are levied on a standard basis throughout the country, a Block Grant finance system might be more appropriate and might make it more likely that there would emerge greater variation in policy (p. 189).

Simpson's conclusion was based on three considerations. First, within a unitary state, tax, transfer and public expenditure policies lead implicitly to transfers among regions. These are the automatic counterpart of the differential impact of such policies upon individuals, themselves grouped territorially. Generally speaking, these territorial transfers are poorly mapped and attract little attention. In contrast, funding mechanisms for devolved government tend to make them more explicit, even without any policy variation.

Second, there are the questions as to how much tax variation there should be, with respect to both bases and rates, and whether there will be equalisation of the tax base. The Stormont period was characterised by tax discretion, which was considerable in principle, but highly restricted in practice. Parity in tax rates and expenditure policies became the implicit condition of subventions, not envisaged in 1920, from the UK Exchequer. The precarious finances of Stormont were further undermined by the growth of person-related welfare state services, such as education, health and social security, which the Northern Ireland economy could not afford from its own resources. In consequence, the ambitious breadth of devolution compromised the substance.

Third, as noted by the Minority Report of the Kilbrandon Royal Commission on the Constitution (1973), devolved government can be financed on either of two bases. One is a revenue basis, with expenditure constrained by available revenue, perhaps enhanced by resources equalisation. The other is an expenditure basis, where a certain level of expenditure, perhaps validated by a needs assessment process, is funded from central government grants or assigned revenues.²⁷ These may be supplemented by marginal tax-varying powers, which permit upward or downward adjustments of expenditure. In practice, what happened in Northern Ireland was what was nominally a revenue-based system became in reality an expenditure-based one.

Simpson's conclusion, based on his interpretation of the 1921-72 period, has been given added weight by recent developments such as globalisation and European integration. The revenue basis, without equalisation, is more likely to be embraced by devolved governments expecting themselves to be rich, in relation to other governments within the same devolved system. This does not apply to Northern Ireland, which is likely to remain a low-resources, high-needs part of the United Kingdom.

Certain information on the public finances of Northern Ireland has been available in a reasonably consistent form because the financial shell of the *Government of Ireland Act 1920* remained in place, even when the fabric had been dismantled. The annual 'Public Income and Expenditure of Northern Ireland' White Paper Account was of no relevance to the operational control system, but was nevertheless interesting in terms of providing long runs of reasonably comparable data.²⁸

On the expenditure side of the annual White Paper Account, most expenditure was included in Supply Services. The income side is more interesting, as is shown by Figure 7. In this Figure, revenue sources are treated like seams, with the annual figures converted to percentages of total public income. The bottom seam is 'Other revenues', consisting of interest received, receipts from certain fees and asset sales, and certain other financial transactions. Regional and district rates, the levels of which are set in Northern Ireland, is the next seam. Then follows Northern Ireland's attributed share of UK taxes. Finally, taking the percentage to 100%, comes the Grant in Aid from the UK government, an arrangement made explicit under Direct Rule, as this was payable under the *Northern Ireland Constitution Act 1973*.²⁹

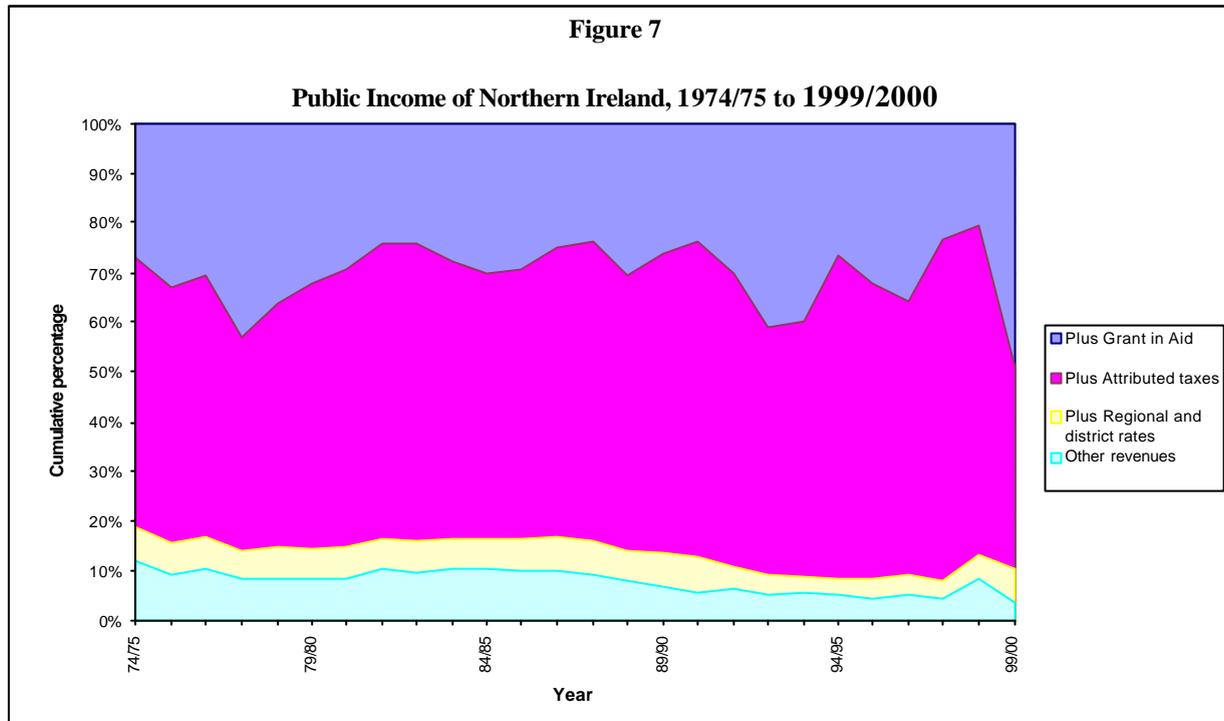
Over the Direct-Rule period, there was a drifting down of the percentage of public income attributable to sources other than the Grant in Aid. The 1999/2000 percentage of public income from sources other than the UK Exchequer was only 51%, though this might have been something of an outlier. The striking feature of Figure 7 is the unexpectedly jagged

²⁷ Heald and McLeod (2002b) discuss alternative models, particularly involving assigned revenues.

²⁸ Publication ceased, with effect from 2000/01, as a result of the *Northern Ireland Act 1998* (s. 100 and Sch. 15), which repealed the *Government of Ireland Act 1920*. Notwithstanding the long run of data, there are doubts about the quality of the data. Moreover, Slattery (1993) emphasised that the existence of multiple funds and channels means that such figures should not be interpreted as a measure of the subvention received by Northern Ireland from the UK Exchequer.

²⁹ In the 1999/2000 Account, there are separate lines for Grant in Aid and Block Grant (Department of Finance and Personnel, 2000, p. 6).

appearance. Apart from cyclical fluctuations in the public finances, one would have expected either greater stability or a clear trend; this is not the picture portrayed by Figure 7.



Source: Public Income and Expenditure of Northern Ireland, successive issues.

One reason for the lack of transparency of the financial relationships may have been the sensitivity attached to Northern Ireland's relationship with the Republic of Ireland. Repealing outdated provisions in the *Government of Ireland Act 1920* could have raised unwelcome diplomatic and domestic complications (Gibson, 1996). The co-existence of statutorily required documents (reflecting continuing provisions from the period of devolved government) and Treasury-mandated documents (reflecting Northern Ireland's position within the UK public expenditure system) rendered the financial system inaccessible.

The 'legacy of history' has long been recognised. Likierman (1985) quoted Mansergh (1936) on the 'financial relationship established between Northern Ireland and Great Britain': 'Neither its intentions nor its operation is understood by half the members of the Legislature, not to speak of the general public'. Writing during the Direct-Rule period, Likierman described the arrangements as 'obscure and cumbersome' (p. 103), concluding:

... the danger is that the impression of an arms length financial relationship will continue to foster economic and political illusions. The danger in [the Westminster] Parliament is that the obscurity of the arrangements will mean that Northern Ireland will continue to occupy a dimly understood half-in-half-out position in Westminster and that

there will be little understanding of the financial facts, either in Northern Ireland or in the rest of the UK (p. 104).

With devolution being part of a broader constitutional settlement, there is now an opportunity for building greater public understanding.

3.3 The Northern Ireland Funding System Before Devolution

The extent to which London dominates UK politics should never be underestimated. Whilst sometimes feeling slighted, the territorial departments appreciated the advantages of their total expenditure constituting a relatively small proportion of UK public expenditure, not least in the way that the Treasury's focus on the 'big numbers' keeps the territorial programmes out of view for most of the time. This is one reason why having a territorial formula has long been viewed as mutually beneficial.

The territorial fiscal system is of asymmetrical importance: it is crucially important for the territorial departments and their ministers, but is often fairly invisible to their counterparts at the centre. Joel Barnett's (1982) memoirs of his experiences as Chief Secretary to the Treasury (1974-79) never once mentioned the Barnett formula, an omission to which his attention was drawn during a Treasury Committee hearing on 13 November 1997 (Radice, 1997). Similarly, Roy Jenkins' (1998) chapter on George Goschen, one of his predecessors as Chancellor of the Exchequer (1887-92), never mentioned the Goschen formula, an omission noted in Donald Dewar's (1998) review of the book.

The operation of the earlier Goschen formula is even more badly documented than the Barnett formula. It was put forward by George Goschen in 1888 as a means of channelling money to education expenditure, and continued to be used in some form until the late 1950s. Heald (1992, pp. 54-57) explained the derivation of the Goschen proportions as 'the assignment of probate duties in the (rounded) percentages of ... overall contributions to the Exchequer'. The use for Scotland of one or the other of these two formulae for approximately 90 of the last 110 years is indicative of the enduring appeal of such a mechanism.

Formula links to mainland public expenditure acquired importance in the financing of the Northern Ireland Parliament once the financial scheme of the *Government of Ireland Act 1920* had effectively collapsed. The 'special formula', devised by the Northern Ireland Special Arbitration Committee (Colwyn, 1925), has been described by Gibson (1996, p. 33) as 'a kind of forerunner of the Barnett formula of some fifty years later'. It can also be seen as a successor to the Goschen formula which had continued to operate on the mainland (McPherson and Raab, 1988). Significantly, Gibson observed: 'none of this material was available for public scrutiny'.

What was described in published documents in the 1990s as the 'NI Block' was not comparable to the Scottish and Welsh blocks. The best way to explain the structure of the then Northern Ireland programme is to think in terms of three 'levels'.

The first level was the Northern Ireland programme which corresponded to expenditure within the responsibility of the Secretary of State for Northern Ireland; this was the focus of the Departmental Report (Department of Finance and Personnel and Treasury, 1999).

The second level excluded expenditure on national agricultural and fisheries support, which was excluded because these are greatly influenced by UK and EU policies. This is what was described in the Departmental Report as the 'NI block'.

The third level was described within Northern Ireland Departments as the 'managed block', though there was no explicit reference to this in the pre-devolution Departmental Reports (Department of Finance and Personnel and Treasury, 1997; 1998; 1999). This was the aggregate which corresponded to the Scottish and Welsh blocks; it was fed by the Barnett formula, and the Secretary of State for Northern Ireland held expenditure-switching discretion over it. Consequently, the managed block contained expenditure by the NIO, predominantly LOPS, as well as by Northern Ireland Departments. The favourable security situation at the time of the 1994 Survey allowed the then Secretary of State to switch expenditure from LOPS into other programmes; the reverse then occurred in the 1996 Survey.

Two further points should be noted. First, the Northern Ireland programme was narrower than identifiable expenditure in Northern Ireland, as annually published by the Treasury, but less so than in the cases of Scotland and Wales, largely because it included Social Security benefit expenditure. Second, there was public expenditure which took place in Northern Ireland, but which fell within the category which the Treasury treated as non-identified (most obviously, the costs of the British Army presence).

Gibson (1996) emphasised that the financial system had encouraged irresponsibility because of the soft budget constraint. UK taxpayers paid for the cost of the Troubles, and also fully funded Social Security benefits (which, at common UK rates and probably less strict enforcement, were more generous relative to private sector earning opportunities than in Great Britain).

A contentious issue in UK public expenditure has been the additionality, or otherwise, of EU programmes, most notably those concerning the European Regional Development Fund (ERDF) (Blewitt and Bristow, 1999). After disputes between the European Commission and the UK Treasury, a compromise was reached in 1992 (European Commission, 1992). Additionality would be 'tested' at the UK (ie member state) level. The Treasury then introduced a separate line in public expenditure tables, identifying ERDF programmes, and stated that public expenditure at the UK level is higher than would have been affordable without such ERDF receipts. Obviously, there is no way of demonstrating that this has not happened. Also, there is no way of demonstrating that public expenditure in the beneficiary region is higher than it would otherwise have been.

From the viewpoint of the territories, this denied them tangible benefit from, for example, Objective 1 status.³⁰ However, the illusion seems to have been perpetuated by the belief that

³⁰ The European Union website provides the following explanation: 'Objective 1 of the Structural Funds is the main priority of the European Union's cohesion policy. In accordance with the treaty, the Union works to "promote

EU programmes made sceptical publics more favourable to the European Union itself and, specifically in the case of Northern Ireland, promoted valuable cross-community collaboration. The territorial departments valued the advantages of the block grant system fed by automated Barnett formula consequences. This issue of EU funding was not viewed as sufficiently large in expenditure terms to be worth the risk of destabilising the broader framework. From a Northern Ireland perspective, the incremental effect of Objective 1 status was much lower than for the Republic of Ireland, for which testing at the member-state level encouraged genuine additionality. In contrast to main ERDF programmes, the EU Peace and Reconciliation Programme is additional, in the conventional meaning of that term. However, Gudgin (1996, 2000) has de-emphasised the impact of EU funding on the Northern Ireland economy.

A recurrent theme in the academic literature on public expenditure in Northern Ireland has been that the large size of the local public sector has crowded out the private sector. These concerns operate on two distinct levels. First, a larger proportion of the workforce than in Great Britain is employed in the public sector,³¹ where wages and salaries are pitched at the GB level. In contrast, local private sector pay rates markedly lag Great Britain, by about 20 percentage points, a differential usually explained in terms of industrial structure and low productivity. The argument has been that higher skilled employees were absorbed into the public sector, denying their availability to embryonic, higher value-added private sector activities (Barnett and Hutchinson, 1998). Second, the combination of lower private sector wages, UK benefit rates and laxer enforcement of benefit regulations (Gibson, 1996, Gudgin, 1999) provides a structural basis for higher unemployment rates.

Co-existing alongside these concerns has always been a countervailing factor: the high levels of public expenditure on employment, implicitly financed from Great Britain, have supported Northern Ireland GDP and incomes. This leads to a concern that reductions in public employment will remove one of the strongly positive factors at the macro level. Moreover, in recent years, the growth of public expenditure and public sector employment in the Republic of Ireland has created a new market for public sector manpower and skills. For certain categories of employee, Northern Ireland public services may be now competing more with the Republic of Ireland than with Great Britain.

3.4 The Northern Ireland Funding System Under Devolution

To a greater extent than in Scotland and Wales, the funding system for devolution in Northern Ireland has been a black box which attracted little attention. For example, the question of peace naturally dominated the Northern Ireland referendum (22/05/98), in contrast to Scotland

harmonious development” and aims particularly to “narrow the gap between the development levels of the various regions”. This is why more than 2/3 of the appropriations of the Structural Funds (more than EUR 135 billion) are allocated to helping areas lagging behind in their development (“Objective 1”) where the gross domestic product (GDP) is below 75% of the Community average... Some fifty regions, home to 22% of the European population, are covered in the period 2000-06’ (Regional Policy - Inforegio, 2002).

³¹ Comparisons of the proportion of public employees in Northern Ireland, in relation to that in Great Britain, need to take account of the coverage of the public sector: certain activities, privatised in Great Britain, have not been privatised in Northern Ireland. Obvious examples are the rail and bus networks.

(11/09/97), where the tax-varying powers were controversial, and Wales (18/09/97). The synchronised wording of the July 1997 White Papers (Scottish Office, 1997, Welsh Office, 1997b) on the role of the Barnett formula did a certain amount of embedding.

Given that there was much less attention to the financial mechanics in Northern Ireland, the necessary consequence of the Barnett formula that headline percentage increases would be lower than in England was not widely appreciated. Ironically, 'reviewing Barnett' became in Northern Ireland a plea for more funding whereas, in London, this had become shorthand for cutting the Assigned Budgets. There was almost no public attention in Northern Ireland to the overall position, necessarily involving consideration of the baseline. It became accepted across all Northern Ireland parties that Northern Ireland was being treated badly by the Barnett formula system and would benefit from a review, in terms of higher resources. Without a full needs assessment, it is impossible to know how the Northern Ireland expenditure index would compare with its needs index. However, at present, it seems more likely that the expenditure index would exceed the needs index, than vice versa.

Devolution has markedly altered the context in which the Barnett formula is operated. First, the Barnett formula has become a mechanism for transferring resources *between tiers of government*, and not a mechanism *internal to one government* (Heald and Geaghan, 1998). The intensity of political and media interest gives some indication of what the future holds. The lack of transparency, characterising the past use of the formula, will no longer be sustainable. The failure to collect or to publish relevant information will be challenged. For example, the Treasury did not publish figures for expenditure comparable to the territorial blocks until March 1999 (Treasury, 1999a), and even then the form of publication was singularly uninformative. There were improvements in the subsequent issues of the block funding rules (Treasury, 2000a; 2002b), though much improvement is still required.

The following exposition focuses upon how the system of devolved financing now operates for Northern Ireland, whilst providing some discussion of certain features (eg the treatment of EU funding) which have continued, unchanged by devolution.

3.4.1 The Structure of Expenditure

Devolution brought significant changes to the structure of government in Northern Ireland. Hadden (2001) explained the distinction between transferred (ie devolved), reserved (ie presently held by the Secretary of State for Northern Ireland), and excepted (ie outside the scope of devolution) functions. This terminology is different from that in Scotland and Wales, where 'reserved' is used in the sense of 'excepted'.

NIO functions, mostly in relation to LOPS, were removed from the managed block, and thereby taken outside the scope of the Barnett formula. The budgets for these reserved services would therefore be settled bilaterally between the NIO and the Treasury. Before devolution, the Department of Finance and Personnel (DFP) had acted as a mini-Treasury for the Secretary of State for Northern Ireland, effectively bridging the gap between Northern

Ireland Departments (Northern Ireland Civil Service) and the NIO (the UK Civil Service). Under devolution, the finances of the NIO are more separate than before.

These changes had two financial effects. First, transferred services could not benefit from such a 'peace dividend' within the managed block, something which had been widely anticipated (Gorecki, 1995, Roper, 1995). Second, devolved functions were protected from the redundancy costs associated with the contraction of policing and prisons, expenditure which would be both large and irregular in timing. Therefore, Northern Ireland sacrificed the notional gains from the peace dividend for such protection, without which programmes could have been seriously disrupted.

3.4.2 The Operation of the Barnett Formula

For 20 years, there was little formal documentation in the public domain as to how the territorial block actually operated. The election of the devolved Parliament and Assemblies was necessarily going to change this. The Treasury (1999a) made public the block rules on 31 March 1999, shortly before the elections in Scotland and Wales. Revised versions were published in July 2000 (Treasury, 2000a) and July 2002 (Treasury, 2002b), just after the publication of the results of SR 2000 and SR 2002.

The July 2002 document, like its 1999 and 2000 predecessors, included a schematic representation of the devolved funding system for Northern Ireland. Reproduced as Figure 8, this demonstrates clearly that the component of expenditure controlled by the Barnett formula is a large part of the total, but not the whole picture. Figure 8 shows that the DEL for the Northern Ireland Assembly has two principal components. The first, and by far the largest, part is the Assigned Budget (formerly the managed block), changes to which are governed by the Barnett formula. The second component is outside the formula mechanism, consisting of specific items³² that are negotiated bilaterally. Similarly, AME has two components: certain items categorised within main programme spending (eg Social Security benefits); and certain items categorised within 'other AME' (eg District Councils' self-financed expenditure). The Barnett formula is not used in relation to AME. In practice, expenditure in AME falls into two categories, which are very distinct in character: that which is most directly controlled by the Treasury on a bilateral basis; and that expenditure which represents the self-financing discretion of the Devolved Administration.

³² In the July 2002 document, the one item remaining in the Non-Assigned Budget is the EU Peace and Reconciliation Programme II. Previously, there were other items: Welfare to Work (in Assigned Budget DEL from 2001/02); Hill Livestock Compensation Allowances (first renamed Less Favoured Areas Support Scheme and in Assigned Budget DEL from 2003/04); and the ERDF gas link and electricity interconnector. The possibility of items being in Non-Assigned Budget DEL remains important, even if this channel now appears to be falling into disuse.

Figure 8
The Public Expenditure Regime for the Northern Ireland Assembly

Public Expenditure Regime		
Assigned Budget	Non-Assigned Budget	
Departmental Expenditure Limit (DEL)		Annually Managed Expenditure (AME)
Barnett Formula determined	Non-Barnett determined	Main programme spending
Agriculture Trade and industry Employment Energy Roads and transport Housing Environment and water Fire Education Health Social security administration Public corporations & other public services Student Loans: implied subsidies and provision for bad debts Capital Receipts Initiative Trust Debt Remuneration Fossil Fuel Obligation Bus Fuel Duty Rebate	EU Peace Programme	Common Agricultural Policy
		Social Security benefits
		NHS and Teachers' Pensions
		Other AME: Certain accrual items such as capital charges for roads and the Water Service
		District Councils' self financed expenditure
		Regional Rates

Source: Treasury (2002b), p.36

The purpose of Table 7 is to convert the diagrammatic representation of Figure 8 into numbers. The aim is to treat items on the basis on which they were treated in a particular financial year. Consequently, this involves discontinuities when treatment changes. In the present context, this is a more interesting approach than adopting a consistent retrospective treatment across years. In this way, the full operation of the Northern Ireland Assembly

expenditure regime can be documented. The Budget documents presented to the Northern Ireland Assembly by the Minister of Finance concentrate almost exclusively on DEL (ie the controllable part).

Table 7 is complicated by the transition from cash (1999/2000 and 2000/01) to RAB Stage 1 (2001/02 and 2002/03) and then to RAB Stage 2 (2003/04 onwards). Consequently, years expressed on different bases are not comparable. DEL is subdivided into the Assigned Budget (ie Barnett formula controlled) and Non-Assigned Budget components. Notwithstanding the complexities introduced by there being items within the Non-Assigned Budget, it is clear that the Assigned Budget dominates DEL. Welfare to Work was absorbed into the Assigned Budget in SR 2000 (taking effect from 2001/02) and the Less Favoured Areas Support Scheme (formerly Hill Livestock Compensation Allowances) in SR 2002 (taking effect from 2003/04).

The only remaining item within the Non-Assigned Budget is the fully additional EU-funded Peace and Reconciliation Programme II. There is a great deal of misunderstanding about the impact of EU funding and how this relates to the overall financial system. Devolution did not change these EU funding arrangements, but gave them more visibility. The absence of additionality at the Wales level for the newly acquired Objective 1 status for West Wales, covering 63% of the land area and 64% of the population, contributed significantly to the downfall of the first First Secretary (Alun Michael). The subsequent concession to Wales, announced in July 2000 as part of SR 2000 (Treasury, 2000c, para 21.3), allowed additionality 'above Barnett' for ERDF receipts, but not for the matching funding which required to be found from within the Welsh Assigned Budget.³³ Like the Scottish Highlands & Islands, Northern Ireland lost Objective 1 status for the 2000-2006 programming period, but was awarded a compensatory programme (Department of Finance and Personnel, 2001b, European Commission Directorate-General Regional Policy, 2001). The forthcoming enlargement of the European Union will fundamentally alter regional support arrangements in the next programming period: this may involve countries which would account for 28% of the enlarged EU population but only for 11% of the enlarged EU GDP (Eurostat, 2001).³⁴

Regarding the EU Peace Programme (Department of Finance and Personnel, 2001a), the size of the fully additional expenditure within the Non-Assigned Budget is small relative to the total budget of the Northern Ireland Assembly. The administrative costs of this type of programme are exceptionally high. It has been justified in terms of the intangible benefits associated with the Programme, such as international goodwill and extensive public engagement and support. Notwithstanding these benefits, there are two dangers to be avoided.

³³ A media campaign to secure Scotland equal treatment instantly stopped when someone pointed out that what was beneficial to Wales at a time of increasing EU receipts would be detrimental to Scotland during a period of decline. Exactly the same consideration applies to Northern Ireland.

³⁴ These figures are based on 2000, and take into account 12 of the 13 countries designated as 'candidate countries' by the European Union. Turkey is excluded as it is not expected to accede to the European Union in the near future. GDP figures are adjusted for purchasing power parities in order to improve comparability.

Table 7					
The Northern Ireland Assembly Expenditure Regime (pro forma)					
	1999/2000 cash	2000/01 cash	2001/02 Stage 1 RAB	2002/03 Stage 1 RAB	2003/04 Stage 2 RAB
Departmental Expenditure Limit					
<i>Assigned Budget</i>					
Barnett formula-determined DEL	XXX	XXX	XXX	XXX	XXX
<i>Non-Assigned Budget</i>					
Welfare to Work (now in Assigned Budget)	xxx	xxx			
Housing loan charges ¹ (now in Assigned Budget)	xxx	xxx			
Less Favoured Areas Support Scheme (now in Assigned Budget)	xxx	xxx	xxx	xxx	
EU Peace and Reconciliation Programme	xxx	xxx	xxx	xxx	xxx
ERDF gas link and electricity interconnector ²	xxx	xxx	xxx		
DEL Total	XXX	XXX	XXX	XXX	XXX
Annually Managed Expenditure					
<i>Main Programme Spending</i>					
Common Agricultural Policy	xxx	xxx	xxx	xxx	xxx
Social Security benefits	xxx	xxx	xxx	xxx	xxx
NHS and teachers' pensions	xxx	xxx	xxx	xxx	xxx
New Deal 50+			xxx	xxx	xxx
Notional, non-cash items			xxx	xxx	xxx
AME Total	XXX	XXX	XXX	XXX	XXX
Overall Total	XXX	XXX	XXX	XXX	XXX
NOTES:					
¹ This represented a minor adjustment for changes in NIHE borrowing costs outside a certain threshold, either up or down; this adjustment was discontinued in SR 2000.					
² As from 2002/03, there is no further spending on the ERDF gas link and electricity interconnector.					
³ The original intention was to populate this Table with numbers relevant to each financial year, on the basis of the treatment of items in that year. However, it has not been possible to produce a version of the Table which can be reconciled with the published Budget documents. Accordingly, a pro forma treatment has reluctantly been adopted. As at the December 2001 Budget, and on a RAB Stage 1 basis, in 2001/02 the Assigned Budget constituted 46.5% of the Overall Total; the Non-Assigned Budget 1.0%; and AME 52.5%.					
<i>Source: Various Budget documents, with additional information supplied by the Department of Finance and Personnel</i>					

First, the time-consuming nature of programme implementation should not divert attention from the tasks of securing Value For Money (VFM) and avoiding underspending on main programmes. Second, additionality tests involve risks. If expenditure would not have been otherwise undertaken, that might indicate a low priority relative to other programmes. There is also the possibility that there might be an overhang of locked-in expenditure, arising from expectations of continued funding after the expiration of this additional funding, whatever the formal conditions of the grant. Accordingly, the importance attached in Northern Ireland to 'sustainable' programmes is to be welcomed.

The Assigned Budget is overwhelmingly important within the funding system. Over the past 20 years, there have been several outsider accounts of the operation of the Barnett formula (Bell et al, 1996, Heald, 1994), and a report by the Treasury Committee (1997). However, these accounts of the process lacked access to the relevant data held within government. Accordingly, the publication of the block rules in the funding policy documents (Treasury, 1999a; 2000a; 2002b) was an important landmark. Nevertheless, crucial information is still missing, for example a series for that expenditure in England which is comparable to expenditure in the Northern Ireland Assigned Budget. Until this information reaches the public domain, conclusions about the operation of the formula have to remain tentative.³⁵

Table 8, which is based upon Annex C of Treasury (2002b), explains the calculation of formula consequences, whereby changes in comparable expenditure in England automatically generate changes to the Assigned Budgets. One reason for the complex structure of Table 8 is that, owing to differences in functional responsibilities, there must be separate calculations for Scotland, Wales and Northern Ireland.

The first column of Table 8 shows the provision in England for 2002/03 (as in July 2002) for each programme. Subsequently there are two columns each for Scotland, Wales and Northern Ireland. The first of the pair of Northern Ireland columns shows the percentage of expenditure which, at the sub-programme level explicitly shown in Annex C (but not in Table 8), is comparable to the Northern Ireland Assigned Budget. This percentage is then applied to the provision in England (column 1) in order to calculate the second of the pair of columns for

³⁵ The following exchange in 2002 between the House of Commons Scottish Affairs Committee and the Scotland Office illustrates just how far there is to go in terms of the transparency of formula operation:

'Paragraph 6 of the Supplementary Financial Memorandum states that "the levels of comparable England spending are not readily available". It is difficult to understand how it is possible to calculate the changes to comparable England spending without the Treasury having data on the levels of such spending for a multi-year period. The Committee would like to have this information, for the years 1999-2000 to 2003-04, with the same level of programme detail as provided in the table in paragraph 3 of the Supplementary Financial Memorandum' (Scottish Affairs Committee, 2002, requesting information on 31 July 2002).

'It is difficult to determine exactly how much is spent in England on services which are devolved in Scotland. The Barnett formula determines increases in provision, not levels of provision. The nature of services devolved in Scotland, Wales and Northern Ireland varies between each country. The detailed arrangements for, for example, local government spending varies between countries. Also, some types of spending exist in one country but not another, for example water is privatised in England but not Scotland... As previously explained to the Committee, therefore, figures on the level of devolved spending in England are not routinely available. However, data on identifiable total managed spending by country are published in chapter 8 of Public Expenditure: Statistical Analyses 2002-03 (Cm 5401)' (Scotland Office, 2002, replying on 6 December 2002).

Northern Ireland. For example, Health in Northern Ireland is 99.66% comparable, whilst Local Government is 40.68% comparable.

These percentages are a weighted average of the comparabilities of the sub-programmes within the main programmes. This averaging process is necessary because, at the time of a Spending Review or Budget, the total change for the Whitehall department is likely to be settled before the detailed composition is determined. Thus, for reasons of speed, the weighted comparability is applied to the change in the English programme.³⁶ The overall comparability percentage for Northern Ireland, shown as 72.91%, is not actually used for any calculation.

The final step in the calculation is to multiply the Northern Ireland population percentage (3.40% in SR 2002) by the product of the actual change in, say, Health expenditure in England and the Northern Ireland comparability percentage (99.66%) for Health.³⁷ The sum of these changes on all programmes represents the Barnett formula consequences, which are then added to the Assigned Budget DEL, over which the Northern Ireland Executive has full expenditure-switching discretion.

³⁶ Prior to the top-down reforms of the public expenditure management system in 1992 (Heald, 1995), formula consequences were calculated at sub-programme level.

³⁷ Accordingly, an increase in Health expenditure in England of £100 million would increase the Northern Ireland Assigned Budget DEL by £3.39 million. This is calculated as £100 million multiplied by 99.66%, then multiplied by 3.40%. Whether this increment is in fact allocated to the Northern Ireland health programme is a matter for the Executive and the Assembly.

Table 8

Comparable English Expenditure and Comparability Percentages (Scotland, Wales and Northern Ireland)

Programme description	2002/03 Provision £ ,000s	% expenditure comparable to Scotland	Comparable English expenditure (S), £ ,000s	% expenditure comparable to Wales	Comparable English expenditure (W), £ ,000s	% expenditure comparable to Northern Ireland	Comparable English expenditure (NI), £ ,000s
Education and Employment	23,324,437	99.72%	23,259,022	93.08%	21,709,886	99.83%	23,284,197
Health	58,232,985	99.62%	58,011,774	99.62%	58,011,774	99.66%	58,032,718
Transport	8,222,401	86.77%	7,134,812	60.20%	4,949,757	89.88%	7,390,379
Office of the Deputy Prime Minister	5,793,550	99.57%	5,768,864	98.41%	5,701,470	99.54%	5,766,816
Local Government	37,648,469	55.82%	21,015,969	99.98%	37,641,969	40.68%	15,314,341
Home Office	9,878,234	99.76%	9,854,136	0.76%	75,236	2.60%	257,309
Legal Departments	3,280,766	95.87%	3,145,280	0.00%	0	1.56%	51,048
Trade and Industry	4,456,541	22.47%	1,001,528	21.86%	974,297	28.07%	1,251,059
Agriculture	2,668,577	83.11%	2,217,875	81.44%	2,173,375	85.49%	2,281,488
Forestry	105,668	100.00%	105,668	100.00%	105,668	100.00%	105,668
Culture, Media and Sport	1,441,929	92.10%	1,328,000	86.25%	1,243,699	97.13%	1,400,561
Work and Pensions	6,465,236	8.65%	559,299	8.65%	559,299	100.00%	6,465,236
Chancellor's Departments	4,541,235	(0.03%)	(1,161)	(0.03%)	(1,161)	3.55%	161,063
Cabinet Office	1,277,534	4.41%	56,335	4.41%	56,335	18.57%	237,186
Total	167,337,562	79.75%	133,457,401	79.60%	133,201,604	72.91%	121,999,069

NOTES:

1. Regarding 'Domestic Agriculture', the following explanation appears in Treasury (2002b): 'The comparability for the Agriculture programme was determined on a Great Britain basis for the 1998 Comprehensive Spending Review. United Kingdom domestic agriculture for Scotland and Wales was therefore calculated by allocating a population share of changes in domestic spending for England. Agriculture sub-programmes have now been re-aligned to reflect spending within England.'
2. 'Social Security' refers only to the administration of benefits, not to benefit expenditure.

Source: Treasury (2002b), p.45-66.

Table 9 provides the full set of comparabilities at sub-programme level for Local Government. Although not a typical case, this shows how there can be interconnections between the devolved funding system for Northern Ireland and the highly complex local government finance system in England. For example, a large increase on one of the 100% comparable sub-programmes on Local Government would only augment the Assigned Budget by the weighted average for the programme. For example, an increase of £100 million would bring formula consequences of £1.38 million (using the weighted average) rather than £3.40 million (using 100%). How the Treasury defines the level at which comparability is exercised is clearly of fundamental importance.

A great deal of concern has been expressed in Northern Ireland about the so-called 'Barnett squeeze'. The main discussion will be postponed until Chapter 5. However, two points should be emphasised here. First, the reason why there is so much discussion at present is, paradoxically, that public expenditure is currently growing so quickly. The Barnett formula delivers to Northern Ireland the same per capita increase as in England. Arithmetically, this is bound to be a smaller percentage increase on the much larger base. As was shown in Tables 3 and 5, the real rate of growth of public expenditure is unprecedented in recent times. The high rates of nominal growth in the 1970s were at times of high inflation and were not deliberately planned. If there were to be marked convergence, this would be through England catching up towards a much higher real level of expenditure in the territories than could ever have been envisaged in 1997.

Second, if public expenditure growth at the present rate were to be continued in the medium term, there would be considerable convergence in per capita indexes. This has not been seen in the past 20 years, though some convergence might have been expected given the properties of the Barnett formula.³⁸ The issue of how far convergence should go has not been addressed, but resolution probably means recourse to some kind of needs assessment. In the pre-devolution period, particularly after the 1992 top-down reforms to public expenditure management (Heald, 1995), there was an understanding that a territorial Secretary of State who thought that convergence was going too far could call for a needs assessment; this option was never exercised. The only published needs assessment was conducted in the 1970s (Treasury, 1979). However, there has been regular updating of that exercise by the Treasury, with major exercises in 1988 (undertaken by a Cabinet Office interdepartmental committee) and in 1994 (by the Treasury itself). The unpublicised nature of this updating, without any of the necessary transparency or institutional independence, might be seen as an implicit threat to the Devolved Administrations. For example, a UK government might suddenly announce that it has completed a new needs assessment, or the results might be spun to newspapers hostile to the Devolved Administrations.

³⁸ There are not enough data in the public domain to be confident about why more convergence has not occurred. Formula bypass and low rates of nominal expenditure growth, together with relative population decline in the case of Scotland, might be expected to be important (Heald, 1994).

Table 9
Comparability for Local Government (Scotland, Wales and Northern Ireland)

Sub-programme description	2002/03 Provision £ ,000s	% expenditure comparable to Scotland	Comparable English expenditure (S), £ ,000s	% expenditure comparable to Wales	Comparable English expenditure (W), £ ,000s	% expenditure comparable to Northern Ireland	Comparable English expenditure (NI), £ ,000s
Local Government							
National non-domestic rate payments - collection costs	83 606	100%	83 606	100%	83 606	100%	83 606
Valuation office rating services repayment	110 067	100%	110 067	100%	110 067	100%	110 067
Valuation tribunals	11 543	100%	11 543	100%	11 543	100%	11 543
Valuation Office Council Tax Services Repayment	16 670	100%	16 670	100%	16 670	100%	16 670
Revenue Support Grants (RSG) excluding Capital SSA and Law & Order	14 227 217	100%	14 227 217	100%	14 227 217	100%	14 227 217
RSG (Capital SSA and Law & Order)	5 701 628	100%	5 701 628	100%	5 701 628	0%	0
National non-domestic rate payments	16 626 000	0%	0	100%	16 626 000	0%	0
National non-domestic rate payments - City of London offset	6 500	0%	0	0%	0	0%	0
Credit approvals: commutation	8 000	100%	8 000	100%	8 000	100%	8 000
Local Government Publicity	738	100%	738	100%	738	100%	738
GI A Preparation Costs	6 997	100%	6 997	100%	6 997	100%	6 997
PEI Special Grant	210 000	100%	210 000	100%	210 000	100%	210 000
General GI A Grant	27 950	100%	27 950	100%	27 950	100%	27 950
Local Government Standards Board	7 900	100%	7 900	100%	7 900	100%	7 900
Rent Value Inspectorate	21 700	100%	21 700	100%	21 700	100%	21 700
Grants to beacon schools	1 700	100%	1 700	100%	1 700	100%	1 700
Rent value intervention costs	1 020	100%	1 020	100%	1 020	100%	1 020
UGC manning costs	400	100%	400	100%	400	100%	400
Invest to Save special grant	11 518	100%	11 518	100%	11 518	100%	11 518
Local Government on line	135 000	100%	135 000	100%	135 000	100%	135 000
Neighbourhood Renewal Fund	300 000	100%	300 000	100%	300 000	100%	300 000
PSA Performance Fund	130 000	100%	130 000	100%	130 000	100%	130 000
Local government research	2 320	100%	2 320	100%	2 320	100%	2 320
Local Government Total	37 648 469	55 82%	21 015 969	99 98%	37 641 969	40 68%	15 314 341

Source: Treasury (2002b), p.52-53.

3.4.3 The Presentation of Budgetary Plans

The Budget documents presented to the Northern Ireland Assembly focus upon DEL. The following discussion is anchored on the numbers presented in the Budget Statement of 11 December 2002 (Northern Ireland Office, 2002).³⁹

Derived from this latest Northern Ireland expenditure document, Table 10 provides a summary of total devolved spending from 2002/03 to 2005/06. The top section analyses spending by department. For two departments, upper and lower figures are provided, necessarily meaning that there are also upper and lower figures for Total Departmental Spend.

The middle section then shows the necessary steps to reach Total DEL. There are two expenditure items: Unallocated Executive Programme Funds⁴⁰ and the EU Peace and Reconciliation Programme II.⁴¹ There are two revenue items here netted off: target for asset sales and regional rates.⁴² The fifth item is a composite, as is explained in the note to Table 10. The sixth item is the anticipated underspend, with the difference between the upper and lower figures offsetting the difference between the upper and lower figures already discussed in the top section. The final step to reach Total DEL is to deduct borrowing under the new powers, £125 million in 2003/04 plan and £200 million in the following two years. Such borrowing therefore enables more expenditure of a DEL character to be undertaken.

The final section of Table 10 then shows the AME components. Benefits and Common Agricultural Policy expenditure are areas where the Executive has least policy discretion. New Deal 50+ is a very small item. Pensions is within AME because what scores is the residual of current pensions and transfers in and out of relevant superannuation schemes, and current contributions. Notional non-cash items are the result of the implementation of stage 2 RAB. Finally, borrowing under the Strategic Investment Programme is scored as AME.

Two further points about expenditure management in Northern Ireland are worth making. First, there is no DEL Reserve as there is, for example, in the UK plans. In practice, the problem of underspending is so pronounced that the December 2002 plans explicitly provide for shortfall. Second, DFP have not cascaded down to departments the new 1998 freedoms allowed by the Treasury to UK departments and the Devolved Administrations. The disadvantage is to postpone the managerial benefits of EYF which have been much proclaimed at the UK level. The advantages are that DFP control is reinforced, at a time of new departmental structures and of weak collective responsibility in the Executive. Moreover,

³⁹ Because of suspension, this document was tabled by the NIO, but relates to devolved expenditure within the responsibility of the Northern Ireland Assembly and Executive.

⁴⁰ Executive Programme Fund (EPF) was intended as a pot out of which Executive priorities could be funded, but in practice has been the subject of a second-round bidding process by departments. Although the numbers in the December 2002 Budget are no longer large, the existence of top slices to be allocated at a later stage means that percentage changes on other programmes have to be interpreted with caution.

⁴¹ This part of EU expenditure is genuinely additional; see Sections 3.3 and 3.4.3.

⁴² See Section 3.5 and Annex 3.1. 'Regional rates' is scored as negative public expenditure, meaning that higher revenue from this source allows more gross expenditure to be incurred whilst remaining within the Total DEL.

DFP's ability to recover unspent money in-year is a means of limiting the scale of underspend. The unusual nature of the Executive will be an enduring feature of devolved government in Northern Ireland, meaning that the balance of advantages regarding the extent of budget delegation may be different from elsewhere.

Table 11 presents the 11 December 2002 Budget in indexed real terms, having converted the data shown in Table 10. The budget weights in 2002/03, calculated on Total DEL, are revealing. Two departments dominate: Department of Health, Social Services and Public Safety (DHSSPS) and Department of Education (DE) together account for 63.2% of Total DEL (or 60.4% of Total Departmental Spend). Three other departments account for a further 26.8% of Total DEL: Department of Employment and Learning (DEL), 9.7%; Department for Regional Development (DRD), 8.7%; and Department for Social Development (DSD), 8.4%.

The conversion to real terms underlying Table 11 uses the latest GDP deflators available.⁴³ This allows for general inflation, not price changes in individual services. Total DEL (100 by definition in 2002/03 plan) is planned to be 110 in 2005/06. The 2005/06 index for Total Departmental DEL is 113 (lower end of range) to 114 (upper end of range). In terms of individual programmes, the strongest growth among the six larger departments is for DHSSPS (121). Only the Department of Enterprise, Trade and Investment (DETI) has a 2005/06 index (lower end of range 83; upper end of range 99) below 100. Finally, the Minister of Finance's intention to increase the proceeds of regional rates is demonstrated by its index being 112 in 2005/06.

The clarity of the Northern Ireland Executive Budget documents on successive changes to the Total DEL allows Table 12 to be assembled, largely from published sources. This starts with DEL immediately after the SR 2000 announcement in July 2000 (Treasury, 2000c), and finishes with the 11 December 2002 statement (Northern Ireland Office, 2002). There is a step-by-step reconciliation at each intermediate stage:

- 12 December 2000 Budget (Northern Ireland Executive, 2000);
- 25 September 2001 Draft Budget (Northern Ireland Executive, 2001b);
- 3 December 2001 Budget (Northern Ireland Executive, 2001a); and
- 5 June 2002 Position Report (Northern Ireland Executive, 2002).

Concentrating upon 2002/03, the evolution of Total DEL can be traced. Rather than go through each stage item by item, the approach adopted here is to highlight issues of importance and items that are numerically significant.

Table 12 demonstrates that the evolution of the Assigned Budget DEL depends upon more than just the application of the Barnett formula to changes in comparable expenditure. At each stage in Table 12, those changes attributable to the generation of Barnett formula consequences have been clearly labelled.

⁴³ Slightly different results would be obtained if alternative GDP deflators, which are issued by the Treasury three-monthly, were used. This would not affect the argument.

Table 10				
Northern Ireland Assembly Expenditure 2002/03 to 2005/06 (current prices, £ million)				
	2002/03 plan	2003/04 plan	2004/05 plan	2005/06 plan
Department of Agriculture and Rural Development	229.3	260.9	254.3	265.1
Department of Culture, Arts and Leisure	89.0	100.0	104.2	101.9
Department of Education	1,427.6	1,535.9	1,624.6	1,671.0
Department of Employment and Learning				
Upper end of range	631.9	710.3	738.0	755.7
Lower end of range	631.9	705.3	728.0	745.7
Department of Enterprise, Trade and Investment				
Upper end of range	275.6	291.8	289.0	294.3
Lower end of range	275.6	251.8	239.0	244.3
Department of Finance and Personnel	157.3	172.2	179.8	190.2
Department of Health, Social Services and Public Safety	2,693.7	3,094.5	3,248.3	3,496.6
Department of the Environment	116.5	136.9	136.4	146.8
Department for Regional Development	567.1	607.5	691.2	707.7
Department for Social Development	548.5	559.4	587.3	622.3
Office of First Minister and Deputy First Minister	35.1	47.0	46.0	48.2
Northern Ireland Assembly	50.4	52.2	52.2	52.2
Other Departments	6.4	7.6	8.0	8.3
Total Departmental Spend: Upper end of range	6,828.4	7,576.3	7,959.2	8,360.3
Lower end of range	6,828.4	7,531.3	7,899.2	8,300.3
Unallocated Executive Programme Funds	13.9	3.6	36.1	42.4
European Union Peace and Reconciliation Programme II	80.0	50.0	62.0	80.0
Target for asset sales		(9.0)	(15.0)	(15.0)
Regional Rates	(350.6)	(375.1)	(395.3)	(420.7)
Other items ¹	(46.0)	(16.6)	28.6	87.2
Anticipated underspend				
Upper end of range		(181.2)	(204.7)	(211.6)
Lower end of range		(136.2)	(144.7)	(151.6)
Total Spend	6,525.6	7,047.9	7,470.9	7,922.6
less borrowing		(125.0)	(200.0)	(200.0)
Total DEL (Assigned Budget + Non-Assigned Budget), net of Assembly Self-Financed Expenditure	6,525.6	6,922.9	7,270.9	7,722.6

Northern Ireland Public Expenditure

Annually Managed Expenditure (AME)				
Benefits	3,721.2	3,863.8	3,938.1	4,094.8
Common Agricultural Policy	179.3	186.9	186.7	187.5
New Deal 50+	1.6	1.0	1.0	1.0
Pensions	191.1	173.5	204.0	233.8
Notional non-cash items	1,459.6	1,657.9	1,669.9	1,681.9
Strategic Investment Programme expenditure financed by borrowing		125.0	200.0	200.0
Total AME	5,552.8	6,008.0	6,199.7	6,398.9
Total DEL plus AME	12,078.5	12,931.0	13,470.6	14,121.5
NOTES:				
¹ Other items include: RAB technical issues; items awaiting final decisions on allocations; expenditure to cover foreseen costs and End-Year Flexibility in those cases where the resources are distributed in-year.				
² This table is based on RAB Stage 2 figurework. Outturn figures would necessarily be on a cash basis for 1999/2000 and on a RAB Stage 1 basis for 2000/01 and 2001/02. Comparisons with previous years would therefore be meaningless. At the UK level, the lack of overlapping data currently makes it very difficult to identify trends in public expenditure (Heald and McLeod, 2002, para 496).				
³ The 2002/03 figures represent the position at the beginning of that financial year.				
<i>Source: Northern Ireland Office (2002), pp 14 and 61, with supplementary information supplied by the Department of Finance and Personnel.</i>				

Table 11					
Northern Ireland Assembly Expenditure 2002/03 to 2005/06 (index of real terms)					
	Budget weight in 2002/03	2002/03 plan	2003/04 plan	2004/05 plan	2005/06 plan
Department of Agriculture and Rural Development	3.51%	100.0	111.3	105.8	107.6
Department of Culture, Arts and Leisure	1.36%	100.0	109.9	111.7	106.6
Department of Education	21.88%	100.0	105.2	108.6	109.0
Department of Employment and Learning					
Upper end of range	9.68%	100.0	109.9	111.4	111.3
Lower end of range	9.68%	100.0	109.2	109.9	109.9
Department of Enterprise, Trade and Investment					
Upper end of range	4.22%	100.0	103.5	100.1	99.4
Lower end of range	4.22%	100.0	89.4	82.7	82.5
Department of Finance and Personnel	2.41%	100.0	107.1	109.1	112.6
Department of Health, Social Services and Public Safety	41.28%	100.0	112.4	115.1	120.8
Department of the Environment	1.79%	100.0	114.9	111.7	117.3
Department for Regional Development	8.69%	100.0	104.8	116.3	116.2
Department for Social Development	8.41%	100.0	99.7	102.2	105.6
Office of First Minister and Deputy First Minister	0.54%	100.0	131.0	125.0	127.8
Northern Ireland Assembly	0.77%	100.0	101.3	98.8	96.4
Other Departments	0.10%	100.0	116.1	119.3	120.7
Total Departmental Spend: Upper end of range	104.64%	100.0	108.5	111.2	114.0
	104.64%	100.0	107.9	110.4	113.2
Unallocated Executive Programme Funds	0.21%	100.0	25.3	247.8	283.9
European Union Peace and Reconciliation Programme II	1.23%	100.0	61.1	73.9	93.1
Target for asset sales			n/c	n/c	n/c
Regional Rates	-5.37%	100.0	104.6	107.6	111.7
Other items ¹	-0.70%	100.0	35.3	(59.3)	(176.5)
Anticipated underspend					
Upper end of range					
Lower end of range					
Total Spend	100%	100.0	105.6	109.2	113.0
less borrowing (AME)			n/c	n/c	n/c

Total DEL (Assigned Budget + Non-Assigned Budget), net of Assembly Self-Financed Expenditure	100%	100.0	103.8	106.3	110.2
Annually Managed Expenditure (AME)					
Benefits		100.0	101.5	101.0	102.4
Common Agricultural Policy		100.0	101.9	99.4	97.3
New Deal 50+		100.0	61.1	59.6	58.2
Pensions		100.0	88.8	101.9	113.9
Notional non-cash items		100.0	111.1	109.2	107.3
Strategic Investment Programme expenditure financed by borrowing			n/c	n/c	n/c
Total AME		100.0	105.8	106.5	107.3
Total DEL plus AME		100.0	104.7	106.4	108.8
NOTES:					
¹ Other items include: RAB technical issues; items awaiting final decisions on allocations; expenditure to cover foreseen costs; and End-Year Flexibility where the resources are distributed in-year.					
² This table is based on RAB Stage 2 figurework. Outturn figures would necessarily be on a cash basis for 1999/2000 and on a RAB Stage 1 basis for 2000/01 and 2001/02. Comparisons with previous years would therefore be meaningless. At the UK level, the lack of overlapping data currently makes it very difficult to identify trends in public expenditure (Heald and McLeod, 2002, para 496).					
³ The 2002/03 figures represent the position at the beginning of that financial year.					
⁴ 'n/c' indicates that an index could not be calculated since the 2002/03 baseline is zero.					
<i>Source: Northern Ireland Office (2002), with supplementary information supplied by the Department of Finance and Personnel.</i>					

However, four other sources of change to the Assigned Budget DEL can be identified. First, there are adjustments that are not done through the formula (eg £72.7 million in 2003/04 as part of SR 2002). Second, there are transfers into Assigned DEL (eg Welfare to Work from 2001/02) and out of Assigned DEL (eg non-cash water costs from 2002/03). Third, there is a sequence of technical adjustments, usually small but massive in the case of the conversion of the measurement basis from Stage 1 RAB to Stage 2 RAB (£866.9 million in 2002/03).⁴⁴ Fourth, there are other changes, such as the SR 2002 baseline adjustment in 2003/04 and the reprofiling of EU Peace and Reconciliation Programme II in 2003/04. Taken together, the number and scale of these changes, and the combination of positive and negative items, demonstrate that the changes to the Assigned Budget come from a wider range of factors than the Barnett formula. An assessment of whether the predicted convergence due to the mathematical properties of the Barnett formula is taking place cannot be made simply on the basis of the numbers published in successive Budget plans. For this to be done, full information on technical adjustments and on comparable programmes in England must be available.

⁴⁴ See the discussion of RAB in Section 4.5.

Table 12						
Modifications to the Northern Ireland Assembly Total DEL (£ million)						
	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
DEL as announced in July 2000 (SR2000)	5,306.1	5,667.4	5,973.2	6,294.1		
Changes:						
CAP modulation		3.0	4.0	4.5		
Technical adjustments:						
Welfare to Work		52.4	52.4	52.4		
New Deal for Schools		8.2	8.2	8.2		
Other		2.9	0.7	1.0		
Barnett formula consequences on allocations after SR 2000		0.9	13.9	18.0		
DEL at time of 12 December 2000 Budget	5,306.1	5,734.8	6,052.5	6,378.2		
Changes:						
Technical adjustments:						
Reclassification of Community Care from AME to DEL			19.0	21.5		
Other technical transfers		4.9	(1.6)	(1.9)		
Barnett formula consequences from March 2001 Budget		19.5	21.3	21.4		
DEL at time of 25 September 2001 Draft Budget		5,759.2	6,091.2	6,419.2		
Changes:						
Barnett formula consequences from November 2001 Pre-Budget		0.3	28.2			
DEL at time of 3 December 2001 Budget		5,759.6	6,119.4	6,419.2		
Changes:						
Technical adjustments			1.2	1.5		
SR2000 baseline adjustment				(22.0)		
RAB Stage 2 conversion			866.9	889.5		
Transfer of certain non-cash costs from DEL to AME ¹			(91.6)	(92.3)		
Barnett formula consequences from April 2002 Budget – Health			10.3	73.6		
DEL at time of 5 June 2002 Position Report (RAB Stage 2)²			6,906.3	7,269.5		
EL at time of 5 June 2002 Position Report (RAB Stage 2)²			6,906.3	7,269.5		
Barnett formula consequences from April 2002 Budget – Health ³				(72.4)		

Technical adjustments ⁴				(18.7)		
Reprofiling of EU Peace & Reconciliation ⁵				(80.0)		
Reclassification of water costs from DEL to AME ⁶			(373.0)	(393.0)		
Baseline for SR2002			6,533.3	6,705.4	6,705.4	6,705.4
Changes:						
Barnett formula consequences from SR2002				148.9	507.0	930.6
Non-Barnett changes from SR2002 ⁷				72.7	67.0	95.1
Technical adjustments			(7.6)	(7.8)	(8.5)	(8.5)
Barnett formula consequences from November 2002 Pre-Budget				3.6		
DEL at time of 11 December 2002 Budget			6,525.6	6,922.9	7,270.9	7,722.6
<i>Memorandum line: DEL Outturn</i>	<i>5,192.8</i>	<i>5,637.2</i>				
NOTES:						
¹ The non-cash costs involved relate to: local roads; personal social services; flood protection; and urban regeneration. In England, these functions would be discharged by local government.						
² Prior to the 5 June 2002 Position Report, all figurework is on a RAB Stage 1 basis, whereas all subsequent figurework is on a Stage 2 basis.						
³ This was removed to align with the baseline for SR2002, which was set before this addition. The sum was added back as part of the formula consequences from SR2002.						
⁴ £ 18.7m was taken out of the provision for 2003/04 as these items were not to be carried forward to future years. The items were subsequently added back, along with the Non-Barnett changes.						
⁵ This was removed to align with the baseline for SR2002. The sum was added back as part of the Non-Barnett changes from SR2002.						
⁶ It is only the non-cash costs associated with water (ie depreciation and cost of capital) that have moved to AME. This is contingent upon the Northern Ireland water system being self-financing by April 2006.						
⁷ This includes some pre-SR2002 Non-Barnett additions.						
<i>Source: Successive Northern Ireland Budget statements, with supplementary information from the Department of Finance and Personnel.</i>						

3.5 Fiscal Effort

‘Fiscal effort’ has a specific technical meaning in the public finance literature. With regard to sub-national governments, it refers to the extent to which they make use of the taxable capacity that they have acquired through the assignment of tax bases. In federations with systematic schemes of fiscal equalisation, such as Australia and Canada, the calculation of vertical transfers to be received from the federal government will involve assumptions about some standard level of sub-national fiscal effort.

In the United Kingdom, most taxes are raised by the central government and applied on a uniform basis. With regard to those limited cases of sub-national discretion, fiscal effort in Northern Ireland is much lower than that in Great Britain. In relation to property taxes, the Northern Ireland fiscal effort is only 55.3% of the England level.⁴⁵ However, this kind of comparison involves certain difficulties, especially when taxation systems diverge.

⁴⁵ The basis of this calculation is explained in Section 3.5.1 below.

The community charge was never introduced in Northern Ireland and therefore there was not the same transition, as in Great Britain, from a rental-value based domestic property tax, through community charge, to council tax, which is based on capital values. There are problems of comparison, even if the systems were identical. For example, the average tax might mean the average amount paid on a house of a certain value (council tax band D on the mainland), or the average amount paid by households (which will be heavily influenced by the distribution of domestic property values across council tax bands).⁴⁶ Moreover, a significant part of domestic rates and council tax is paid by the Social Security system. The fact that about 20% of increases in council tax are not met by council tax payers⁴⁷ is used by the Treasury in order to justify its powers to make offsetting reductions in the Assigned Budgets (Treasury, 2002b, para 5.3), should property tax increases in the Devolved Administrations be out of line with increases in England.⁴⁸

If fiscal effort is interpreted to include charges for public services as well as taxes, variations in fiscal effort can make expenditure comparisons even more difficult to interpret. The different allocation of functions in Northern Ireland from that in Great Britain between central and local government also hinders comparisons. It was shown in Table 2 that Northern Ireland's identifiable public expenditure per capita is much higher than England's; this is measured on a net expenditure basis. Higher net expenditure per capita can be the result of higher gross expenditure per capita, or of lower charges per capita, or of some combination. An important example is the absence in Northern Ireland of water and sewerage charges for the publicly provided service. Industrial derating is another example of lower fiscal effort. Under the present funding system, this means that expenditure of an equivalent amount is foregone, that other charges or taxes must be higher, or some combination of these.

3.5.1 Property Taxes

The lower yield of property taxes in Northern Ireland is connected in part with the much-reduced scope of local government, following the Macrory Report (1970). This led to a single-tier local authority structure with limited functions; major areas of spending were pulled back into central government departments and other centrally-controlled bodies (Carmichael, 1996).

The academic literature scores property taxes highly as suitable revenue sources for sub-national governments, and they are used throughout the world for this purpose. However, two issues have to be addressed. The first is ensuring that the tax base is kept up to date by means

⁴⁶ In Great Britain, there are two different banding systems for council tax: one system applies to England and Wales, and another system (which applies the same band labels to lower property price brackets) applies to Scotland. It is also relevant to note that resources equalisation to offset differences in tax bases is conducted separately in England, Scotland and Wales, and not at the GB level.

⁴⁷ Gieve (1997) illustrated some of the complex interactions between local government revenue-raising and central government expenditure. For example, part of incremental council tax revenue will be met from the Social Security budget. Moreover, local authorities have recognised that increasing council rents provides them with access to the Social Security budget.

⁴⁸ There is an equivalent provision with regard to the impact of higher rents on rent rebates (Treasury, 2002b, para 5.3).

of regular revaluations. This is often troublesome, primarily because politicians in office detest revaluations. Those taxpayers who would pay a larger share of the (constant) tax revenue complain vociferously, whereas those who would pay a smaller share either do not notice or remain silent. The second is how to moderate the burden of domestic property taxes (taxing housing consumption) on lower income groups, without sacrificing a large proportion of revenue or introducing serious economic and political distortions.⁴⁹

Northern Ireland exhibits the first problem, in terms of a seriously outdated valuation basis for domestic property. The valuation basis retains rental values from the late 1960s as established by a 1976 revaluation (Department of Finance and Personnel, 2002b, para 39), since when the dispersion of property values must have widened considerably and there must have been significant geographical shifts within Northern Ireland in the distribution of market values. In consequence, some households will face pre-rebate bills that are 'too high', whereas others will face pre-rebate bills that are 'too low'. Once such a situation develops, it is very difficult to correct this without intense political controversy. Following an internal review within DFP of the rating system, a consultation paper was published on 27 May 2002 (Department of Finance and Personnel, 2002b) and a summary of the consultation process was published on 5 December 2002 (Department of Finance and Personnel, 2002a). The Committee for Finance and Personnel (2002b) has also reported. An extended discussion of regional and district rates can be found in Annex 3.1 to this Chapter. The likely course of development is that there will be a move to a capital value-based system in the domestic sector.

There has been considerable media discussion about the distributional effects of peace in Northern Ireland. In the long run, there would be downwards pressure on the real incomes of middle-class households (especially those benefiting from GB-pegged wages and low house prices), though in the short run this may be masked by the availability of windfall capital gains as house prices rise in response to economic confidence and GDP growth. Muellbauer and Murphy (1998) attached exceptional macroeconomic importance to UK house-price inflation, and Muellbauer (1997) has strongly argued that residential property is too lightly taxed under the council tax system, even at GB tax levels well above those in Northern Ireland.

The Northern Ireland Executive should consider carefully the desirable future path of regional rates. The 1998 change of public expenditure treatment of the regional rate in Northern Ireland is of major long-term significance. Whereas the regional rate was previously only a financing issue, in the sense that its level did not affect expenditure totals, variations upwards or downwards now directly affect how much can be spent.

The average gross domestic rate bill in Northern Ireland in 2002/03 is £445. However, the average gross council tax bill in England, excluding water charges, is £804. The gross Northern Ireland figure, therefore, represents only 55.3% of the gross England figure

⁴⁹ A claim by those who advocated the community charge was that the domestic rate rebate system meant that high-spending Labour councils could increase the rate poundage, knowing that a large proportion of their voters were exempt from paying (increases in) domestic rates.

(Department of Finance and Personnel, 2002b).⁵⁰ In part, this is because Northern Ireland taxpayers benefit from the Domestic Rate Aid Grant (DRAG), which had the effect of reducing the average domestic rate bill in Northern Ireland by £116 in 2002/03.⁵¹

Another fiscal effort issue concerns industrial derating, whose continuation has been advocated by CBI Northern Ireland (2001). This is now an expensive form of industrial support for Northern Ireland because it reduces the yield of a given level of regional and district rates. The DFP (2002b, para 13) estimates the cost of industrial derating in 2002/03 at £66 million, now met by public expenditure in Northern Ireland being lower (or other locally controlled taxes and charges higher) than otherwise. A decision has now been taken that industrial derating will be abolished, though the timing and phasing are not yet settled.⁵²

3.5.2 Water and Sewerage

A significant difference between Northern Ireland and Great Britain is that domestic consumers in Northern Ireland do not pay water and sewerage charges. The industry was privatised in England and Wales in 1989, whereas in Scotland it has remained in public ownership but is financed through charges.⁵³ In Northern Ireland, the Water Service is an Executive Agency within the Department for Regional Development. In 2001/02, it incurred a net deficit on operations before interest and cost of capital charges of £165.846 million (Water Service, 2002). After cost of capital and interest charges, the net deficit was stated as £442.751 million. From its 2001/02 accounts, the actual amount received from the DRD was stated as £198.8 million. In the December 2001 Executive Budget, this single item was planned at £217.5 million and represented 3.7% of total departmental DEL (46.4% of DRD departmental DEL) in that year. The charges paid separately in England represent significant

⁵⁰ It is estimated that raising the domestic rate bill to constitute the same proportion of average household income as England would raise an extra £116 million in revenue in Northern Ireland (Department of Finance and Personnel, 2002b, para 12). Even with such an increase in revenue, rate bills would be at a level 'no greater than the least prosperous areas of England and Wales'; household income and GDP are significantly lower in Northern Ireland than in Great Britain.

⁵¹ It should be noted that DRAG applies only to the regional element of domestic rate bills, not to the District Council part of the bill. In 2002/03, DRAG was set at 66.82p and so, with an average domestic Net Annual Value (NAV) of about £173, represents a reduction in the domestic rate bill of about £116. The cited figures for council tax in England and domestic rates in Northern Ireland take no account of council tax benefit or rate rebates.

⁵² The Parliamentary Under-Secretary at the NIO, currently with responsibility for Finance and Personnel (Ian Pearson MP), announced at the CIPFA annual conference in the Slieve Donard Hotel, Newcastle, County Down on 24 October 2002 that industrial derating would be phased out (Pearson, 2002). Neither the start date (possibly April 2004 or April 2005) nor the period of phasing has yet been determined. Primary legislation will be required and the presumption is that this will be taken forward by Direct-Rule ministers. If a restored Assembly wished to overturn this decision, the loss of revenue would have implications for spending plans.

⁵³ The three geographically-based Scottish water authorities, established in 1996 when these services were removed from local authority control, were merged on 1 April 2002 to form Scottish Water, now treated as a self-financing public corporation. The term 'charging' has to be used circumspectly in the context of unmeasured domestic water and sewerage, as charges are based on council tax bands. The Water Industry Commissioner for Scotland (2001, p.304) states that 'in 2002-03, customer revenue funds 86% of the total expenditure of Scottish Water'.

amounts: according to OFWAT (2002), the average household water and sewerage bill in England and Wales in 2002/03 is £227.52.⁵⁴

These differences in institutional arrangements between Northern Ireland and England result in there being no Barnett formula consequences on account of the water and sewerage service. While this may be reasonable, given that consumers in Great Britain are paying for the service over and above what they pay in taxes, the Northern Ireland Assembly is currently faced with a need for additional expenditure of £50 million per year to meet EU requirements (Department of Finance and Personnel, 2002b, para 122).

Several measures have recently been announced. First, the Treasury has agreed to non-cash water expenditure (ie depreciation and capital charges) being transferred from DEL to AME, though resource expenditure on water remains within the Assigned Budget. An advantage of this step is that it protects the Assigned Budget from the volatility and unpredictability likely to be a feature of this sector. However, the condition of that transfer was that the Water Service would become self-financing by 1 April 2006. Second, the Treasury have agreed to additional borrowing by the Executive, provided it is then serviced from additional local revenues.⁵⁵ Third, the section of the Review of Rating Policy's Consultation Paper (Department of Finance and Personnel, 2002b) dealing with water lists four possible methods of distributing the cost burden among domestic consumers: a uniform household contribution at a flat rate; a linkage to property valuation such as NAV, as in England; a linkage to property valuation such as capital value, as in Scotland; and some combination of these methods.

3.5.3 Additional Revenue from Fees and Charges

The present author is not in a position to judge whether other fees and charges in Northern Ireland are currently at the same level as those in Great Britain, or to assess the scope for generating additional revenue from charges. Significant charges are likely to be intensely controversial within Northern Ireland. Another consideration is that inappropriate or badly designed charges may seriously hinder the achievement of programme objectives. Charges will affect the behaviour of the users of public services, in ways which may be beneficial (eg transport congestion charges ration capacity) or dysfunctional (eg priority groups reduce their use of services) (Bailey, 2002). There will often be some conflict between efficiency and distributional considerations, though these may sometimes point in the same direction, either for or against user charges.

⁵⁴ This is a weighted average of measured (£197.94) and unmeasured (£236.16) consumers. Comparable figures for Wales in its entirety are not available, but the average total water and sewerage bill for Dwr Cymru, which serves more than one million properties in Wales, is £275.56. Figures for Scotland are provided by the Water Industry Commissioner: the average planned water and sewerage bill for 2002/03 across the whole Scottish Water area was £248.44 (North of Scotland Water Authority area £279.57; West of Scotland Water Authority area £230.88; East of Scotland Water Authority area £254.84).

⁵⁵ Further discussion of borrowing powers appears in Section 5.3's coverage of the Reinvestment and Reform Initiative, announced in May 2002.

The point to be stressed is that the Assigned Budget system operates in terms of expenditure net of fees and charges. Consequently, a higher level of fees and charges permits a given level of Assigned Budget to support a higher level of gross expenditure.

3.5.4 A Northern Ireland Variable Rate of Income Tax

Only the Scottish Parliament has a tax-varying power over income tax (Heald and Geaughan, 1997); the Northern Ireland Assembly has legislative powers without this income tax power,⁵⁶ whilst the Welsh Assembly has neither. In Scotland, where the Labour Party had ruled out use of the Scottish Variable Rate of Income Tax (tartan tax) during the first Parliament, the issue of raising additional revenue temporarily subsided.

There is a broad academic consensus that elected bodies should be fiscally responsible at the margin, especially when they have legislative powers (Bell et al, 1996, Blow et al, 1996, Constitution Unit, 1996, King, 1984, Smith, 1996). The key qualifier is the phrase 'at the margin', meaning that, after the fiscal equalisation system has compensated for differences in needs and resources (ie taxable capacity), the cost of additional expenditure (and the benefit of lower expenditure) should fall on 'local' taxpayers. There are powerful economic factors, including globalisation and membership of the European Union, which mean that sub-national governments cannot be fully 'self-financing' (Heald et al, 1998).

There was an intense political debate before Scottish devolution on the topic of the tartan tax. This allows the Scottish Parliament, by passing a resolution initiated by the Executive, to vary the basic rate of income tax in Scotland by up to 3p in either direction (Heald and McLeod, 2002c, para 538). The Inland Revenue would collect the additional amount from taxpayers with Scottish residence and, similarly, would deal with rebated amounts. In the case of an upward variation, the allowed spending of the Scottish Parliament would be increased by the Treasury by the relevant amount. In the case of a downward variation, an offsetting reduction would be made.⁵⁷

The Labour Government's plans for Scottish devolution were tested in a pre-legislative referendum held on 11 September 1997; the second question, effectively about the tartan tax, though worded more broadly, was carried by 63.5% to 36.5% on a 60.4% turnout (Heald and Geaughan, 1997). The legislative intention was that this would provide a capability for the Scottish Parliament to determine its overall budget size, though to a modest extent. The actual operation of the tartan tax would require more transparency in the operation of the Barnett

⁵⁶ The restrictions on the taxation powers of the Northern Ireland Assembly (*Northern Ireland Act 1998*, Schedule 2 para 9) are as follows. It cannot levy: (a) taxes or duties under any law applying to the United Kingdom as a whole; (b) stamp duty in Northern Ireland before the appointed day (ie date of devolution); and (c) taxes or duties substantially of the same character as those mentioned in sub-paragraph (a) or (b). Thus, the Assembly has powers to levy taxes where the UK government is not already occupying the base. In practice, this probably amounts to not much more than property taxes.

⁵⁷ The counterpart diagram for Scotland to Figure 8 shows the classification of the proceeds of the tartan tax, whether positive or negative, as Other AME (Treasury, 2002b, p. 32).

formula than currently exists, as otherwise it would not be possible to establish whether the total budget had indeed been varied by the relevant amount.

The tartan tax power is embedded in the UK tax system and thus affected by changes in it. The March 1999 Budget restructured tax bands, replacing the existing 20% band (£0£4,300 of taxable income) with a starting band of 10% (£0£1,500), with the net effect that the basic rate (23% in 1999/2000, 22% from 2000/01) started at a taxable income of £1,500. Treasury (1999b, p. 99) stated:

Effects on the Scottish Parliament's tax varying powers – statement regarding Section 7b of the Scotland Act 1998: After the changes..., a one penny change in the Scottish variable rate in 2000-01 could then be worth approximately plus or minus £230 million, compared with plus or minus £180 million prior to these changes. In the Treasury's view, an amendment of the Scottish Parliament's tax-varying powers is not required as a result of these changes.

Paradoxically, these changes increased the potential yield of the tartan tax, yet arguably made it more difficult to levy because its starting point would now be lower down the income scale. At the 1999 Scottish Parliament elections, there was a mistaken, but widely accepted, view that the tartan tax is regressive because it applies to the basic rate and does not extend to the higher rate. The Institute for Fiscal Studies (1999) showed that, until the top decile, the tartan tax would be progressive.⁵⁸ The difficulty in using the tartan tax is essentially political, and there would be much manoeuvring regarding whether the Scottish Executive or the UK government took the blame. One practical concern is that, given the Treasury's control over data and scoring, recourse to the tartan tax might be neutralised by a reduction in the Assigned Budget. However, the best safeguard would be full transparency about the Assigned Budget calculations.

The politics of the tartan tax have become rather tortured. The Labour Party gave an explicit electoral commitment not to use the tartan tax in the first term of the Scottish Parliament. This commitment, widely believed to have been imposed upon the Scottish Labour Party by the London leadership, was accompanied by a campaign against the SNP's 'Penny for Scotland' (ie the upward use of 1p of the 3p power), forecasting economic doom and mobilising business persons and celebrities, in a way highly reminiscent of the 'No' campaign during the 1997 Referendum.

Quite apart from these political developments, there was always a case for caution, in that the first step for the newly elected Parliament and Assemblies was to assess the expenditure situation, notably composition and the possibilities for greater VFM. Contrary to all expectations prior to devolution, the Devolved Administrations have thus far experienced financial plenty. Rather than a shortage of spending power, the problem has been mobilising real resources, as manifest in high levels of underspend across both the Devolved

⁵⁸ On the considerations which led to the tartan tax not being applied above the higher rate threshold, see Heald and Gaughan (1997).

Administrations and UK central government more generally (Treasury, 2000b; 2001d; 2002e).

Perhaps one of the most significant aspects of the tartan tax is that this proposal explicitly linked the legislative and executive powers of the Scottish Parliament to revenue raising. Although the referendum on the basis of two questions (one about the Parliament, the other effectively about the tartan tax) was widely interpreted as an attempt by the Labour Government to backslide on the revenue-raising power, the practical impact was to highlight the link in a way not previously done, despite the commitment of the Scottish Constitutional Convention (1990, 1995) to this proposal. After the referendum, some of those who had forecast dire economic consequences arising from a modest proposal then switched to a position advocating that the Parliament should raise all its own resources.⁵⁹

For reasons which were entirely predictable and understandable, the pre-referendum debate in Scotland about financial aspects of devolution concentrated heavily upon the tartan tax and the possible repercussions upon the Barnett formula. The first priority of the Devolved Administrations should have been to review systematically the VFM secured from existing programmes. Nevertheless, the Scottish Parliament needs to use the tax-varying power in the medium term, as it will otherwise atrophy (Heald and Geaughan, 1997), both politically and administratively.

In the short term, such a tax-varying power is of marginal relevance to the tasks facing the Northern Ireland Executive and Assembly. Nevertheless, Northern Ireland needs to equip itself to contribute fully to UK debates.

3.5.5 Conclusion on Fiscal Effort

This emphasis on improving fiscal effort should not be taken as encouragement to the Northern Ireland Assembly and Executive to think solely in terms of spending more. Per capita expenditure in Northern Ireland currently exceeds the UK average by a large margin (Barnett and Hutchinson, 1998, Gorecki, 1998, Treasury, 2002f). Revenue-raising should be regarded as a means of securing fiscal accountability at the margin (Barnett and Knox, 1992), and of securing proper attention to the full range of allocative and distributional effects of public expenditure programmes. Given the likelihood of downward pressure on the expenditure index in the medium term, there has to be a greater awareness in Northern Ireland of the opportunity costs of public sector activity.

Despite attracting little attention at the UK level, the pre-devolution system of territorial government embodied extensive devolution of expenditure responsibilities (Heald, 1980). The essence of contemporary constitutional reforms is to transfer these responsibilities from members of the UK Cabinet to those who owe their position and legitimacy to the support of directly elected territorial assemblies. The issue of 'local' fiscal accountability has naturally acquired more salience (Heald, 1990). The Devolved Administrations should eventually have

⁵⁹ The arguments in Scotland about 'fiscal autonomy' are examined in Section 4.3.

more responsibility for raising revenue at the margin, though the obstacles to this should not be underestimated.

Fiscal accountability at the margin can only be secured for the Devolved Administrations following a thorough review of sub-national taxation in the United Kingdom. Indeed, the financing of devolved assemblies is intricately interwoven with questions about the financing of local authorities. This is more obvious in Great Britain than in Northern Ireland, where local authorities are less important in expenditure terms because of their much narrower functional responsibilities. Northern Ireland is nevertheless affected by these interconnections through the operation of the Barnett formula.

There is a warning in the block funding rules (Treasury, 2002b, para 5.2) that disproportionate growth in self-financed expenditure relative to England might be scored against the Assigned Budget.⁶⁰

It is, however, open to the Government to take into account levels of this self-financed expenditure in each country when determining the assigned budget where:

- i. levels of self-financed spending have grown significantly more rapidly than equivalent spending in England over a period; and
- ii. this growth is such as to threaten targets set for the public finances as part of the management of the United Kingdom economy.

This seems likely to be an area of delicate negotiations between the UK government and the Devolved Administrations. There would only be scope for a sustained switch of the burden of financing a given level of sub-national expenditure if there were a UK-wide consensus about the desirability of such a change.

Fiscal effort is primarily about the extent to which the resources required to finance public services are extracted from the taxpayers and service users of that political jurisdiction. However, a number of related technical issues are also examined here, even though they do not all fit into a narrow understanding of fiscal effort.

First, there is an urgent requirement for UK-wide rules on a series of technical issues which have considerable potential for generating political conflict. Obvious examples relate to the treatment of EU funds, National Lottery funds, assets financed through the Private Finance Initiative (PFI), and tax expenditures granted by UK government which touch upon devolved programme areas. Each of these issues opens up scope for budgetary gamesmanship and poor VFM, suggesting that scorekeeping on these should be part of the remit of a Territorial Exchequer Board, the establishment of which is proposed in Section 5.6.

Second, one of the ways in which the Northern Ireland Executive might generate additional proceeds relates to the sale of public assets, particularly those now redundant, or business undertakings to the private sector. There is explicit coverage of this issue in the Treasury

⁶⁰ The tartan tax is specifically excluded.

(2002b) funding rules.⁶¹ Therefore the treatment of such asset sale proceeds would have to be discussed bilaterally with the Treasury, the obvious point being that desirable disposals might not go ahead in the presence of a high level of clawback.

Such disposals would not be easy or uncontroversial; a classic case is the Chancellor of the Exchequer's initiative of 11 May 1998 (Treasury, 1998d), whereby the managed block was enhanced by £70 million in anticipation of sales proceeds from the privatisation of the Belfast Port Authority. On that occasion, the managed block gained the money but the privatisation never took place. One aspect of the Reinvestment and Reform Initiative (RRI), launched on 2 May 2002 (Treasury, 2002c), is the transfer, at zero cost, of certain UK government assets in Northern Ireland. Some of these constitute economic development opportunities, and the disposal of others, which will count as negative expenditure, will bring financial benefits to the Assigned Budget.

Third, the present level of recourse to the PFI in Northern Ireland seems to be substantially below that in Great Britain for comparable services, most particularly in Scotland where there is, for example, a large programme of schools' PFI new build and renovation (Accounts Commission, 2002). Although VFM justifications are offered in Scotland, the political context is one in which local authorities know that they would definitely not receive consents to undertake capital expenditure themselves (such consents score against the Assigned Budget), without which there would be no new schools. The PFI has definitely been the 'only show in town'.

The PFI may, in certain contexts, be useful if it brings management benefits, but care is required to ensure that bills for budget-funded services are not simply posted to the future. Although there are shortfalls in Northern Ireland's physical infrastructure, there is also much evidence of extensive shopping lists of projects, rather than of prioritisation (CBI Northern Ireland, 2000).⁶² Care will have to be taken to avoid getting the worst of both worlds along the public/private finance spectrum: not using the private sector when there are genuine efficiency gains to be reaped, but using the private sector to postpone scoring against the Assigned Budget even when the present-valued cost is higher.

Fourth, a good rule of thumb is that the funding system needs to reward fiscal effort by sub-national governments (rather than punish it), provided that the (at least first-round) incidence of sub-national taxes is broad and not unreasonably targeted at particular groups. A political rather than technical difficulty is that the Devolved Administrations will naturally fear that higher fiscal effort will afford the Treasury opportunities to reduce the Assigned Budget in

⁶¹ Para 7.4 of the July 2002 document states that the Treasury has the right to reduce the 'grant' if Devolved Administrations make capital receipts from the sale of assets, originally financed by UK taxpayers, which represent a 'major change in the role of the public sector'. Para 7.5 additionally states that, like all UK departments, the Devolved Administrations may retain 100% of receipts only if the individual sale is less than £100 million and total asset sales are less than 3% of total departmental provision. Para 7.6 requires the Devolved Administrations to tell the Treasury before selling assets which may cause the Assigned Budget to be adjusted, and requires the Treasury to tell the Devolved Administrations before making such adjustments.

⁶² An assessment of the potential role of the PFI in Northern Ireland is provided by the Committee for Finance and Personnel (2001).

discretionary ways. The system could then become gridlocked: low fiscal effort by the Devolved Administrations would encourage the Treasury not to take seriously requests for additional resources; and high fiscal effort could be seen by the Treasury as a substitute for central grant.

The final point is political rather than technical: the public finance culture of Northern Ireland has to change. There has been a financially irresponsible culture, in the sense that the UK Exchequer would insulate the residents of Northern Ireland from the cost of internal conflict and the resulting inefficiency in both microeconomic and macroeconomic terms (Gibson, 1996). Even when – perhaps especially when – there are generous fiscal equalisation arrangements, there has to be a credible budget constraint. These Northern Ireland circumstances give added force to the general requirement that perceptions of a soft and manipulable budget constraint have to be erased. There will have to be an increase in Northern Ireland's fiscal effort if the Assembly and Executive want to maintain anything like the existing expenditure differentials on England. There also has to be tougher enforcement of certain taxes and regulations, regarding which a culture of non-payment may have developed.⁶³

⁶³ A frequently discussed example is the lower proportion of Northern Ireland households holding television licences, not thought to reflect lower use of televisions. This particular licence fee is a UK imposition, though it seems unlikely that non-payers are making this distinction.

Annex 3.1 Regional and District Rates in Northern Ireland

In 1995, the Valuation and Lands Agency undertook a revaluation of the non-domestic sector, with the revised NAVs, based on 1995 rental values, coming into effect in April 1997. Industrial property was revalued, but the present system of industrial derating, now estimated to cost £66 million per year in foregone revenues, was unaffected. The overall NAV adjusted to a 1995 valuation base is £1,637.80 million in 2002/03. This consists of £882.82 million of non-domestic NAV, and £754.98 million of domestic NAV, after adjusting to a 1995 valuation.⁶⁴ This calculation holds constant the relative shares of the tax base attributable to the domestic and non-domestic sectors (Department of Finance and Personnel, 2002c). There has recently been another non-domestic revaluation, which will take effect from 2003/04, with businesses valued on the basis of 2001 rentals.

There are two components to the property tax paid by both domestic and non-domestic ratepayers. Regional rates are set by the DFP in respect of such services as education, housing, personal social services, roads, and water and sewerage. The level of regional rates is decided annually by the Executive, brought forward into legislation by the DFP and approved by the Assembly. Both the domestic and non-domestic regional rates are uniform across Northern Ireland.

District rates are fixed by each District Council to meet its own net expenditure on such functions as leisure facilities, economic development and environmental matters. The variation in district rates reflects the rateable resources and spending policy of individual councils. Individual rate bills are calculated by multiplying the property's NAV by the regional and district rate poundages. The domestic regional rate poundage is calculated by factoring up the non-domestic regional rate poundage by the conversion factor (6.342) and then subtracting the Domestic Rate Aid Grant poundage.

The collection and rebate system in Northern Ireland has distinctive characteristics. Central roles are played by the Rate Collection Agency (RCA) (an executive agency of DFP) and the Northern Ireland Housing Executive (NIHE) (an Executive Non-Departmental Public Body of the Department for Social Development); District Councils have no role.

The channel of payment depends on the category to which the taxpayer belongs: owner-occupiers; NIHE tenants; and private tenants. First, owner-occupiers pay a combined bill, though separately itemised, for regional and district rates to the RCA. Where relevant, owner-occupiers apply to the RCA for a rate rebate. Such applications must be accompanied by documentary confirmation, provided by the Social Security Agency (SSA), to state that the applicants are entitled to Income Support. On the basis of this evidence, the RCA estimates how much housing benefit in the form of rate rebate is to be allowed and how much rate income to write off as a consequence. Second, NIHE tenants apply to NIHE to determine the amount of rate rebate. The NIHE pays the gross amount of rates to the RCA, obtaining reimbursement of the rate rebates from the SSA. Third, private tenants apply to the NIHE, which either pays the tenant directly or, at the tenant's request, pays the rate rebate directly to

⁶⁴ The domestic NAV at 1995 valuation is calculated by multiplying the 1976 valuation of £119.04 million by a factor of 6.342, which is the ratio of the non-domestic NAVs at 1995 rental values to 1976 rental values.

the RCA. Alternatively, private landlords can apply to the NIHE for rent and rate rebate on behalf of private tenants; the NIHE either pays the landlord directly or, at the landlord's request, pays the rate element to the RCA.

The total rate receipts collected by the RCA are paid into the Northern Ireland Consolidated Fund, out of which each District Council is paid the rate receipts owing to them. The amount payable to each District Council is reduced by an amount equal to 3% of the total amount of rebates in the year within the district.

The previous chapters have analysed the UK public expenditure context and the special circumstances of Northern Ireland. The purpose of this Chapter is to provide a bridge from these analyses to the proposals set out in Chapter 5. Sections 4.1 and 4.2 evaluate the Barnett formula: the former analyses the technical properties of the formula, whereas the latter reviews the political controversies that are now enveloping it. Section 4.3 considers the Scottish debate on fiscal autonomy, as this may influence UK-wide discussion of the future of the funding system. Interestingly, there are strong echoes of the issues already discussed in Section 3.2 (Legacy of History). Section 4.4 examines the institutional deficit that currently characterises intergovernmental fiscal relations in the United Kingdom. Finally, Section 4.5 discusses the impact of the implementation of RAB, the switch of UK central government accounting and planning from cash to accruals.

4.1 The Predicted Effects of the Barnett Formula

The Barnett formula has often been misrepresented and even more frequently misunderstood, in part because its operation has not been transparent. There is now a reasonable account available, though not securely rooted in hard data, of how the UK territorial finance system operated in the 1980-1999 period. Following the implementation of devolution in 1999, more systematic data are coming into the public domain, though they remain seriously incomplete. The purpose here is to explain how the present system has evolved and why it now takes the form it does. Although a few insiders know how the system works, most people are understandably confused by much error in political comment and media reporting.

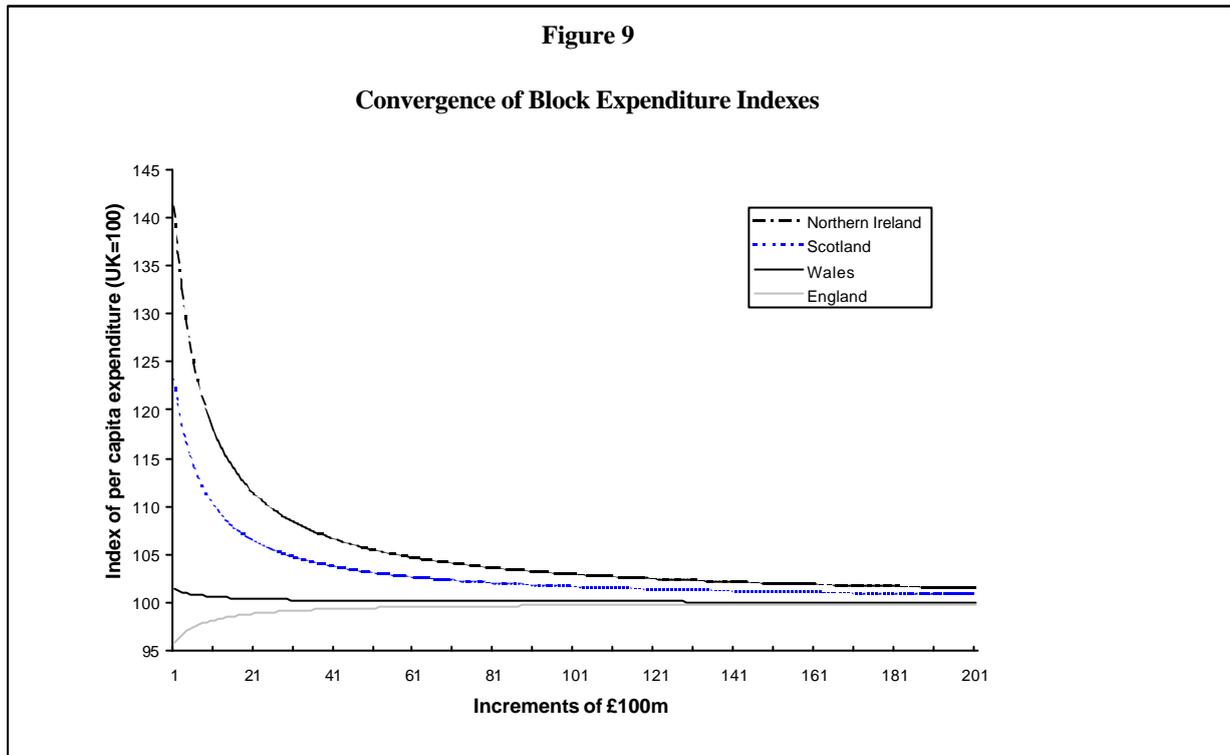
An explanation is first provided of what would be involved in a systematic application of the formula. Having established key results on its convergence properties, it is then stressed that the Barnett formula has not in fact been operated on this 'clean' basis. Instead, there have been a number of important factors which combine to qualify the convergence results.

Figure 9 demonstrates that the internal dynamic of the Barnett formula, when implemented over a long period in which all increments of expenditure pass through the formula, will bring about the convergence of per capita expenditure in all four countries. As expected, base expenditure (on which the three territories have per capita indexes above UK = 100) over time becomes a smaller proportion of total block expenditure, with incremental expenditure (which has passed through the population-based formula) becoming a larger proportion.

In Figure 9, the vertical intercepts indicate the per capita index at the beginning of the simulation. In this particular simulation, the starting points are Heald's (1994) estimates of the positions in 1981/82.⁶⁵ The horizontal axis measures successive increments of expenditure, all of which go through the Barnett formula. Moving from left to right, the cumulative amounts

⁶⁵ 1981/82 was the first year for which the Barnett formula was used for Scotland, Wales and Northern Ireland. This particular simulation, taken from Heald (1996), uses the original formula proportions 10:5:85 and 2.75:100. Precisely which constant formula proportions are used makes little difference to the appearance of the diagram. This kind of simulation cannot be run in the case of changing population and formula proportions, without a prior specification of that relative population change. As a result of the data published for Wales (Treasury, 1998a), there are doubts about the 1981/82 starting point for Wales which Heald (1996) used to determine that intercept.

of incremental expenditure become very large and the initial baselines become a small proportion of total expenditure.



However, this conclusion critically depends upon three assumptions: that the initial formula proportions exactly match relative populations; that relative populations do not change through time; and that all expenditure increments pass through the formula (Heald, 1996). There are important implications if these three assumptions do not hold.

First, the original formula proportions were advantageous to Scotland (10/85 rather than 9.57/85.31 as at mid-year 1976) and disadvantageous to Wales (5/85 rather than 5.12/85.31). On this basis, the convergence would not be on 100: Scotland would converge on an index above 100 and Wales on one below 100. Even though the Northern Ireland formula percentage was expressed to two decimal places (2.75%) in relation to its base of Great Britain, there was an adverse ‘rounding’ as the population percentage at mid-year 1976 was 2.79%. Consequently, Northern Ireland, like Wales, would converge on an index below 100. This point was important because the formula proportions were not updated until 1992. With effect from CSR 1998, there would be annual updating of the formula proportions, based on the mid-year estimates of the Registrars General (Darling, 1997). Taken together, the 1992 recalibration (by moving the GB component of the formula to two decimal places) and the 1997 modification (annual population updating) have eliminated rounding as an inhibitor of long-run convergence.

Second, significant changes are taking place in the relative populations of the countries of the United Kingdom: in particular, the population of Scotland relative to England is in long-term decline. Cuthbert (2001) proved mathematically that territories with future relative population decline would converge, even with current populations being used in the Barnett formula, on an index above 100, and those with a future relative population increase on an index below 100.

The contrast between Scotland and Northern Ireland is particularly marked; the population ratio between Scotland and England has changed from 11.24% (ie 9.57/85.13) in 1976 to 10.23% in 2002. In contrast, Northern Ireland's population expressed as a percentage of GB population has risen from 2.79% to 2.92%. This equates to an increase from 3.28% (ie 2.79/85.13) in 1976 to 3.40% in 2002, expressed relative to England.

Therefore, the convergence effect of the Barnett formula on per capita expenditure indexes has been attenuated in Scotland (falling relative population) but accentuated in Northern Ireland (increasing relative population). Even with the current practice of regular population updating, the figures used in determining Barnett formula consequences will be somewhat out of date, meaning that a territory experiencing relative population decline (eg Scotland) will receive a higher percentage of English expenditure than it would on the basis of actual population at the time of the settlement. Additionally, when relative population is falling, the territory's per capita index will be higher due to the relative reduction in the denominator. The numerical effects of population updating clearly depend upon how much incremental expenditure is going through the formula. If nominal expenditure growth is low, marginal changes in the formula proportions will have a limited effect.

Third, Heald (1994) summarised the limited evidence in the public domain about the mechanisms of formula bypass, whereby not all incremental expenditure has gone through the formula. Heald's (1994) examples were confirmed by Treasury (1997a, 1997b) evidence to the Treasury Committee (1997), but there has been no quantification of the numerical importance of bypass.⁶⁶ An example from the 1980s clarifies the issue. When the territorial expenditure index on health is substantially above UK = 100, this is likely to reflect in part a higher per capita employment of nurses. If the Treasury were to underwrite the full cost to each health department of a UK nurses' pay settlement, the territories would receive more than if the total UK cost of the award were to be distributed through the Barnett formula.

If a considerable amount of expenditure change does not go through the formula, the convergence results may not hold. It is generally believed that there were more opportunities for formula bypass, favourable to the territories, in the 1980s than there were after the 1992 revamping of the public expenditure control system (Heald, 1995). There is no guarantee that bypass will be more favourable to the territories than the Barnett formula. On at least one

⁶⁶ The concept of bypass is problematic at the operational level. It is sometimes difficult to decide what are structural features of the public expenditure system with consequences for territorial funding, and what are cases of the Barnett formula not being applied. An example concerns the effects of volume planning (and its partial continuation in the form of the annual uplift). One reason why this has become labelled as bypass is that the arrangements for uplift, and indeed its abolition, were not in the public domain, and thus rendered incomplete pre-1997 accounts of the operation of the Barnett formula system.

occasion during the 1992-97 Major Government, the Treasury implemented an across-the-board percentage reduction in departmental baselines, before applying the formula. Whether by accident or design, this device allowed ministers to state that the Barnett formula had been implemented, even though it eroded the protection afforded by the formula to inherited expenditure.⁶⁷ This device was permitted by the then secret rules governing the operation of the formula; it now appears within the published rules (Treasury, 2002b), though a recourse to it is now more likely to attract attention.

Figure 10 presents the effect of convergence in a different way. It shows the inevitable downside for Northern Ireland of a formula which does not challenge the baseline, but which allocates incremental expenditure on a population basis. Arithmetically, it must be the case that expenditure in Northern Ireland, regulated on this basis, will rise more slowly than expenditure elsewhere in the United Kingdom. This is an inevitable consequence of Northern Ireland having the highest per capita expenditure.

In Figure 10, the plotted lines show the percentage formed by dividing the growth rate in the Northern Ireland block by that, for example, in Scotland. In contrast with Figure 9, in which the horizontal axis measured cumulative expenditure increments, the horizontal axis in Figure 10 is the percentage of total expenditure accounted for by cumulative increments. At the origin, there is only baseline expenditure and no cumulative increments. Moving from left to right, the cumulative increments become successively more important.

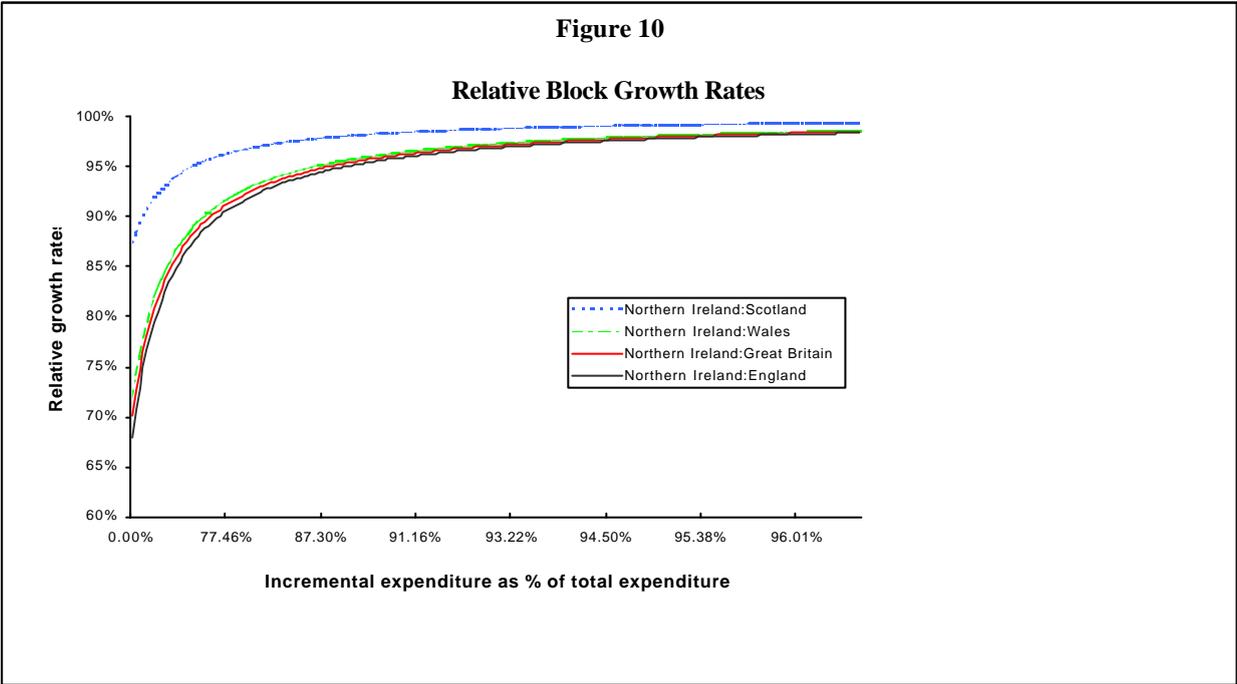
At the beginning of the convergence process started by the adoption of the Barnett formula in the context of then expenditure indexes, the percentage increase in expenditure in Northern Ireland would be approximately 70% of that in Great Britain. The growth indexes with England and Wales are little different from that with Great Britain. In contrast, the comparable figure for Northern Ireland with Scotland would be between 85% and 90%; this is a direct result of Scotland itself converging. Naturally, the more expenditure which has gone through the formula (ie the further to the right along the horizontal axis), the closer these percentages tend to 100.

Heald (1994) demonstrated that the effects of the formula can be significantly modified by unconnected changes in the technical detail of public expenditure management systems.⁶⁸ For example, the switch from volume to cash planning in 1982 increased the amount of expenditure which would, in principle, pass through the formula. Previously, the territorial

⁶⁷ Money 'saved' by applying a constant percentage cut to the territorial blocks and to comparable expenditure can then be passed through the Barnett formula, generating formula consequences supplementary to those generated by year-on-year increases in comparable expenditure. Naturally, the arithmetical effect is disadvantageous to the territories because the constant percentage cut generates more 'savings' from their blocks than they subsequently receive back in these 'artificial' formula consequences.

⁶⁸ This can happen even when changes in the public expenditure planning system (Heald, 1995) have no immediate connection with policy on territorial programmes. Some changes are not even announced by the Treasury. Heald (1994) identified that the Treasury's practice of creating a baseline for the third year of each Survey by incorporating an automatic inflation adjustment meant that a significant proportion of the increment for that year did not go through the formula. Not until December 1997 did it reach the public domain that this practice had changed: 'In Surveys since 1993 it has been the practice to create the year three baseline by rolling forward Year 2 cash plans at the same level in cash terms' (Treasury, 1997b).

blocks had been revalued by specific price factors each year before the formula was applied to the growth component. Subsequently, both the growth and inflation components would pass through the formula; in practice, however, an element of revaluing the ‘horizon’ year in successive surveys continued until the early 1990s. Other things being equal, putting the inflation component through the formula would speed up convergence. This should be taken as a caution that all discussion about the impact of the Barnett formula must be located within a secure knowledge of the operation of the UK public expenditure system as a whole.



4.2 Controversies Surrounding the Barnett Formula

Both 1997 devolution White Papers (Scottish Office, 1997, Welsh Office, 1997b) stated that there would not be fundamental change to the Barnett formula without a new needs assessment. Perceptions of how each territory has fared under the Barnett formula are markedly different, and perceptions can diverge from reality. It seems likely that both Scotland and Northern Ireland have fared well out of the Barnett formula arrangements, resulting in their expenditure indexes probably being kept at a higher level than their needs indexes. In comparison, it is often claimed that Wales has done less well (MacKay et al, 1997, Richards, 1997). Firm conclusions cannot be reached without a full needs assessment. The only previous *published* assessment of needs (Treasury, 1979) was conducted in the context of the then Labour Government’s devolution plans for Scotland and Wales (Heald, 1980). Those figures are dated, were constructed under a different system of public expenditure aggregates and government policies, and relate to a different range of services from those that are now devolved.

It seems to be taken for granted in Wales that the needs index for Wales would definitely be higher than its expenditure index. However, the indexes for comparable expenditure in 1995/96, which can be calculated from data supplied by the Treasury (1998a) to the Treasury Committee, suggest that expenditure, on definitions relevant to a needs assessment, may be higher in Wales than had been appreciated.⁶⁹ On the basis of data presently in the public domain, second-guessing the outcome of a needs assessment is a dangerous activity.⁷⁰

Political debate about funding concentrates upon the supposed inequities of the Barnett formula. The Barnett formula is frequently said to be unfair, unjustifiable, or at least to have run its course. Among those taking this view are Lord Barnett himself, for example in the House of Lords debate which he personally initiated on 7 November 2001 (Lords Hansard, 2001), having been successful in a ballot. This apparent unanimity is deceptive, since the Barnett formula – even when correctly understood – is criticised from diametrically opposing viewpoints. This view that ‘something better must be found’ conceals dramatically different understandings of how the present system works and divergent predictions of what would be the results of a ‘review’ of the Barnett formula, as advocated by Lord Barnett in both 1997 and 2001.⁷¹

On the one hand, the so-called Barnett squeeze is said to be wrecking public services in Scotland, Wales and Northern Ireland; therefore, the Devolved Administrations should be funded ‘above Barnett’. In Northern Ireland, for example, there has been much extravagant language about the ‘injustice’ of the Barnett formula. Many comments have focused on headline increases being lower than those in England.

On the other hand, the Barnett formula is regularly portrayed, especially in the London and English regional media, as a gravy train of subsidy for the territories. It is said to sustain the unfair advantage in terms of public expenditure per capita held by the Devolved Administrations; therefore, they should be funded ‘below Barnett’.

⁶⁹ Expressed in terms of England = 100 for that expenditure which is comparable with each territorial block, the coverages of which differ significantly, the block indexes for 1995/96 implied by the Treasury data are: Scotland 132; Wales 125; and Northern Ireland 132. The Northern Ireland figure is significantly affected by the inclusion of social security expenditure in the comparison, thereby reducing the index. Whilst the Scotland index is in line with the data for earlier years in Heald (1994), the Wales index is considerably higher. Nothing more can be said definitely, unless the disaggregated, rather than just summary, numbers are published. Speculatively, the uncertainty may in part be rooted in past failures to fully separate out Welsh expenditure from that in England, and the differential way in which successive public expenditure aggregates have scored local authorities within identifiable expenditure (Heald, 1995).

⁷⁰ A topical issue indicates the kind of complex questions which will arise during a needs assessment. The ethnic minority populations of Scotland (1.52% of total population, 1998) and Wales (1.48%) are shown by the Office for National Statistics (2000) to be much lower than that of England (7.26%). Although there have been no official data compiled on ethnic populations in Northern Ireland, Irwin and Dunn (1997) approximate this at 1.5%. It is obvious that one of the issues confronting a needs assessment would be whether, say, a large proportion of schoolchildren whose home language is not English increases the cost of school education.

⁷¹ ‘Review’ has become code for abolition. On 27 January 2003, Lord Barnett asked the following oral Parliamentary question: ‘Whether [Her Majesty’s Government] have any plans to scrap the Barnett formula with respect to the allocation of public expenditure’. In response to a negative answer, he replied: ‘... if [the Minister] has no plans to scrap the formula, the simple question must be, “Why not?”’ (Barnett, 2003).

Both before and after devolution, McLean (1997, 2001) has expressed enthusiasm for evicting Scotland from the Union; his analogy is with Slovakia, effectively thrown out of the Czechoslovak federation by the Czech Republic in 1993. The terms on which Scotland would be allowed to stay in the Union would include per capita expenditure at the England level and Westminster parliamentary representation at the below-parity level established for Northern Ireland by the *Government of Ireland Act 1920*. His argument could, if so desired, be extended to Wales and Northern Ireland, though this was not done.

Heffer's (1999) book is noteworthy for its offensiveness and technical inaccuracy. As examples of the latter, a Scottish general government financial deficit is treated as the measure of subsidy received from England, in years in which the United Kingdom as a whole had a large financial deficit; and there is a failure to distinguish between expenditure indexes and deficit levels. It has become fashionable in the media to blame Scotland for the dire condition of the London underground system; this happened frequently during the May 2000 mayoral election campaign. A predictable consequence of the new governmental arrangements for London is that both the Mayor and the Greater London Authority (2001) will lobby hard for extra public expenditure in London. More specifically, arguments will be mounted against the transfer of tax revenues from London to other regions, as, for example, through the Revenue Support Grant system for English local authorities. In turn, this will make the Barnett formula system more visible to the English regions; the North East, in particular, campaigns vociferously against what are perceived to be unfair advantages held by Scotland. This is the background to the 'blood on the carpet' threat by John Prescott MP, the Deputy Prime Minister, on the eve of the 2001 General Election (Hetherington, 2001).

Overall, however, events in the territories still attract relatively little attention, though more than before devolution. Several participants in the House of Lords debate on the Barnett formula noted the predominance of Scottish and Welsh speakers, with limited attendance and participation by peers from England. Midwinter (1997) observed that spreading, across England, feasible reductions in the territorial programmes would make only a marginal difference to the level of per capita expenditure in England. Despite this arithmetic, differences in per capita expenditure will have a much higher prominence in future.

There is also a set of reasoned arguments that need to be addressed. First, Lord Barnett's (1997, 2001) criticism of the eponymous formula overstates the significance of relative GDP, on which measure Scotland has improved its position. Given the composition of expenditure financed by the Assigned Budgets, geography, demographic structure and participation rates in publicly provided health and education will be far more important determinants of relative need than will be relative GDP.

Second, it has frequently been argued that the funding arrangements for devolution are inherently unstable, and that a system based on the Barnett formula is untenable beyond the short term (Bell and Christie, 2001; 2002). Midwinter and McVicar (1996a, 1996b) provided statements of this position, written before the 1997 General Election. Indeed, their contributions read as an exhortation not to sail into the 'uncharted waters' (Midwinter and McVicar, 1996b), as they characterised the proposed funding scheme (later enacted by the *Scotland Act 1998*).

Arguments about the inherent instability of the funding arrangements also appear in Hazell and Cornes (1999). Much of the criticism, however, oscillates between two arguments, sometimes run in tandem: that the Devolved Administrations will be starved of resources, which will lead to political conflict; or that they will be fiscally irresponsible and will have to be bailed out by the UK government. Simultaneously, there is argued to be an excessively hard budget constraint, but also an indulgently soft budget constraint. There may be a problem in terms of the costing of long-term commitments, particularly those taken on by the Scottish Executive in relation to teachers' pay (McCrone, 2000), student financial support (Cubie, 1999), and care of the elderly (Sutherland, 1999). In part, this represents a challenge to the policy leadership of Whitehall departments. The eventual net cost to the Devolved Administrations of new expenditure commitments critically depends upon whether England subsequently emulates and thereby generates formula consequences. Potential problems of over-commitment are presently obscured by the problem of underspending.

With Devolved Administrations in place, the obvious question relates to what would replace the Barnett formula, if it were abolished. This is likely to be a matter of continuing political controversy. Yet, if the Barnett formula did not exist, something like it would now have to be invented. This does not mean that the formula might not be modified, or renamed to detach the use of a formula-adjustment mechanism from the controversy which now surrounds the Barnett formula.⁷²

Given the vertical fiscal imbalance⁷³ which characterises the United Kingdom, and the limited likelihood of that changing, the devolved funding system will, in the terminology of the Kilbrandon Report (1973), remain expenditure-based, not revenue-based. Providing the power to vary some taxes would facilitate limited flexibility on total budget size, though what is achievable in the UK context is fiscal accountability at the margin (Smith, 1996).

4.3 The Scottish Debate on Fiscal Autonomy

A very quiet 2001 UK General Election campaign in Scotland was enlivened by a controversy about 'fiscal autonomy', taken to mean that the Scottish Parliament would finance all its own expenditure. This was prompted by a letter to the *Scotsman*, signed by 12 economists (Cross et al, 2001), whose case was taken up by that newspaper. The discussion here can only be brief,⁷⁴ but this is a debate of which Northern Ireland should be aware, even if not an active participant.

⁷² McLean (2002) has proposed the following reforms. There should be a territorial grants board making allocations by a unanimity rule. In the case of unanimity not being achieved, incremental grant in the next time period would be awarded by an inverse GDP rule. If this mechanism were applied only to increments, the path of expenditure indexes for Scotland would not be substantially different from the paths under the present population-based rule.

⁷³ Vertical fiscal imbalance refers to a mismatch between the expenditure responsibilities and the revenue-raising powers of different tiers of government.

⁷⁴ See, also, the discussion in Ashcroft (1999), and the Symposium in the journal *Scottish Affairs*, particularly the papers by Darby et al. (2002) and Cuthbert and Cuthbert (2002).

The concept of fiscal autonomy is ambiguous. If Scotland were independent, its public finances would be entirely separate from those of the remaining part of the United Kingdom. There would be no more link than there presently is between the public finances of the United Kingdom and those of the Republic of Ireland. Scotland would have the same powers, and be subject to the same EU constraints on taxation policy, as any other member state.

The difficulty arises when the discussion is of fiscal autonomy in the context of devolution. From the content of the letter to the *Scotsman*, Scotland would retain all the tax revenue generated in Scotland and meet all its own public expenditure requirements, including a payment to Westminster for reserved services, effectively modelled on the Imperial contribution of the *Government of Ireland Act 1920*.⁷⁵ By implication, there would be no equalisation with other parts of the United Kingdom. It was explicitly stated that the present direction of subsidy runs from Scotland to the rest of the United Kingdom. The legality or practicality of a devolved Scotland setting particular tax rates was not considered, leaving doubt as to whether the Scottish Parliament would determine its own total revenue or receive an amount effectively set by the UK government.

There are three sets of issues to consider: the implications of being a *component* of an EU member state; the implications for control over public borrowing; and the relationship between interpersonal and territorial fiscal redistribution. First, there are significant differences in the way that EU constraints affect variations in taxes within a member state, as opposed to among member states. For example, much of the tax policy discretion which would be enjoyed by an independent Scotland would not be enjoyed by a devolved Scotland. In other words, revenue attributed would have to be calculated mainly as UK tax rates applied to an estimated Scottish base.

Second, such an arrangement would require that the Scottish Parliament had extensive borrowing powers, as otherwise it could not balance expenditure and revenue at the time of a cyclical downturn, especially if Scotland were differentially affected. Under such a scheme, there would have to be some mechanism for joint decision-making on UK fiscal policy.⁷⁶

Third, fiscal autonomy, in the sense that fiscal derivation applies without any fiscal equalisation between jurisdictions, raises fundamental questions about the nature of the state. If the state operates a scheme of interpersonal redistribution, that necessarily implies that there will be territorial transfers of resources, except in the unlikely case that households with different resources and needs are spread evenly across all jurisdictions. If this unlikely condition does not hold, fiscal autonomy for the sub-national government cannot be combined with interpersonal redistribution at the national level, unless there is a clear separation between central (redistributive) and devolved (non-redistributive) functions. Although this

⁷⁵ This is the arrangement in Spain for the Basque Country and Navarra, though the level of the 'cupo' is a political, rather than economic, calculation. Unlike Catalonia, which is within the uniform scheme applying to the rest of Spain, these do not contribute to equalisation transfers to the poorer Autonomous Communities (Lámbarri and van Mourik, 1997).

⁷⁶ The House of Lords Select Committee on the Constitution (2003, para 109) proposed 'consultation'. In the context of a genuine revenue-based system, consultation alone would not be sufficient.

might have been possible in the context of the Gladstonian minimal state, it is not consistent with the existing European model of welfare states.⁷⁷ Commentators on the public finances of the 1921-72 Stormont period regularly made the point that Northern Ireland could not afford the British welfare state from its own resources (Green, 1979), thus undermining the viability of the 1920 scheme.

It is important to disentangle two strands of opinion behind the arguments advanced in Scotland for fiscal autonomy. One strand operates on the assumption that Scotland would be financially better off outside the Union, because the direction of fiscal transfer is from Scotland to England.⁷⁸ Accordingly, fiscal autonomy would facilitate a higher level of public expenditure and/or lower taxes where tax rates are under the control of the Scottish Parliament. There is little enthusiasm for fiscal equalisation to England, Wales and Northern Ireland. Indeed, some of the advocates within this strand are explicitly thinking in terms of independence rather than devolution.

The second strand considers that the direction of fiscal transfer has been to Scotland, but believes that huge economies can be made in public expenditure. This is the current editorial stance of the *Scotsman*: antagonistic towards the Scottish Parliament and the Scottish Executive; hostile to the euro and dismissive of EU constraints on fiscal decentralisation; contemptuous of the alleged inefficiency of the Scottish public sector and canvassing private sector substitution in health and education; and optimistic that the resulting budgetary shortfall would lead to fundamental economic changes.

4.4 The Institutional Deficit

Asymmetric government has long existed in the United Kingdom, even though this attracted little attention in England. Devolution takes this further in one sense, namely that there are two distinct sources of democratic legitimacy. In most federations, the existence of a considerable number of sub-national governments provides protection against the power of central government. Sometimes, this protection originates from the design of the federal constitution. For this reason, the standing of the German Länder is massively increased by their representation in the Bundesrat (Upper House of the Federal Parliament) (Keating, 1999). In Australia, there is a well-developed formal machinery for conducting policy dialogue between the Commonwealth government and the States. Arrangements differ, but a common effect is to afford the sub-national tier far more protection from central power than is embodied in the formal constitutional position. For example, assigned tax revenues do not have the same appeal in the United Kingdom as in the German context, because the Länder's Bundesrat role gives them genuine influence over policy and budgetary matters.

⁷⁷ A different vision, reflecting the distinctive US tradition of fiscal federalism, is presented by Weingast (1995) and McKinnon (1997). This treats territorial equalisation with suspicion and emphasises the role of market forces in equilibrating regional incomes and public service standards. Riker (1996) considers that the great benefit of federalism is that it imposes limits on government size.

⁷⁸ Conflicting views on Scottish public finances are assessed by Heald et al. (1998) and Heald and Geaughan (1999).

There is the pressing issue for the United Kingdom of how to design institutional machinery to regulate the devolved funding system. Northern Ireland's unfortunate precedent (Joint Exchequer Board from 1921-72) should prove less relevant than the experience of Australia's Commonwealth Grants Commission (Searle, 1996). Nevertheless, there is bound to be scepticism, as there was in 1979:

There is little in the history of Northern Ireland's Joint Exchequer Board to reinforce the extended role proposed by Kilbrandon for a comparable body for a devolved Scotland or Wales (Green, 1979, p. 8).

The counter-argument is that the context of 'devolution around the periphery' is quite different from the context of 'reluctant devolution' in Northern Ireland under the *Government of Ireland Act 1920*. The potential role of a Territorial Exchequer Board will be briefly considered in Section 5.6.

4.5 Resource Accounting and Budgeting

The financial arrangements for devolution have been implemented at a time when there has been substantial change in the UK public expenditure planning system. Resource Budgeting (RB) was only partially implemented in 2001/02, following the completion of SR 2000 in July 2000; this is described as RAB Stage 1. The Treasury fully implemented RB, with effect from SR 2002 and financial year 2003/04; this is described as RAB Stage 2.

The introduction of RAB in central government has involved both Resource Accounting (RA) and RB. As a result of RA, capital assets are valued and depreciated, with financial reporting much more closely aligned to that of the private sector. The Treasury has adopted the term 'resource' to signify the use of accruals accounting, as modified for application in central government. The effects of RB are that the planning and control systems are operated in resource terms, and Supply is voted by Parliament at a disaggregated level in resources and at a more aggregated level in cash (Treasury, 2001a; 2001b).

These modifications to the planning system have implications for the calculation of formula consequences. These could have been worked out in resource, in cash, or in both. Under RAB Stage 1 for the SR 2000 settlement, the Treasury's decision to place the non-cash items in AME rather than DEL greatly limited the impact. With effect from SR 2002, these items were transferred into DEL, with a considerable impact on territorial funding via Barnett formula consequences.⁷⁹

Northern Ireland is differentially affected by this change, owing to the higher level of public assets. Data on this differential are provided in the 2001 edition of the National Asset Register (Treasury, 2001c), on which Table 13 is based. Part A shows asset levels by territory; the Northern Ireland total is much the highest, despite its lower population. Part B analyses, by

⁷⁹ In Table 12, it was noted that non-cash water costs, transferred from AME to DEL as part of SR 2002, were subsequently transferred back to AME. Moreover, the Treasury agreed that certain other non-cash costs would also be transferred to AME on the basis that the counterpart services in Great Britain were provided by local government.

asset category, those assets on the balance sheet of the NIO, then repeats the analysis for the Northern Ireland Departments. A large proportion (71%) of the asset base of the Northern Ireland Departments is held by the Department for Regional Development. Of this, 28% is represented by the Water Service, and 71% by the Roads Service.

The Treasury prepared carefully for the implementation of RAB and consulted with the UK Parliament at each stage of implementation. Nevertheless, it has been important to ensure that the full implementation of RAB did not have unintended consequences (eg intensify convergence) for the operation of the Barnett formula. This is another illustration of the general point that such a formula mechanism can be sensitive to unconnected changes in the public expenditure system as a whole.

Table 13							
The Northern Ireland Entries in the National Asset Register							
PART A: TERRITORY							
£ ,000s (all tables)							
Scotland Office	1,113,318						
Scottish Executive	15,609,977						
Scotland Total	16,723,295						
Wales Office	14,117						
National Assembly for Wales	8,185,241						
Wales Total	8,199,358						
Northern Ireland Office	581,676						
Northern Ireland Departments	21,420,373						
Northern Ireland Total	22,002,048						
PART B: DISAGGREGATION FOR NORTHERN IRELAND							
	NIO Core Department	Police Authority	NI Prison Service	Compensation Agency	Forensic Science NI	Probation Board for NI	Total
Northern Ireland Office							
Land and Buildings	11,884	336,970	109,148		285	2,363	460,650
Plant and Machinery	2,008	43,843	10,986	275	1,585	220	58,917
Assets under construction		300	3,243				3,543
Assets awaiting disposal			1,018				1,018
Intangible Assets	368				60		428
Heritage Assets ¹							57,120
Total	14,260	381,113	124,395	275	1,930	2,583	581,676

Future of the Devolved Funding System

Northern Ireland Departments	Land & Buildings	Plant & Machinery	Other Tangible	Intangible	Total
DARD	146,841	10,949	168,390	806	326,986
Dept of Education	1,290,361	5,491	16,481		1,312,333
DETI	88,530	6,041	810	31,076	126,457
Department of Environment	17,908	3,952	1,920	655	24,435
DFP	181,729	25,311		135	207,175
DHFETE	9,626	1,331	971	1,935	13,863
DHSSPS	1,084,941	75,129	111,965	823,461	2,095,496
DRD	14,982,418	284,276		5,210	15,271,904
DSD	2,008,551	2,820	30,111		2,041,482
OFMDFM		236	6		242
NI Departments Total	19,810,905	415,536	330,654	863,278	21,420,373
NOTE: ¹ Heritage Assets refer to Hillsborough Castle, which belongs to the Northern Ireland Office but not to any separate department therein.					
<i>Source: Treasury (2001c). Some literals have been corrected.</i>					

The purpose of this Chapter is to bring the various arguments together and to draw policy conclusions about the devolved funding system, specifically, though not exclusively, as it affects Northern Ireland. This context of ‘devolution in the periphery’ is extremely important; the isolation of the Northern Ireland funding system during the 1921-72 period was a fundamental problem.

5.1 Building Policy Capacity

In the UK system of government, it is not possible to embed anything: Westminster could repeal its own primary legislation, drawing back all devolved powers. This possibility received a great deal of attention in Scotland during the 1990s, when plans were being drawn up for Scottish devolution. It seems unlikely that the United Kingdom will convert itself into a formal federation, though quasi-federal characteristics are becoming increasingly apparent.

In practice, the only protection that can be afforded to a devolved system is political, namely that the costs of challenging that system are too great for a UK government. In formal constitutional terms, the future application of the Barnett formula, indeed its possible abolition, is entirely a matter for the UK government of the day. The practical politics are quite different. There is an irony in that what was widely interpreted as an attempt to sabotage devolution, namely the two-question referendum in Scotland, conferred an unexpected legitimacy upon the devolved funding system. The Labour Government urged affirmative votes for devolved Assemblies financed via the Assigned Budget system, with the tax-varying power only in Scotland. Given that the referendum was conducted on the basis of the wording of the 1997 White Papers, this gave the Barnett formula more status than even a statutory formula. It therefore puts pressure on UK governments not to alter the system, unless this is to propose financial arrangements preferred by the Devolved Administrations.⁸⁰ White Paper undertakings would normally be regarded as of questionable value, but this may be different. In the absence of a total and unlikely revamp of the UK tax system in a more decentralised form, there is clearly a benefit to the Devolved Administrations in preserving this line of legitimacy back to those referendums. Both 1997 devolution White Papers (Scottish Office, 1997, Welsh Office, 1997b) stated that there would not be fundamental change to the Barnett formula without a new needs assessment. The financing issue was predictably of secondary importance in the Northern Ireland referendum, but the unified funding system for devolution effectively extends the commitment.

Devolution has arrived in Northern Ireland in circumstances when Northern Ireland is short of policy capacity, especially outside government. This is a failing obviously attributable to the historical inheritance. The problems of small size have been exacerbated by experience during the devolved period (when parity offered the route to matched funding) and the period of Direct Rule (when the lack of local democratic legitimacy encouraged lagged imitation of mainland policy). This gap will be hard to fill, but there are steps that can be taken.

⁸⁰ Some of the issues involved in modifying the existing funding arrangements are discussed by the House of Lords Select Committee on the Constitution (2003, particularly paras 103-109).

What makes it even more important to build policy capacity in Northern Ireland is that the devolution settlement incorporates all major parties in government. In contrast, the Lab-Lib Dem coalition in Edinburgh may be replaced in May 2003 by, for example, an SNP-Lib Dem coalition. In parliamentary democracies, oppositions have a double role: they criticise government programmes (in general, a valuable function); and they develop alternative programmes for government. Higher-order considerations in Northern Ireland effectively remove this government-opposition distinction. Therefore, compensatory mechanisms have to be developed to deal with the absence of prospects for alternation. It will be difficult to build collective responsibility within the Executive, as clearly illustrated by the opposition in the Assembly, by parties that had agreed them in the Executive, to regional rate increases for 2001/02.⁸¹ Assembly Committees will have to form a vital part of the accountability mechanism, though this should not be taken as implying a duty on the part of the Executive to follow Assembly Committee recommendations.

In time, devolution should gradually erode the oppositionist politics stimulated by Direct Rule (Knox, 2001), under which there was no reason for Northern Ireland parties to accept any responsibility for unpopular decisions taken by Direct-Rule ministers. One historical factor is that the domination of electoral politics by the constitutional issue has limited the development of conventional left-right politics. Whatever its other faults, such a spectrum focuses attention on what the state should do, and how it should do it. Not least, this is important in terms of developing policy options and in discouraging populist posturing, such as advocating 'spend but not tax'.

Additionally, there are difficult accommodations to strike between civil servants, elected politicians, and various organisations in civil society. Each of these groups has to make adjustments to the devolved context. Civil servants were not encouraged to develop distinctive policies under Direct Rule, looking towards the mainland, particularly England, for policies to imitate. In terms of escaping oppositionism, the task facing politicians is rendered more difficult by the electoral politics of multi-member Single Transferable Vote constituencies; there is likely to be even less enthusiasm than usual for closing local facilities. Civil society organisations partly filled the vacuum of policy development under Direct Rule, but their credentials will increasingly be challenged by those with electoral mandates. One of the forums where these groups can meet is in the evidence-gathering process of Assembly Committees, which can both monitor performance and encourage a more relaxed debate about policy.

A small polity such as Northern Ireland has to look to its local universities for some of its policy capacity. The absence of recent academic research on Northern Ireland public expenditure was discussed in Section 3.1; the gap in applied economic research is wider. The research priorities of a small academic community are likely to be driven by a mixture of factors: the chance events of individual careers; the demands of the Research Assessment

⁸¹ For 2001/02, at the Draft Budget stage, there was a proposed regional rate increase of 8% (domestic) and 6.6% (non-domestic). However, following intense opposition, it was announced at the Budget stage that savings had been found, thereby limiting regional rate increases to 7% (domestic) and 3.3% (non-domestic). This was passed with cross-community support.

Exercise which determines institutional funding; and the diversion of much effort towards the 'bigger' constitutional and conflict-resolving issues. Moreover, the absence of 'normal politics' may have simultaneously drawn some academics closer to these bigger issues, but also detached others from policy engagement.

The kind of public expenditure work done at an earlier period by Wilson (1955), Lawrence (1965) and Simpson (1980, 1984) no longer exists. This earlier work was probably, in part, the product of a better funded and more leisurely age in universities, where curiosity-driven research had greater scope. Universities have been compelled to become more business-like; systematic research on applied Northern Ireland topics is unlikely to be forthcoming unless it is supported by an identifiable funding stream. Paradoxically, some of those most instinctively sympathetic to universities being business-like expect work relevant to the local economy automatically to be done, irrespective of the incentive structure. In reality, researchers in a small polity may find their work difficult to publish in internationally-rated outlets, unless it is genuinely comparative. Comparative work is not only difficult, but also very expensive.

Independent work on public expenditure is double-edged: on occasions it may prove unhelpful to the current generation of policy-makers. There needs to be confidence that a better informed polity leads, in the long term, to better public policy. The bottom line is that, unless core funding on the Northern Ireland economy, including public expenditure, is provided directly or indirectly by the Executive, this kind of research and policy contribution will not be forthcoming. Occasional pieces commissioned on a contractual basis will not resolve this deficiency; continuity in public expenditure research is urgently required. Northern Ireland needs to find a mechanism for promoting long-term research with the potential of inputting into policy development, without becoming too concerned if this sometimes turns out to be 'off-agenda' or produces inconvenient results.⁸²

Although the interests of the three Devolved Administrations may diverge, there is much to give them common ground, in contrast with the isolation of Northern Ireland from 1921-72. In turn, Northern Ireland can facilitate relationships with Scotland and Wales under the aegis of the British-Irish Council (Meehan, 2001), whose significance is enhanced by the 'Celtic Tiger' performance of the Republic of Ireland economy since 1988. Devolution may fundamentally challenge the centralist *status quo* of UK public policy development. A trivial – but indicative – incident is the absence of Northern Ireland participation in the House of Lords debate of 7 November 2001, occasioned by Lord Barnett's winning of a ballot and his call for a 'review' of the eponymous formula. This debate was dominated by Scottish and Welsh peers, with no contribution from Northern Ireland. 'Review' was understood by peers other than the Welsh peers to mean cuts in expenditure baselines in the Devolved Administrations. For the time being, the continuation of the Barnett formula, or something resembling it, is probably assured by its legitimation through the referendum campaigns, though such underpinning will depreciate.

⁸² There are similar problems in Scotland, though it is much larger than Northern Ireland, having 13 rather than two universities. Academic work on devolution, though 'off-agenda' from 1979-97, undoubtedly provided some of the ballast for the devolution scheme enacted in 1998.

As Chapter 2 demonstrated, the practical effects of the Barnett formula, and other aspects of the funding system, can be unexpectedly affected by changes made by the Treasury to the public expenditure system, for reasons unconnected with territorial management. The avoidance of damaging effects through this route is one of the considerations that should bind together the finance officials of the three Devolved Administrations.

The required institutional mix in Northern Ireland will be a strong DFP, functioning as a mini-Treasury, monitored by a vigorous Assembly Committee for Finance and Personnel and by an external policy community which will have to be publicly funded on an arm's-length basis. Policy capacity therefore should have two dimensions. The governmental part, incorporating both Executive and Assembly, must generate objective statistics, facilitate scrutiny and compensate in part for the role that would customarily be played by the opposition. The external policy community must also partly compensate for the missing opposition, as well as undertaking the filtering and interpretation roles that are performed in other jurisdictions.⁸³

5.2 The Future of the Barnett Formula

The operation of the Barnett formula causes political difficulties in Northern Ireland, rather than public expenditure management problems. There is a high level of media and political awareness of the headline numbers on the mainland, such as the announced percentage increase in NHS or education spending in England. For the reasons explained in Section 3.4.2, Northern Ireland cannot match these percentage increases without distorting allocations among programmes. This is a matter of taking the rough (lower percentage increases) with the smooth (no challenge to, or close Treasury control over, the base). Although the Barnett formula is now heavily criticised, these criticisms come from diametrically opposing viewpoints: the formula is variously said to overfund and to underfund the Devolved Administrations.

There are no data in the public domain which would enable confident judgements to be made about whether there has been convergence, or, if not, why. Although it is generally thought that the formula was applied with less bypass in the 1990s than in the 1980s, no data are available (Heald and McLeod, 2002a). The 1990s were a period of low nominal expenditure growth, reflecting both low inflation and low real expenditure growth. Under such circumstances, the mathematics of the formula suggest that there would not be much convergence.

Figure 11 explores the relationship between convergence and the annual rate of nominal expenditure growth. In terms of the mechanics of the Barnett formula, the relative proportions of inflation and real expenditure growth are of no significance. The horizontal axis represents years over which the Barnett formula is strictly applied, without any bypass. No allowance is made in Figure 11 for relative population change, though it could be modified if the mathematical form of the relative population change were specified.

⁸³ The Executive has agreed to merge the Northern Ireland Economic Research Centre and the Northern Ireland Economic Council to establish a new independent economic advice body. This will create a significantly larger organisation with the potential to provide more outputs than the existing bodies working separately. Work on the establishment of the new body is ongoing (Neill, 2003).

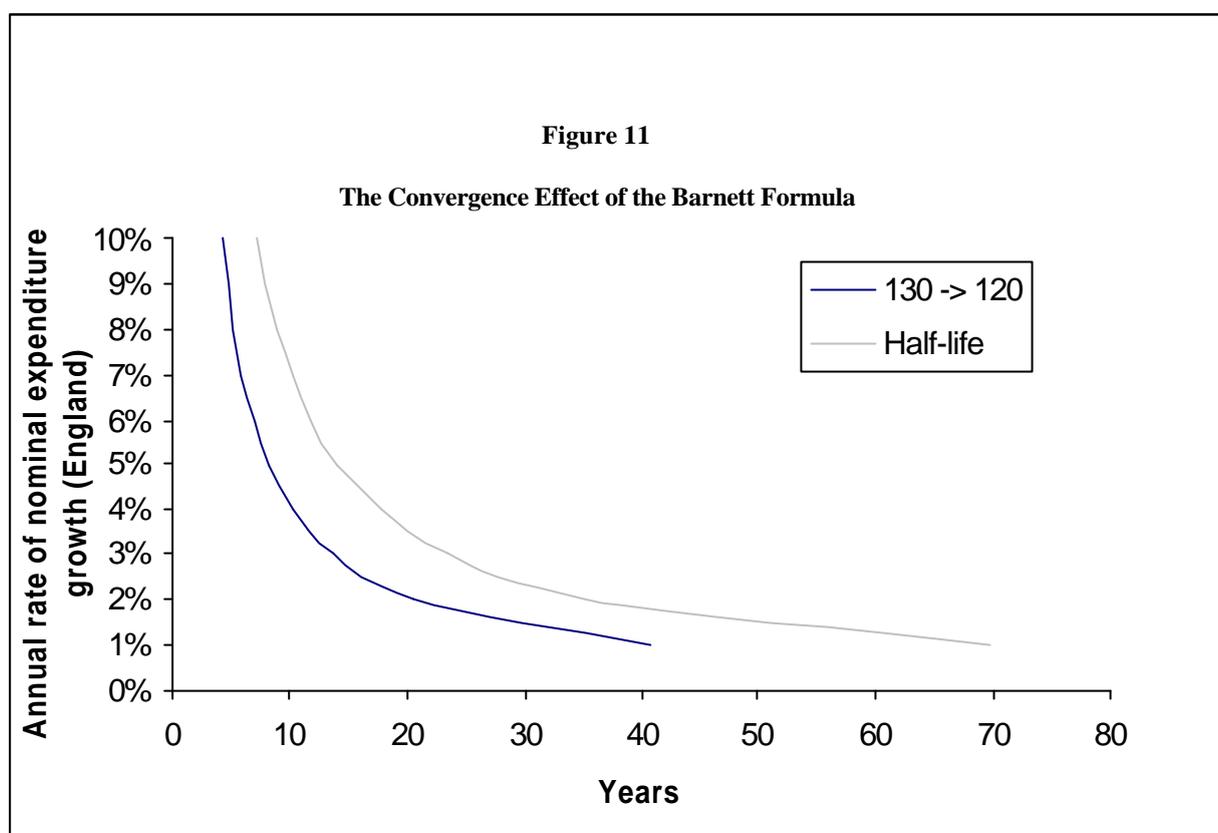


Figure 11 provides insights into why there appears to have been less convergence than expected, and into the prospects for the future. Indexes converge asymptotically on 100, meaning they will never precisely reach 100. Practical measures of the rate of convergence are therefore required.

Two lines are plotted in Figure 11: the half-life; and the number of years for the strict operation of the formula to reduce an index of 130 to 120. The concept of the half-life comes from nuclear physics, where the half-life indicates the time it takes for the activity of a radioactive particle to decay to half its original value. With an annual rate of nominal expenditure growth of 2%, it would take 35 years for half the differential (upwards or downwards) from 100 to be eliminated, for example to move from 120 to 110, or from 110 to 105. With a nominal annual expenditure growth rate of 8%, this half-life becomes nine years.⁸⁴

It is also possible to consider how many years it takes for the index to fall from one value to another; the example plotted is from 130 to 120. The effect of the annual rate of nominal expenditure growth is clear: 20.5 years at 2%; and 5.3 years at 8%.

⁸⁴ For the calculations underlying Figure 11, all growth rates relate to English expenditure only. Automatically, nominal annual expenditure growth in the territories is lower.

Comparable lines can be plotted for any pair of index values. The line for 130 to 120 is to the left of the half-life line because this reduction is less than 50% of the initial difference. This means that, for any given annual rate of nominal expenditure growth, this reduction takes less years than the half-life. In the case of a specified reduction greater than 50%, the corresponding line would be to the right of the half-life line. In Figure 11, both the half-life and '130→120' functions are 'steep' when there are annual rates of nominal expenditure growth above 6%.

If the annual rate of nominal expenditure growth envisaged by SR 2000 and SR 2002 were to be continued throughout the first decade of the 21st century, and the Barnett formula was strictly applied, evidence of convergence with regard to the formula-controlled DEL would soon appear.⁸⁵ Nevertheless, were this to happen, devolved expenditure would be at a much higher level in absolute terms than would have been envisaged when devolution was implemented in 1999.

Such a development would make a needs assessment much more likely, and Section 5.6 will consider some of the relevant issues. If a needs assessment had been completed for all four countries, the issue would then arise of how the upward or downward adjustments from the actual expenditure indexes to the needs indexes would be effected. It would certainly not be feasible for a sudden drastic reduction to be imposed on any of the Devolved Administrations, as that would destabilise them. It would be possible, though the Treasury might well resist, for a Devolved Administration whose expenditure index was below its needs index to receive a sudden increase. The availability of EYF within the three-year SR system would offset some of the traditional concerns about a sudden budget increase not being well used. Something looking rather like the Barnett formula, operating on increments, would be quite likely to follow the conduct of a needs assessment, particularly in the case of a country whose expenditure index exceeded its needs index.

Over the past 20 years, the limited data available have not suggested strong convergence; indeed, there has been little apparent shift, at least at the level of identifiable expenditure indexes. However, this may now change, as a result of high rates of growth of nominal (and real) expenditure, and stricter application of the Barnett formula (ie less opportunity for formula bypass).⁸⁶ This necessitates thought as to how the convergence process should be managed as the expenditure index comes closer to the needs index.

Figure 12 plots expenditure and needs indexes on the vertical axis (England = 100). The horizontal axis measures cumulative incremental expenditure, which begins at zero and increases along that axis. The horizontal axis can also be thought of in terms of years, provided that the annual rate of growth of nominal expenditure is known.⁸⁷ Line B represents

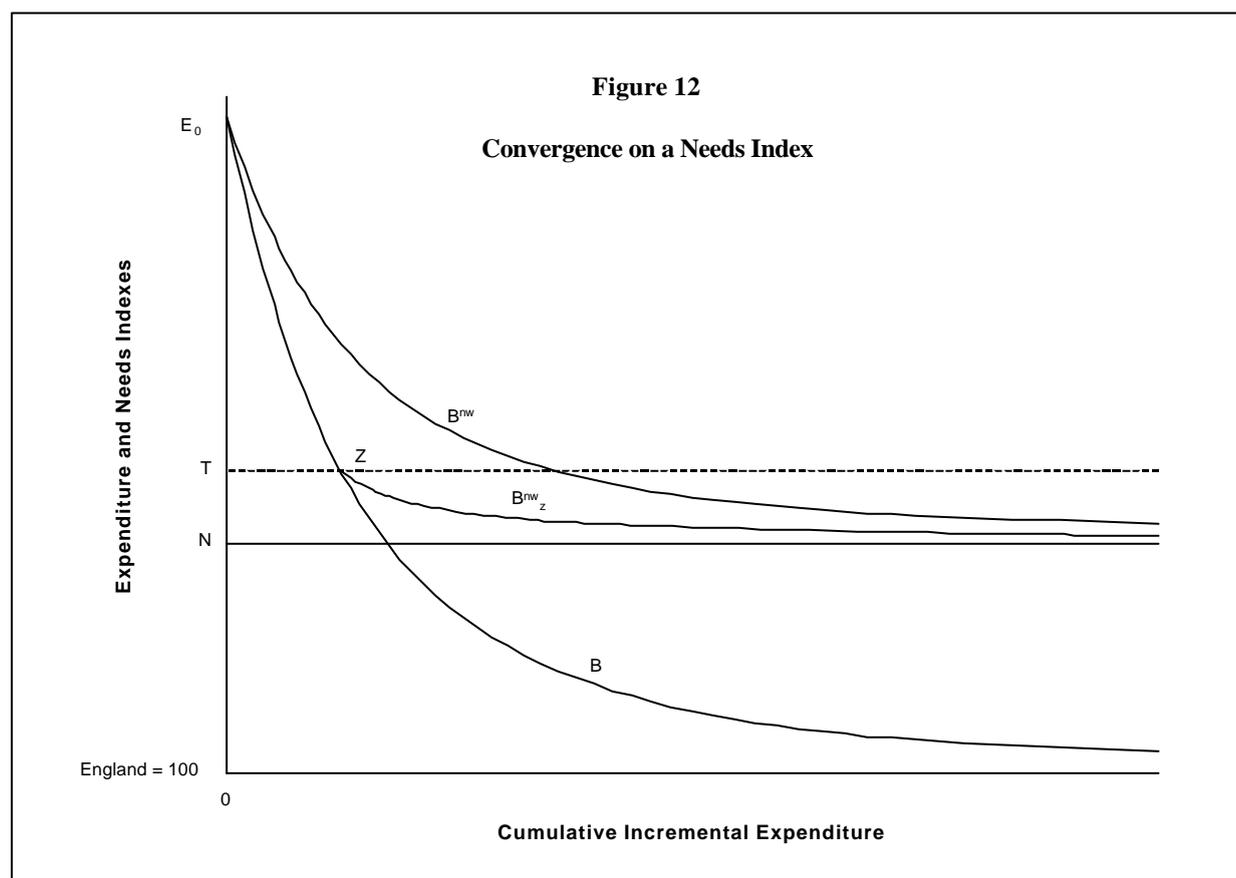
⁸⁵ However, the data required to monitor convergence are not in the public domain (Scotland Office, 2002, Scottish Affairs Committee, 2002).

⁸⁶ Goudie (2002, Figure 6) provides data for Scotland supporting the view that, if the correct expenditure aggregate were to be used for comparative purposes, more convergence would be observed.

⁸⁷ Strictly, the annual rate of nominal expenditure growth must be constant, or the average rate up to a specific date must be known.

the Barnett formula convergence on 100, in the case where there is no relative population change.⁸⁸ Line B^{nw} plots what might be described as the needs-weighted Barnett formula. Instead of incremental expenditure being allocated on the basis of population, it is allocated on the basis of weighted population (ie population multiplied by the needs index for that Devolved Administration). Obviously, B^{nw} can only be implemented after a decision has been taken on relative needs, possibly through the mechanism of a needs assessment.

There has been concern that rapid nominal expenditure growth would produce excessive convergence, with a Devolved Administration ‘crashing through’ its needs index as the Barnett formula drives convergence on England = 100. The motivation for using B^{nw} would be that convergence is now upon N (the needs index of that Devolved Administration). It would be possible to adopt B^{nw} either immediately (when expenditure is at E_0) or when the expenditure index reaches some threshold value above N . In Figure 12, the threshold is represented by T and the horizontal dotted line. The convergence path from Z (the intersection of B with the threshold) is labelled B^{nw}_z .



⁸⁸ With higher levels of nominal public expenditure growth and thus convergence over shorter time periods, relative population change becomes less important.

The adoption of either B^{nw} or B^{nw}_z would be more favourable to the Devolved Administrations than using B , and therefore more expensive to the Treasury. Regardless of the political importance of devolution, territorial funding remains a minor part of the Treasury's portfolio of activities. An advantage from the viewpoint of the Treasury would be that, by avoiding the risk of overshooting the needs index, there would be less risk that the devolved funding system would be subjected to excessive strain. A possible consequence of excessive strain would be large amounts of *ad hoc* formula bypass. Consequently, the cushioning of convergence, as shown in Figure 12, might increase the resilience of the formula system.

5.3 Expenditure Which Has No Effective Comparator

The Assigned Budget system, modulated by a formula, can work smoothly when public services in Northern Ireland are also provided in England. However, an obvious difficulty arises when there is no comparable English service that generates formula consequences. In such cases, additional expenditure in Northern Ireland on such a service necessitates the use of formula consequences generated by those services that do have comparators, unless there is special treatment.

First, there may be a view in the UK government that the public sector should not provide this particular service, in which case special treatment may be denied. Even when there is public expenditure, in support of a service which has been privatised (such as rail in Great Britain), the time profiling of formula consequences from subsidy payments may not match what is required in terms of, for example, investment in Translink (Northern Ireland rail). There are several such examples in Northern Ireland, particularly in services that were not privatised in the 1980s and 1990s, either because the Northern Ireland component was small or the security situation would complicate the sale.

Second, in order for the Northern Ireland public sector to continue to maintain an expenditure differential over England, more of the financing for services without effective comparators may have to come by means of raising revenue from fees and charges levied upon users. Fees and charges are always controversial, but their role should be assessed when making decisions on expenditure levels. As the Assigned Budget operates in terms of net expenditure, higher fees and charges permit higher gross expenditure.

Necessarily, there has to be political agreement between the Northern Ireland Executive and the UK government on the extent to which funds will be separately channelled in support of activities for which there is no comparator. Some of these services are sufficiently important to the performance of the Northern Ireland economy that it is clearly desirable that they avoid capital starvation and do not put undue pressure on mainstream devolved services.

A significant change in SR 2002 was the reclassification of non-cash water costs from DEL to AME. This reduced the Assigned Budget DEL by £373 million in 2002/03 and by £393 million in 2003/04 (see Table 12). This transfer was made on the basis that the water sector would become self-financing by 1 April 2006, a position justifying treatment as AME. This

decision means that the problem identified above, namely the absence of a comparator to generate formula consequences, is resolved. However, there are also disadvantages within the devolved financing system in expenditure being classified to AME rather than DEL. First, the Executive loses the flexibility of being able to transfer funds between water and services within the Assigned Budget. Second, savings generated by increased efficiency automatically accrue to the Treasury and do not stay with the Devolved Administration. In contrast, Scottish Water is treated as a public corporation. Its net borrowing and subsidy (the latter being zero) is scored as DEL. Consequently, the Scottish Assigned Budget benefits directly from increases in efficiency which reduce Scottish Water's net borrowing. Third, a substantial amount of policy autonomy may be sacrificed when total expenditure on non-cash water costs has to be agreed on a yearly basis with the Treasury. Notwithstanding the desirability of greater fiscal effort in Northern Ireland, towards which 'payments' (ie taxes or charges) for water should play a part, the leverage now enjoyed by the Treasury over the staging of increases may well cause future difficulties on a politically sensitive issue.

In terms of the changes made at the time of SR 2002, the changed treatment of non-cash water costs may be seen as part of a larger package, including the granting of borrowing powers.⁸⁹ The specific issue arose that Northern Ireland, where local government functions are limited, would be unable to benefit from an equivalent to the prudential regime for local government borrowing, in the course of being introduced in Great Britain.

There are several components to the RRI,⁹⁰ announced by the Chancellor of the Exchequer in May 2002 (Office of the First Minister and Deputy First Minister, 2003). First, the Executive has gained a temporary borrowing power of £125 million in the financial year 2003/04. This takes the form of a loan from the Treasury, repayable from regional rate income. Second, a permanent borrowing power, which requires legislation currently being progressed at Westminster, will become available from 2004/05. This will be repayable from regional rates and additional revenue sources, as yet unspecified. There is a commitment that there will be no major increases in local revenue until after full public consultation and until there is a fairer system for raising revenue from the domestic property tax. Third, the UK government has transferred, without charge, some exceptional security assets, the proceeds of whose disposal will be available to the Executive.

⁸⁹ 'In May 2002 the Government announced new borrowing powers for the Northern Ireland Executive and the establishment of a new strategic investment body, with funding of £200 million in the first three years' (Treasury, 2002d).

⁹⁰ The Office of the First Minister and Deputy First Minister (OFMDFM) have been taking forward legislation over recent months to cover two key aspects of the RRI, namely the establishment of the Strategic Investment Board (SIB) and the empowerment of OFMDFM to hold and develop the former military and security sites which were transferred under the RRI. The draft Strategic Investment and Regeneration of Sites (Northern Ireland) Order 2003 was laid in Parliament on 14 January 2003 and is expected to come into effect shortly. After the legislation comes into effect, the SIB will be created as a company limited by guarantee; a designation Order will also be required. The process is likely to be completed by the end of March 2003.

5.4 The Trade-Off between Expenditure and Fiscal Effort

It is not a popular thought, but the benefits of public expenditure in Northern Ireland will have to be traded off, at the margin, against their costs in terms of locally-borne taxes and charges. This trade-off will become more explicit for a number of reasons: the return to normality in which public services and financing issues rank more prominently on the political agenda; the restoration of the devolved legislature; and the mechanics of the Barnett formula. These factors will generate demands for better economic statistics about Northern Ireland in general, and specifically about its public finances.

There is no counterpart in Northern Ireland to *Government Expenditure and Revenues in Scotland (GERS)*, an annual series which began in 1992 (Scottish Office, 1992). Although there has been much controversy about *GERS*, its existence anchors political debate about Scottish public finances.⁹¹ The Welsh Office abandoned its counterpart after only two issues (Welsh Office, 1997a). The reason why such a document does not exist for Northern Ireland might well be that provisional estimates suggest that the picture would be bleak, in terms of its dependence on external subvention. In the new context of devolved government, that is not a persuasive argument against developing and publishing better statistical data. Not least, a counterpart (Government Expenditure and Revenues in Northern Ireland: GERNI) would provide a benchmark for monitoring future improvement in the Northern Ireland economy and its public finances.

Better data from a future GERNI are likely to reinforce Simpson's (1984) conclusion, drawn from his study of the 1921-72 Stormont period, that a block grant system is appropriate in Northern Ireland. Unlike Scotland, whose macroeconomic performance does not depart much from the UK mean, Northern Ireland is well below. Several arguments used in Scottish debates do not affect Northern Ireland: for example, the territorial claim to oil revenues which allows different bottom lines to be struck; and the speculation that Scotland, freed from policies constructed for London and the South East, would emulate the recent economic performance of the Republic of Ireland. Fiscal autonomy, in whichever of the meanings covered in Section 4.3, is not relevant to Northern Ireland in the foreseeable future.

Against the background of a block grant system, Smith (1996) and Blow et al. (1996) emphasised the importance of fiscal accountability at the margin. In the short run, this is a question of increasing fiscal effort from the mechanisms (regional rates, water and sewerage charges etc.) within the competence of the Northern Ireland Assembly. In the medium term, there is bound to be a UK-wide review of how the devolution arrangements have bedded down in the three territories. That would provide an opportunity, *inter alia*, for Northern Ireland to request the tax-varying power over income tax now only allowed to the Scottish Parliament. Nevertheless, there should be no illusions about how difficult politically it would be to use such a power, especially given the land border with the Republic and the widely held view that there is a disproportionately large black economy. Leaving aside such issues of fiscal architecture, the point needs again to be stressed that current concerns about a shortage of budgetary resources are exaggerated. Obviously, such a situation is unlikely to last.

⁹¹ For an analysis that brings together the data in successive issues of *GERS*, see Goudie (2002).

Crucially, fiscal accountability at the margin should involve the ability both to increase and to reduce taxes and charges, without offsetting adjustments to the Assigned Budget.

5.5 Improving VFM

In this discussion, VFM should be understood to include ‘policy effectiveness’ as well as ‘managerial efficiency’. Deciding exactly what is policy and what is management is notoriously elusive, not least because decisions characterised as policy are taken outside the scope of the public auditor. A neat example is the contrast between the privatisation of public utilities and the PFI. The Conservative Government embraced privatisation as a policy, thereby restricting the National Audit Office (NAO) to reviewing the implementation of that policy, though some reports stretched that remit. Both Conservative and Labour Governments have consistently stated that the PFI is about VFM, thereby allowing much greater scope to the NAO and the NIAO.

One of the advantages of the Assigned Budget system is that the Devolved Administrations automatically retain 100% of all savings from improved VFM. The particular circumstances of Northern Ireland have meant that improved VFM will be a gradual process, likely to involve substantial rationalisation of public administration and perhaps more outsourcing. Neither of these processes is likely to be easy, but a failure to use them, where appropriate, will negate an important element of the flexibility enjoyed by the Executive.

The Northern Ireland Executive exercises direct control over a much larger proportion of the Assigned Budget than do its Scottish and Welsh counterparts. This is a direct consequence of the much smaller importance, in terms of functions and expenditure, of local authorities in Northern Ireland. Consequently, the Executive can make policy over a broader canvas, without there emerging difficult issues of competing mandates and conflicting legitimacy.

The nature of the multi-party basis of the Executive makes it difficult to establish and sustain a corporate view of public expenditure priorities. Nevertheless, it is essential to think seriously about the scope for policy choice in Northern Ireland, within the framework of the scope of UK devolution (Keating, 2001). One of the distinguishing features of Northern Ireland is that there are far fewer political feedbacks between central and devolved government, via party, than in Great Britain, where the main parties compete at three (ie central, devolved and local) levels. The isolation from the UK party system means that the fear of ‘embarrassing party colleagues’ at different levels does not arise. Northern Ireland still enjoys the potential policy freedom arising from a lack of mainland interest. Pre-devolution, nothing emptied the Chamber of the House of Commons more effectively than a debate on Scottish legislation; being invisible can, on occasion, be a big advantage. Post-devolution, there is certainly more metropolitan interest in Scottish and Welsh policy measures which can be represented as ‘anomalous’.

A crucial issue in Northern Ireland is how to insulate decision-making on incremental budgetary allocations from the pattern of incremental allocations in England. If Northern Ireland attempts to replicate English percentage increases on services involving large amounts

of expenditure, this will suffocate other programmes. There will undoubtedly be pressure via media headlines to ‘pass through’ to Northern Ireland functional programmes, such as education and health, the percentage increases applicable in England to services currently spending markedly different amounts per capita and characterised by different service delivery problems. If formula consequences are passed through in this way, the Assigned Budget itself will become effectively segmented, thereby sacrificing one of the inherited advantages enjoyed by the Devolved Administrations.

Several priorities can be identified. First, a key issue in Northern Ireland will be to secure better VFM from devolved expenditure. Despite the problems of comparing expenditure levels, there can be no doubt that per capita expenditure is well above the UK average. An external observer would speculate that sustained peace in Northern Ireland should help this process, as the security situation must have complicated public service delivery across the board. There will be great interest in whether higher expenditure is represented by higher quantities and qualities of output, or by higher unit costs (which may themselves be the result of either more difficult production conditions or lower technical efficiency).

Managerial efficiency has been investigated by the NIAO, established in its present form in 1987, somewhat later than the establishment of the NAO in 1983. The NIAO’s remit will, following the current transfer to it of local government audit and HPSS audit, cover ground occupied in England by the NAO and the Audit Commission. Northern Ireland public bodies might be expected to have been subject to audit pressures broadly comparable to those of their GB counterparts.

It seems likely that patterns of service configuration in Northern Ireland may significantly differ from those in Great Britain, or from what they would otherwise have been without the history of the last 35 years. These are not the questions of managerial efficiency on which the NIAO concentrates. For example, there is likely to be substantial duplication of certain facilities resulting from conflict between the two communities, thereby limiting catchment areas. Protests against facility closures acquire a significance in Northern Ireland not attached to parallel events in Great Britain.⁹² Furthermore, communities outside Belfast are probably more self-contained in public facilities than would otherwise have been the case. Such differences in service configuration are likely to become an issue in the context of a needs assessment (see Section 5.6), during which there will be disputes as to which model of service configuration should be costed. For example, it will be questioned whether the more fragmented provision in Northern Ireland constitutes evidence of greater need or of lower efficiency.

⁹² For example, a riot and 141-day occupation against the closure of Go vanhill Baths in Glasgow in 2001 was treated as an unpleasant specific incident, constituting a serious threat to law and order but not a challenge to the authority of the state.

Second, an urgent priority must be a rationalisation of the machinery of government in Northern Ireland,⁹³ the complexity of which (eg Education and Library Boards, and Health and Social Services Boards) suggests a use of quangos to legitimise Direct Rule. Carmichael (1996) discussed the political and historical background to service delivery by quangos, leading to centralisation in public service delivery. With devolved government restored, there would seem to be potential savings to be secured from simplification and delayering. This is rendered more urgent by the additional number of ministerial departments created when the Executive was established.

A systematic effort to streamline and simplify will be required. However, with the UK-wide emphasis now on public service delivery, it is important not to allow reorganisations and restructuring to divert managerial effort and to undermine service delivery. Moreover, such a process will not be painless; it will mean the disappearance of relatively well-paid jobs and may involve substantial up-front redundancy costs.

Third, and outside the scope of this Report, there will be important questions to ask about the optimal allocation of expenditure. For example, there is the question of how best to encourage economic development in Northern Ireland, with the objective of catching up with Great Britain and the Republic of Ireland in terms of GDP per capita. Two different views might be articulated: allocating more expenditure to economic development programmes, including subsidies to inward investment and tax expenditures; or giving expenditure priority to improved social and economic infrastructure, including mainstream services such as health and education. On these issues, Northern Ireland's position differs from those of the other two Devolved Administrations, notably because of its competitive position relative to the Republic of Ireland and because its demographic profile contains greater pressure for higher expenditure on education.

5.6 The Role and Conduct of a Future Needs Assessment

A caveat is required before discussing the arrangements for a needs assessment. Such an exercise does not measure absolute needs, despite a general impression to the contrary. It is best thought of as providing an index of relative need, which can become the basis for dividing up a given amount of public money, when that amount is, at least in the short term, exogenously determined.

Needs, in an absolute sense, are extremely large, if not infinite, and it is certainly beyond the capacity of the public purse to meet all of them. One of the reasons why a needs assessment is often thought appealing is that it provides particular functional sectors and spending lobbies with an opportunity to press their claims. Generally speaking, even if people are well informed about the absolute level of their own needs, they are poorly informed about the needs of others, and hence about their relative need. This point is reinforced when the needs

⁹³ In May 2002, the Executive established a Review of Public Administration, which has established its own website (Review of Public Administration, 2002) (www.rpani.gov.uk). It has undertaken a mapping exercise of the Northern Ireland public sector, which is nearing completion. The intention is to prepare a formal consultation document. In practice, abolishing some existing non-trivial bodies will be difficult, as will resisting the creation of new ones.

assessment covers a wide range of public functions, whose benefits cannot be reduced to a common measurement.

A needs assessment is not a guarantee that needs will be met. Instead, the purpose is to construct a rational and defensible basis for allocating limited public resources in line with measured relative need. For example, the resource allocation mechanism might be thought of as allowing the same proportion of measured need to be met in each jurisdiction, at a standard level of fiscal effort.⁹⁴ It is possible, of course, that the conduct of a needs assessment may indicate to the UK government that the present ratio of public expenditure/GDP is insufficient to provide world-class public services across the board, leading to either higher taxes or the load-shedding of public functions. However, it is an illusion to think that a needs assessment automatically brings more resources.

Embarking on a needs assessment would bring to the fore some awkward questions. First, how does one strike a balance between territorial equity (ie full equalisation of taxable capacity relative to needs) and incentives (eg to adopt policies which enhance taxable capacity and minimise the generation of needs)? Second, how can the system avoid the perverse incentives which are created by rewarding failure: for example, should more NHS funds automatically go to areas with poor health outcomes, especially if these are controllable either by residents or by other public sector bodies? Third, there are trade-offs within any fiscal equalisation scheme. For example, it may be necessary to accept ‘rough justice’ in certain funding mechanisms, as preferable to costly administrative systems and incessant central intervention in service delivery patterns. In particular, a periodic needs assessment would be superior to an annual system. Serious thought must now be given to issues such as these.

In due course, there will be a comprehensive UK-wide needs assessment, whether the stimulus is resentment in England at the perceived advantages of the Devolved Administrations (‘blood on the carpet’ (Hetherington, 2001)) or concern in the Devolved Administrations that convergence may be going too far. If the present high rates of nominal expenditure growth continue for long, the timing of such a needs assessment will be sooner than previously expected.

A needs assessment will be a highly complex exercise, taking a lot of time and resources. Moreover, no-one should underestimate either the technical difficulty or the political sensitivity of such an exercise. The practical and political difficulties were highlighted, in the House of Lords debate on 7 November 2001, by Lord Forsyth (2001) and Lord Sewel (2001).⁹⁵ These issues have also been examined by Midwinter (1999).

⁹⁴ There are alternative formulations of the territorial equity objective: for example, to leave the same per capita level of measured need unmet in each jurisdiction. Where the sub-national jurisdiction has taxable capacity of its own, decisions on how to use this might lead to more, or less, relative need actually being met, dependent on the actual level of fiscal effort.

⁹⁵ Lord Forsyth was Secretary of State for Scotland from 1995-97; Lord Sewel was Minister of State in the House of Lords at the Scottish Office from 1997-99 and responsible for the Lords’ passage of the *Scotland Act 1998*.

Devolution on the basis of an unchanged Barnett formula probably exceeded the bargaining expectations of the territorial departments in the period before the devolution legislation was enacted. Furthermore, the Devolved Administrations gained some protection from the Labour Government's undertaking not to substantially revise the Barnett formula without a needs assessment, about which the Devolved Administrations would be fully consulted.⁹⁶ Subsequently, the Devolved Administrations have faced difficult political judgements about whether to keep their heads down and hope that 'dangerous' issues would go away. The political problem for the Devolved Administrations is that they must always look simultaneously in two directions. Such contortions, which were easier to effect in the pre-devolution period when territorial business was regarded as boring in London, are now less feasible. It is now more difficult to say one thing in Belfast (or Edinburgh or Cardiff) and something else in London. Not least, there is electronic access to what appears in the *Belfast Telegraph*, *Scotsman* and *Western Mail*.

There have been times when the lack of transparency about the Barnett formula and the confusion about what constitute valid comparisons have been advantageous to the territories. There remain questions about whether it is in the interests of the Devolved Administrations to flush certain numbers into the public domain. These would be helpful in explaining the present system to domestic audiences, but might also be used against the Devolved Administrations by hostile commentators. Nevertheless, continued reliance upon opaqueness is highly dangerous. For example, the present situation leaves the Devolved Administrations vulnerable to spins and leaks at crucial moments. The UK government has access to much better data on spending on comparable services than is in the public domain, and more work has been done within the Treasury to update the 1979 needs assessment exercise (Treasury, 1979) on a periodic basis than has ever been made public. Treasury officials tend to subscribe to the view that the territories have done too well out of the existing system, a view conditioned by the extent to which both the territorial departments and now the Devolved Administrations have been 'out of reach'. Given these circumstances, transparency is now the best protection for the Devolved Administrations.

This is the time to argue for better data in the public domain, and to deny the Treasury and other UK departments leverage over when to release data which are, or can be portrayed as, damaging to the Devolved Administrations. There is a pre-devolution Scottish example of the disreputable commissioning of research in this area. The terms of reference of the study (Coopers & Lybrand and Piedad, 1997) on comparative local authority expenditure, commissioned by the Scottish Office under Secretary of State Ian Lang, explicitly prevented the contractors from speaking to specified groups of organisations who were knowledgeable about policy differences and data issues. Predictably, this led to the report being portrayed as a political attack by central government on Scottish local authorities.

The Devolved Administrations need to be well prepared for the eventual needs assessment, even if they make the tactical judgement that they should not themselves initiate

⁹⁶ The July 2002 Statement of Funding Policy (Treasury, 2002b, para 11.3) states: 'Substantial revisions to this Statement of Funding Policy would need to be preceded by a study of relative spending needs across the United Kingdom. The detailed arrangements for such a study would need to be decided at the time, but the Treasury would fully consult the Secretaries of State and devolved administrations on the arrangements.'

developments. The vehicle which does the needs assessment, and its terms of reference, is of paramount importance. Categorically, the needs assessment should not be done by the Treasury or the Cabinet Office. The legacy of centralised government renders these bodies unsuitable for making the judgements necessary to sustain equalisation in a decentralised polity. The results of exercises under their control would lack legitimacy. This task has to be entrusted to a new body, at arm's length from both the Treasury and the Devolved Administrations. Heald and Geaghan (1996) proposed the establishment of a Territorial Exchequer Board on the Australian model. A similar proposal has recently been made by the House of Lords Select Committee on the Constitution (2003). The ineffectiveness of the Northern Ireland Joint Exchequer Board (Gibson, 1996), though providing a warning of the dangers to be avoided, should not discourage such an institutional innovation.

The most obvious example of such a body is the Commonwealth Grants Commission (CGC) in Australia, which is responsible for assessing the relative needs of the states and territories. Its judgements, though sometimes controversial, command respect (Commonwealth Grants Commission, 2001; 2002, Searle, 1996). The CGC is a technical body, which makes recommendations on grant distribution to the Commonwealth government; the final decision is political. The advantage of such a system is that it separates out, to the greatest extent possible, the technical issues about data, comparability and relative needs from the final political decision. Clearly, a Commonwealth government that wishes to depart from CGC recommendations will have to account for its actions.

Given the UK starting point, the specification of the terms of reference of such a UK body will be crucial, as these would determine the working methods and the scope for subsequent disagreement. Variations in demography can be objectively verified. However, a key issue will be variations in participation rates in public services, both total participation rates (ie proportion of an identified cohort consuming that service) and public sector participation rates (ie proportion of an identified cohort consuming that service from a public body). One of the factors behind the announcement of the Goschen formula in 1888 was higher participation rates in secondary education in Scotland than in England. There is a parallel issue now, with participation rates for higher education considerably higher in Scotland and Northern Ireland than in England. Also, there are marked differences in the extent of middle-class exit from publicly provided services such as health and education. This is much lower in the territories than in England, though much of the difference is attributable to London and the South East.

The needs assessment might proceed on the basis that the costed participation rate in publicly provided services would be the rate in England, or a UK average rate. Alternatively, it might proceed on the basis that there is a universal entitlement for members of a given cohort to use specified publicly provided services, and that budgetary resources should follow actual usage. It is unquestionably in the interests of the Devolved Administrations to pay careful attention to how these terms of reference are drafted. A needs assessment has to be given strong political steerage, otherwise it will become enmeshed in controversy and bad feeling. In political terms, the question of differentiation within England would force itself onto the agenda. However, such a development would greatly accentuate the data problems.

Admiration for the independence of the CGC does not necessarily mean that its detailed methods should be emulated. There are important contextual differences between Australia and the United Kingdom. Australia is a long-established federation, towards the centralised end of the spectrum of federations. In particular, the Commonwealth government dominates revenue-raising. However, there are six states and two territories, none of which totally dominates the federation. In contrast, the United Kingdom currently has devolved government only on its periphery: devolution covers only 16% of the 2001 census UK population, though 47% of the land area. It is therefore impossible to speak of average practice in the United Kingdom which does not effectively mean English practice. The Devolved Administrations would rightly be wary of any kind of annual needs assessment exercise, which would in practice bind them to English policy mixes and implementation structures. Indeed, the suggestion has been made that the Devolved Administrations should become part of the Standard Spending Assessment for English local authorities and of the Resource Allocation Working Party assessment for health expenditure (Davies, 1997). It would be contrary to the spirit of devolution to bring the Devolved Administrations within annual mechanisms designed to allocate expenditure within England. Nevertheless, the developments set in train by the Labour Government's White Paper (Cabinet Office/DTLR, 2002) on devolution to the English regions means that these issues will not disappear.

Notwithstanding the broad similarities of public service provision throughout the United Kingdom, it is easy to find examples of difficult areas. First, the line between 'need' and 'policy choice' is less clear cut than it first seems. Assessments of relative need are partly technical exercises and partly matters of political judgement, notably about: what constitutes a policy; what is a consequence of policy discretion; and what is a binding constraint. A Scottish example illustrates this point. Since 1918, there have been separate non-denominational and Catholic school systems, both managed by local authorities. This duplication undoubtedly imposes extra costs, particularly in the Scottish context of falling school rolls. Treasury officials, especially if their ministers were hostile to devolution, might argue that these extra costs should be met entirely from Scottish resources. Needless to say, this would raise hugely sensitive issues because of the history of this separate provision (Devine, 1998). Whether this is treated as policy choice for the Scottish Parliament or as part of the topography of Scotland (as are the Cairngorm mountains) would become the subject of heated controversy.

Second, the system of four-year Honours degrees in Scottish universities is different from the three-year degree in England and has been criticised as wasteful. However, this is closely linked to marked differences from England in the structure of secondary education: a move to three-year Honours degrees would require greater capacity in the Scottish school system. There are other differences connected with qualification systems and the extent to which higher education is delivered within further education institutions. If the model costed for needs assessment purposes were the English model, there would be far-reaching repercussions, including pressures for greater policy and institutional uniformity.

It is misleading to think of a needs assessment exercise replacing the Barnett formula. Rather, a key question is how the Barnett formula and the needs assessment would interact. The purpose of a needs assessment would be to validate the continuing use of a Barnett-type

mechanism for adjusting the Assigned Budgets. Such an exercise should be periodic, partly because of the resources involved and partly because greater frequency is likely in practice to reinforce uniformity in policy and delivery mechanisms. The cycle might be, say, every seven or ten years.

Once the results of a needs assessment have been produced, the key comparison is between the needs index (assessed need to spend per capita on devolved services, expressed as England = 100) and the expenditure index (actual expenditure per capita on devolved services, expressed as England = 100). The purpose of the formula is then to eliminate these differences on timescales which are administratively and politically feasible. With high dependence on block grant, sudden reductions, and perhaps sudden increases, would be destabilising.

The finance ministries of the Devolved Administrations should therefore commence advance planning for a UK-wide needs assessment. Despite the temptation in Scotland and Northern Ireland to postpone any discussion of expenditure indexes, it will be safer for the Devolved Administrations to see such machinery put in place whilst the constitutional reform agenda still enjoys a reasonably fair wind at Westminster.

Unlike from 1921-72, Northern Ireland is now part of a broader system of devolved government. There is scope for the development of formal and informal links with Scotland and Wales, at Executive, Parliamentary and civil society levels. The Devolved Administrations are to some extent competitors, most obviously in the field of inward investment, but they share many common interests, including a stable funding system.

There will be material differences in circumstances in Northern Ireland which are relevant to a needs assessment. Two examples illustrate the kind of issues on which prior planning is required, so that relevant data can be assembled. First, there are 31% more school pupils per capita in maintained schools in Northern Ireland than in England (Office for National Statistics, 2002, Table 4.1), reflecting the different age structure of the population. This is clearly relevant to levels of expenditure per capita. There is no published relative for schools expenditure; for Education as a whole, the index is 142 (England = 100). Second, there is a desire to expand higher education provision in Northern Ireland, in part in order to reduce the net emigration of those well-educated young people who, having studied in Great Britain, may not return.

There has recently been a lot of preparatory activity in Northern Ireland, with the DFP urging departments to think about both their performance and relative need factors. However, the results of this activity have not yet reached the public domain. The Executive commissioned six Needs and Effectiveness Evaluations (NEEs), covering the areas of: Financial Assistance to Industry; Education; Health and Social Care; Vocational Education and Training; Housing; and Culture, Arts and Leisure. The needs section of the reports sought to assess the level of need in Northern Ireland relative to England, using a variety of objective factors. The Public Finance Research Unit of the Northern Ireland Assembly commissioned Professor Arthur Midwinter of the University of Strathclyde to provide a preliminary assessment of the NEEs. The draft reports were being considered within the Executive, but the exercise has not

continued under suspension. Consequently, the reports have not been published, though the Assembly's Committee for Finance and Personnel has expressed its desire to debate them (Committee for Finance and Personnel, 2002a, para 5.10).

6 CONCLUDING COMMENTS

The proposals of this Report have been expounded in Chapter 5, so that this final Chapter is limited to some concluding remarks. These stress the importance of transparency, optimism and realism, and of meeting the challenges ahead.

First, the Northern Ireland Assembly and Executive should embrace *transparency*, as indeed should their counterparts in Scotland and Wales. This is a virtue much proclaimed by the Treasury, for example in its *Code for Fiscal Stability* (Treasury, 1998b). Such an approach will form the best long-run protection of the autonomy of the Devolved Administrations, and also serve as a means of educating their publics. Transparency naturally entails some risks, though it is clear from the Report that those risks already exist. Greater transparency of the territorial fiscal arrangements is now inevitable: the Devolved Administrations can either willingly embrace it, or wait for it to be imposed upon them, probably at an inconvenient time. The present author has an unshakeable belief that the principles governing the UK territorial fiscal system can be made accessible, despite the inevitable technical complexity of its detailed operation. The present opaqueness has owed much to obsessive secrecy and to limited institutional memory.

Second, there are grounds for *optimism* about financing devolved government. There is so much political capital tied up in making a success of devolution in Northern Ireland that the opportunities outweigh the difficulties. As stressed at many points in this Report, ‘devolution all around the periphery’ is very different from the isolated experience of devolution from 1921-72. Devolution in Northern Ireland is unlikely to fail because of questions of funding, though this conclusion should not be interpreted as implying that there will be a soft budget constraint. Managing fixed budgets, with limited revenue discretion, will prove demanding when resources are less abundant.

Third, there needs to be *realism* about the pace at which institutional developments can be embedded and at which desired improvements in the economy and in public services can be effected. In part, existing expenditure patterns are the result and price of consensus-building and the striking of a political accommodation. Accordingly, change needs to be managed carefully.

If there is sustained peace and economic prosperity, Northern Ireland can expect over the medium term to see its identifiable public expenditure index considerably reduce. The same will happen to its Assigned Budget index. Under such circumstances, this is a development which should be planned for and even welcomed. However, the need to spend on devolved services will remain dependent on, for example, demographic factors, which would feed into a needs assessment. High-quality information needs to be assembled well in advance.

The most likely outcome is for there to be some compression of territorial expenditure indexes, particularly from a level which may be higher than would emerge as needs indexes from a needs assessment exercise. This convergence needs to be accomplished in a gradual, non-disruptive way. The possibility of this being achievable has been greatly enhanced by the extent to which the results of CSR 1998, SR 2000 and SR 2002 favoured those functional areas that are devolved. For example, the substantial boosts to education and health expenditure in England have generated large formula consequences for Northern Ireland.

Even were strong evidence of convergence to appear, this would still represent absolute levels of per capita expenditure in Northern Ireland much higher than would ever have been anticipated in 1997. Mixing up absolute levels and indexes in public debate is a guaranteed route to confusion.

Fourth, there are significant *challenges* ahead, about which much has been said in this Report. It is important that Northern Ireland does not become preoccupied with other people's agendas. In this instance, its detachment from mainland politics positively helps. It should not buy into the 'crumbling public services' agenda which now dominates the metropolitan media and which has provoked panic in the Labour Government, producing spending commitments in advance of the timetable originally set by SR 2002. What is required is reflective consideration of Northern Ireland circumstances, taking careful account of the extent to which expenditure and performance are different from those in England. Moreover, Northern Ireland should not become obsessed with headline comparisons of percentage increases, taking no account of the expenditure base. There is no rational basis on which Northern Ireland should expect to match percentage increases, regardless of the base. Matching must not be elevated into a principle, whatever the headlines, for example describing as 'robbery' the difference between the English percentage applied to the Northern Ireland base and the formula-derived increments. If there remains a fixation with the Barnett formula, that would be a recipe for paralysing changes in expenditure mix and for defeating the purpose of devolved government.

Finally, the contribution which this Report hopes to make is to render more accessible the funding arrangements for devolution in Northern Ireland. Consequently, it has contained a detailed technical description of the financial system as it operates today, showing how Northern Ireland is embedded within a system also covering Scotland and Wales. By pulling together the most up-to-date expenditure data, the Report has provided an explanation of recent trends and considered likely future developments. The proposals in Chapter 5 provide a basis for taking the agenda forward.

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