

## Written evidence submitted by Professor David Heald<sup>[1]</sup>

1. I watched with interest the Committee's session with Treasury officials on 10 June 2019 and provide my own responses to the Committee's core questions. I have organised by topic, citing for convenience the question numbering on the Committee transcript (Public Accounts Committee, 2019).

### Sustainability of the Barnett Formula

**Q3:** "What longevity do you think there is for a system that is as complex, interwoven and arguably opaque as the Barnett formula?"

**Q6:** "do you believe that the Barnett formula, as the chunk in the middle of that system, will still be fit for purpose in five or 10 years' time to properly ensure that there is a fair allocation of funding around the United Kingdom?"

**Q2:** "how fit for purpose [do] you think the Barnett formula is for funding adequately the nations of the UK outside of England?"

2. The predecessor Goschen formula lasted from 1888 until at least 1958, so the 1978 Barnett formula has not yet matched its longevity.<sup>[2]</sup> In the jargon of academic political science, the UK is a 'union state' not a 'unitary state', neither Scotland nor Northern Ireland having been fully assimilated. Constitutional and governmental arrangements have always been asymmetric, in part because Scotland, Wales and Northern Ireland constitute 47% of the UK land mass but only 16% of the UK population. The 20 years of political devolution since 1999 have made these differences more visible, particularly to England. The recent expansion of devolved powers in Scotland, which are often followed with a lag by Wales and Northern Ireland, resulted from the close-run 2014 Scottish Independence Referendum, with the "Vow" (Cameron et al, 2014) offering a "better devolution deal" as an alternative to independence.
3. The fact that there has been a formula<sup>[3]</sup> for roughly 110 out of the last 130 years indicates that a "rough justice" mechanism has advantages over alternative systems when asymmetry is so pronounced:
  - it allows the Devolved Administrations to choose their own priorities within the UK-determined spending envelope
  - it protects the Devolved Administrations from targeted reductions in the block grant when the UK Government disapproves of devolved policies
  - it protects the Devolved Administrations from UK funding relating to devolved services bypassing them and going straight to public authorities
  - it economises on Treasury time and administrative effort at fiscal events because the Barnett consequentials of changes in comparable English expenditure can easily be calculated

- it provides some political protection for the Treasury from side deals driven by territorial politics, which is one of the reasons the Treasury proposed the Barnett formula in 1978
  - it depoliticises changes in the block grant by recourse to a mechanism, which though much-criticised, attracts the support of most UK political parties when they publish their election manifestoes
  - it attracts criticism from across the UK, whether for over-funding Scotland or for under-funding it when the UK benefited from “Scottish” oil tax revenues
4. My answer to questions about the sustainability of the Barnett formula is that something that is recognisably Barnett will survive, though it might get new political wrapping. Barnett has always been embedded in UK public expenditure control (Heald and McLeod, 2005), developments in which have made the originally simple formula more complex.<sup>[4]</sup> Tax devolution (see below) brings further complications in the form of Block Grant Adjustments, but these are inevitable consequences of political decisions to improve the fiscal accountability of the Devolved Administrations. More can certainly be done to improve transparency and understandability.

### **The Mechanics of the Barnett Formula**

**Q11:** “Unlike UK government departments, the devolved administrations are not involved in direct negotiations with HM Treasury on their funding settlements. Why not?”

**Q96:** “You mentioned challenging Treasury decisions. To what extent do the devolved Administrations have an ability to challenge some of the decisions that you have made on funding settlements?”

**Q92:** “why does Wales have a needs-based factor in its funding?”

**Q36:** “I want to take two specific categories of spending. First, on city deals, when the 23 or whatever it was city deals for England were announced, a proportion of that funding was in the devolved settlement under the Barnett formula, yet all the city deals in Scotland were funded in full under the settlement. Can you explain how that works? Likewise, when Leeds was granted city of culture in 2017, a portion of that was given to the devolved Administrations under the Barnett formula, but for example—I know it was a little while ago—the Cardiff city of sport in 2014 was presumably funded in full under the Welsh devolution settlement. How is it fair that the devolved Administrations get that funding in full, but when England gets them, a proportion of the expenditure is given in a Barnett formula allocation to the devolved countries?”

5. The core idea of Barnett is that changes in comparable expenditure in England drive changes in the block grants. What the Devolved Administrations need to know early is the UK spending envelope and how that is likely to be divided between comparable and non-comparable. Direct negotiations are not required. My own view from outside is that the Treasury has played the formula reasonably straight in the 20 years of devolution, with serious disputes (for example

over the funding of the Olympics and the use of the Reserve to fund expenditure after the Carter Review of English prisons) being few.

6. I have no detailed knowledge of the financial arrangements for City Deals, City of Culture, City of Sport and Stronger Towns Fund, so I will leave them for the Treasury to clarify. However, I will make three points:
  - In order to preserve the block grant mechanism, funding outside the Barnett formula requires careful justification
  - Funding which bypasses the Devolved Administrations weakens their expenditure autonomy
  - There is an important distinction between the announcement of “new money” for comparable English programmes and reallocations of existing money, which can be obscured in expenditure announcements.

### **Threats to the Barnett Formula**

**Q80:** “if Ministers can just give as much money to the nations as they wish, what is the point of the Barnett formula and all the other revenue streams we have discussed in the last hour and a half?”

**Q81:** What is the purpose of having all these structures and levers in place to secure fair and balanced allocations based on per capita spends and various other things, but on the other hand having a massive free-for-all for whoever has the stickiest fingers and can make the best argument for votes in this place?

**Q77:** “Some £410 million was allocated through a deal done between the Government and the Democratic Unionist party. How was the Department justified in not paying consequentials to other nation states when Northern Ireland received an increase in direct funding because of that deal?”

**Q99:** “What would the impact be of a policy decision made in Whitehall that said, ‘We’re going to have more privatised services’?”

7. A striking feature is the way successive UK Governments have kept the formula but have not communicated its purposes. In terms of total spending, the amounts of ‘pork barrel’ remain modest, partly because Barnett limits their development. Yet the political risks referenced in Q80 and Q81 are serious, especially in the context of increasing tax devolution. Using devolved tax discretion upwards is politically difficult and, if there are ready pork barrel alternatives, these will be taken, frustrating the intentions of the Calman, Smith and Holtham Commissions to make the Devolved Administrations more fiscally responsible and accountable.
8. Barnett formula consequentials result when there is a change in English comparable programmes, none resulting when there are increases for one or more of the Devolved Administrations. Therefore funding increases from the Democratic Unionist Party-Conservative Party “Confidence and Supply” arrangement (Cabinet Office, 2017) do not generate formula consequentials. In the context of hung Parliaments and the fragmentation of the party system,[\[5\]](#) the threats to legitimacy are obvious.
9. A mechanism such as Barnett works – as would most other devolved fiscal arrangements – on

the basis that there is some consensus on what are the responsibilities of the state. Outsourcing the provision of tax-financed health or education services is irrelevant to Barnett, as it is public funding that counts. If, however, a UK Government decided to privatise the funding of the National Health Service in England, for example by mandatory private insurance, then the Devolved Administrations would receive large negative formula consequentials. This would lead to reductions in devolved spending and possibly forced imitation of the English change, as well as to political consequences.

### Tax Devolution

**Q101:** “I have another point about the situation in Scotland with regard to the new taxation system and the way the system works. There is quite a considerable time gap between what the Government are expecting to have in taxation revenues and what might actually be collected. Again, what are the processes in place to try to smooth that out, so we do not have a feast and famine situation, and so the new taxation system can bed in properly, without Scotland being so adversely affected annually by the ups and downs of the taxation that is collected?”

10. There was relatively little discussion of tax devolution at the meeting on 10 June 2019. After the atrophying of the 1998 settlement ‘tartan tax’ power, the *Scotland Act 2016* expanded the tax-raising powers of the Scottish Parliament and exposed the Scottish Government to macro-fiscal and tax policy risks. The mechanisms for calculating Block Grant Adjustments are specified in the Scottish Fiscal Framework (HM Government and Scottish Government, 2016). The Scottish Fiscal Commission (2019) has cautioned about forecast large negative Block Grant Adjustments which could exhaust the Reserve and the borrowing capacity of the Scottish Government. A difficulty facing the Scottish Government (Mackay, 2019) is uncertainty about the timing of the next UK Spending Review which has been delayed because of political difficulties related to Brexit. The timing of UK fiscal events has systemic implications for budgetary decisions by the Devolved Administrations.
11. The Committee and others have a responsibility to educate politicians and policy makers about the delicate balances that fiscal devolution brings. For example, cutting Rest of UK income tax and partly financing this by increases in National Insurance Contributions (UK revenue) would stress the public finances of Scotland where income tax on Non-Savings Non-Dividend Income is devolved. Abolition of VAT would eliminate partial VAT assignment. The crucial point is that the UK Government has a much broader portfolio of taxes than the Scottish Government.
12. The risks of “feast and famine” do not solely derive from Block Grant Adjustments for devolved or assigned taxes. From 1999-2000 to 2009-10 the Scottish Government’s real-terms Total Departmental Expenditure Limit increased by 62.5% but then fell by 7.9% from 2009-10 to 2017-18.<sup>[6]</sup> In my view, increases in the 2000s were too rapid because real resources (such as physical facilities and trained staff) were not always available, resulting in some of the extra

Barnett money evaporating in higher costs. Then, 2010s' austerity has been too harsh, with damage to the quality of public services. It would have better in the 2000s if more could have been put aside for future years, but the UK public expenditure control system did not allow this.<sup>[7]</sup>

### Alternative Systems

**Q87:** "If you had to explain a better system, what would that look like?"

**Q50:** "If Barnett worked in reverse, so the devolved Administrations kept all the taxation, made up their own spending plans and decided that they would hand money back to the Treasury to pay for foreign affairs and defence and so on, how happy would you be to not know how much you would get back from each devolved Administration?"

**Q86:** "But you are saying it is at least as fair as the alternatives. Is that what you are saying?"

13. I have already explained why Barnett fits the asymmetric nature of UK devolution. The most discussed alternative would be needs assessment on the model of the Australian Commonwealth Grants Commission. In the context of population asymmetry, this would be portrayed as the costing of English policies to the circumstances of Scotland, Wales and Northern Ireland, a risk that is accentuated when there has been policy divergence since 1999. Twenty years ago I expected that there would eventually be a UK-wide needs assessment to re-calibrate Barnett, though my proposal (Heald and McLeod, 2002) for a convergence floor for Wales reflected later doubts that this would happen. Support for needs assessment, together with proposals as to how that could be conducted, has been provided by McLean (2005) and King and Eiser (2016).
14. "Barnett in reverse" is not viable because expenditure increases in the Devolved Administrations would drive much higher expenditure in England, threatening macro-fiscal control. Question 50 implicitly refers to the model for Northern Ireland contained in the *Government of Ireland Act 1920*. In reality, the so-called 'Imperial contribution' rapidly became fictitious because Northern Ireland was so poor. In the case of Scotland, such a system would transfer UK-Scottish disagreements from expenditure that is devolved (how generous funding should be for health and education) to how much should be spent on reserved services such as defence.
15. "Fairness" in territorial finance is inevitably contested. For example, there will be claims that regions which generate high levels of per capita tax revenue should benefit from them. Public finance economists distinguish between 'interpersonal equity' and 'territorial equity'. Interpersonal equity across a nation state requires that an individual's tax and public services do not depend upon their jurisdiction of residence. This requires total centralisation of tax and spending decisions and there will be huge, often invisible, fiscal transfers between locations. In practice, total centralisation does not deliver equal treatment, for example because of the legacy effects of previous decisions on facilities such as hospital beds.
16. Territorial equity requires that each political jurisdiction has the resources to provide broadly

equal services, without the requirement that they do so. Accordingly, fiscal decentralisation, especially when it also applies to taxation, leads to otherwise-identical individuals being treated differently according to their place of residence. There is a trade-off: efficiency may be improved by better matching of public services to ‘local’ preferences, and legitimacy and fiscal responsibility may be enhanced by ensuring that elected public authorities raise at least some of their revenue from taxes that they control. Such variations in tax and spending lead to allegations of ‘postcode lottery’, often made without recognition that this is an inevitable consequence of providing certain services through decentralised authorities such as Devolved Administrations and local authorities.

### Transparency

**Q1:** “One of the key things that we think is an issue is the lack of transparency. I don’t think the average citizen in Scotland or Wales—or, indeed, in England—would really know how it is working, so we want to probe that a bit.”

**Q102:** “I want to ask a further question on the transparency issue that we touched on right at the beginning. What plans do you have to make it easier for people to understand? In the whole of Government accounts, which we will obviously be talking to you about soon, you have a bit about the big blocks of money, but do you have any plans to make it simpler and easier for people to understand, so they can avoid having to sit through the whole of the Public Accounts Committee, and can just go to one place and find it?”

**Q82:** “The estimates process is woefully inadequate. We cannot really reject things. It is very hard to do that. We have tried, and it does not happen very often. The way you described it earlier was, ‘Once it’s gone through the estimates process, the devolved Administrations know it’s coming anyway.’ Are you suggesting that if it was outrageously pork barrel politics, you would have faith in Parliament to knock it back?”

17. I have been calling for more transparency about territorial funding arrangements since I named the Barnett formula in 1980 (Heald, 1980) and published analyses of expenditure relatives (Heald, 1994) and formula consequentials (Heald and McLeod, 2005). The Treasury (2017) has now published more comprehensive documentation on formula consequentials, though I never succeeded in getting the Treasury to publish comparable expenditure in England – these differ for Scotland, Wales and Northern Ireland because of differences in devolved competences.
18. The weakness of the UK Parliament in *ex ante* scrutiny is a topic beyond the scope of this memorandum, though I have made suggestions in written evidence to the Procedure Committee (Heald, 2016). One of the successes of devolution is that the devolved legislatures take their budgetary responsibilities more seriously than does the UK Parliament which is trapped by legacy, inertia and Executive dominance.
19. The “average citizen” will always find it difficult to understand technical matters of public

finance, even when the motivation is there. However, prompt, accurate and well-designed publications can enhance transparency for elected members, the media and members of the public who wish to engage. My longstanding view is most public finance technicalities are less difficult to explain if there is a willingness on the part of governments to communicate openly and to resist presentational games.

### Conclusion

20. The arrangements discussed in this Memorandum are inevitably technical, and often neglected or misunderstood in political discussion. Nevertheless, they involve contestable political choices. The future existence of the UK, as it has been understood since 1921, depends on making existing or alternative fiscal arrangements work in a way that secures sufficient consent across the nations of the UK.

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[2] It does not seem coincidental that Goschen was established at the time of conflict over Irish Home Rule and that Barnett was established at the time of the modern emergence of the Scottish National Party.

[3] Mitchell (2003) showed that Goschen had narrower coverage than Barnett and was less systematically applied. Barnett has been more rigorously applied since 1999, from which date the financial flows have been between governments rather than within government.

[4] For example, the division of Departmental Expenditure Limits into Resource DEL and Capital DEL, and the later introduction of Financial Transactions DEL.

[5] UK political parties do not contest Northern Ireland seats, and the positions of the Conservative and Labour parties in Scotland are vulnerable, weakening one of the historically integrating mechanisms in UK politics. Different electoral systems for the Westminster Parliament and the devolved legislatures increase detachment.

[6] There is no consistent official data series but these are my best estimates.

[7] Devolved Administrations rightly suspected that balances of End-Year Flexibility would eventually be cancelled, and Scottish Governments dared not use the tartan-tax power downwards in the 2000s, for fear of destabilising the Barnett formula.