

Response to the Holtham Commission's Five Broad Questions

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Q1 Is the Barnett formula appropriate for allocating resources to Wales and how might it be improved? This will include consideration of whether it is appropriate to move to a formula that includes an element of needs assessment and whether the gradual equalisation of expenditure per head in different parts of the UK built into the current formula (the Barnett squeeze) is justified.

Although I have been studying devolution finance since the mid-1970s, I know less about the detailed position of Wales than about those of Scotland (about which there has been most debate) and Northern Ireland (about which I published a report¹ in 2003). The limited research literature on devolution finance in Wales is regrettable, but possibly reflects the small size of the relevant academic community. Although I do not have any hard evidence, Wales seems to have been less well resourced in finance capacity than either Scotland or Northern Ireland, in both the pre-devolution Welsh Office and post-devolution periods.

The convergence properties of the Barnett formula are predicated on the tacit assumption that Scotland, Wales and Northern Ireland were 'over-funded' relative to England in 1978, which was the year in which the original 10:5:85 formula proportions were established. There was probably less justification for such an assumption with regard to Wales, as its public expenditure relative was then well below those for Scotland and Northern Ireland. Moreover, the original formula proportions (10:5:85) involved an adverse rounding for Wales.

In practice, movement in the direction of convergence has not materialised to the extent expected, though judgement is hampered by missing data (see Q2 below). As shown in my academic writings, particularly *Regional Studies* (2005),² the operation of the Barnett formula is embedded in the UK public expenditure system. Until that article was published, it was not possible to see the transition from the Wales DEL in one Spending Review to that in the next. (This analysis ought to be a routine part of announcements of changes in UK funding to the Devolved Administrations.) The evolution of a Devolved Administration's Departmental Expenditure Limit depends not only on Barnett consequentials but on instances of formula bypass,³ changes in public expenditure definitions, and changes in accounting treatment. Per capita relatives depend crucially on relative population change: this has been a powerful factor in damping convergence with regard to Scotland. Whereas there is a long annual series of *Government Expenditure and Revenues in Scotland*, the counterpart Welsh publication ceased publication after two issues because of a decision by incoming Labour ministers in 1997. This decision kept information out of the public domain and also damaged the quality of information available within government relative to that available for Scotland. Moreover, the Welsh

¹ Available at: <http://www.niec.org.uk/documents/Healdfinalpaper2.pdf>.

² Available at: http://www.davidheald.com/publications/emb_heald.pdf.

³ See the explanation of formula bypass at <http://www.davidheald.com/publications/terra.pdf>. Since devolution, formula operation has been stricter, with less recourse to bypass than before.

economy is less detached from that of England than is Scotland's as a result of the way in which the border cuts through areas of economic activity and patterns of travel to work.

I have always emphasised that the Barnett formula was intended to produce movements in the direction of convergence, never to reach convergence. There appears to have been an understanding that the pre-devolution Secretaries of State could and would call for a needs assessment if convergence went 'too far' (ie below the need relative they believed they could justify to the Treasury).⁴

If the Barnett formula were to continue, at some point a needs assessment would be essential. However, no-one should underestimate the technical difficulty of that nor ignore the political context when there are Devolved Administrations under different political control from the UK Government. There are two options for a needs assessment. First, there could be a broad-brush approach, under which a limited number of needs indicators would be used. Second, there could be a comprehensive approach, working at the level of fine detail, modelled on the work of the Commonwealth Grants Commission in Australia. The first approach might have worked before devolution, or when there was the same political control. In the present context, it seems unlikely that the self-perceived losers would accept the rough justice of the broad brush. The second approach would be administratively expensive and take years (not least in setting up reliable data sources), and the resulting conclusions would be disputed. Under both scenarios, it is imperative that this task is undertaken by a Territorial Exchequer Board,⁵ independent of the Treasury.

Much could be written about the conduct and consequences of a needs assessment, but three points will suffice here. First, given relative population size, a needs assessment would probably increase pressures to follow the English pattern of service provision, even if this were not intended. Second, what counts as a needs indicator that justifies compensation is subjective and time specific. It now seems very surprising that the bilingual nature of Wales was not accepted in the needs assessment published in 1979.⁶ Moreover, international migration has changed the population of England over the last 30 years more than it has changed the rest of the United Kingdom, both in numbers and heterogeneity. A controversial issue in a future needs assessment would be whether and, if so how, to compensate for schools having pupils whose home languages were not the language of instruction. Third, after a needs assessment, there would have to be a transitional formula, particularly in the case of a Devolved Administration whose expenditure significantly exceeded its assessed expenditure need.

Notwithstanding all the criticism of the Barnett formula – from diametrically opposed standpoints – I would expect that the Devolved Administrations will continue to be funded by something that looks recognisably like Barnett. The present system delivers a

⁴ See the book chapter by Alasdair McLeod and myself on the present and possible alternative convergence formulae: <http://www.davidheald.com/publications/ippr2.pdf>.

⁵ See <http://www.davidheald.com/publications/makingdevolution.pdf>, particularly pages 26-32, where I proposed such a mechanism in 1976.

⁶ Treasury, *Needs Assessment Study: Report*, London, HM Treasury.

predictable block grant, over which each Devolved Administration can exercise its own priorities with minimal interference from the UK Government. For example, the fact that local government finance and structure are devolved means that the UK Government cannot bypass the Devolved Administrations in the way that the Spanish Government can bypass the Autonomous Communities and deal directly with local authorities. The effective autonomy over expenditure priorities of the Devolved Administrations contrasts markedly with increasing centralisation of decision-making within England.

Q2 Is the operation of the formula – in whatever form it takes – appropriate? For example, do dispute resolution procedures need strengthening? Can the operation of the formula be made more transparent to improve predictability?

For almost 30 years, I have been complaining about the lack of transparency of the operation of the Barnett formula. Some progress has been made with regard to the numerical operation of the formula, as evidenced by the chain-linking of Spending Reviews in the *Regional Studies* article. Also in that article, for Scotland alone, there is a table showing how the SR2002 and SR2004 formula consequentials were built up. In a future article, I will be undertaking a comparable analysis of CSR2007, this time including Wales and Northern Ireland. This information should be routinely published.

An area where there has not been progress relates to the available public expenditure relatives. Far too much public debate centres on the data in the annual *Public Expenditure: Statistical Analyses* which are much wider than devolved expenditure. My efforts to obtain data on devolved expenditure relatives, which could be extracted from the Treasury's public expenditure database, have always failed. The format in which comparability factors etc are published in the Funding Guide⁷ means that such an analysis cannot be done. This is an important deficiency, particularly as the 2002 article published by Andrew Goudie (Chief Economic Adviser, Scottish Government)⁸ suggests that there has been considerable convergence for the relevant measure of Scottish devolved expenditure.⁹

This question about dispute resolution procedures should be addressed to those in the Devolved Administrations who deal with the Treasury. My understanding is that the Treasury takes unilateral decisions: for example, about the separate treatment in CSR2007 of near-cash, non-cash and capital (which makes the assigned budgets more difficult to manage), and about the non-comparability of certain London regeneration expenditure that is within the 2012 Olympics budget.

Compared with alternative systems, the Barnett formula system, distinguishing base and consequentials, is highly predictable. Late changes to comparable spending in England will inevitably lead to forecast consequentials being different, but I regard that as a

⁷ This is published at each Spending Review, with the result that changes between Spending Reviews are not publicly documented until the next Review.

⁸ A. Goudie, 'GERS and fiscal autonomy', *Scottish Affairs*, 2002, No. 41, pp 56-85.

⁹ Because of significant differences in what is devolved, there need to be three different series: Scotland indexed on England; Wales indexed on England; and Northern Ireland indexed on England.

reasonable price to pay for ensuring that the Barnett formula is strictly applied. It should be noted that Barnett consequentials for Wales have been supplemented by Objective 1 funding and that there has been supplementary funding for Northern Ireland.

Q3 If the UK moves to fiscal devolution (with Scotland leading), should the same principles apply to a revenue equalisation formula as to the current expenditure formula?

I have difficulty understanding what is meant here by ‘same principles’. The Barnett formula is not an equalisation formula but a combination of protection of the inherited base plus population-proportions increment.¹⁰

The present system is mostly expenditure-based, with the qualification relating to the netting off of charges and to the role that the local government financial system plays beneath the assigned budget level. If the system were to become revenue-based, five questions need to be answered:

- (a) which tier of government sets the tax base?
- (b) which tier of government sets thresholds and tax rates?
- (c) is there a system of fiscal capacity equalisation (ie a floor level of taxable capacity per head, with any shortfall on this offset by the central government acting as a notional taxpayer on the missing tax base)?
- (d) is there a system of fiscal potential equalisation (ie each jurisdiction can finance any given level of expenditure per head at the same tax rate as other jurisdictions could)?
- (e) is there a centralised system of needs assessment to inform judgements about costs and needs equalisation, as well as resources equalisation?

Different countries make different political judgements on these issues. For example, there is little formal equalisation in the United States, other than through the direct taxing and expenditure decisions of the Federal Government. Whilst Australia has an elaborate system of needs equalisation, Canada proceeds mainly in terms of resource equalisation. Whereas transfers in most federations are from central to sub-national governments, in Germany an important part of the fiscal equalisation system is among the Länder. These differences reflect, *inter alia*, history and cultural attitudes to spatial differences in prosperity and access to public services.

My own judgement is that, in the United Kingdom, the expectation of broadly comparable public services is sufficiently strong that a devolution finance system that heavily depended on own revenue would require there to be a formal equalisation system. The likely tax yield from either all taxes or a sub-set of taxes would be lower in Wales in relation to the UK average than it would be in Scotland. This emphasises the importance of clear thinking. Sometimes proposals are made for relying on own revenues whose practical relevance is later removed by the way in which equalisation would work.

¹⁰ For a mathematical treatment, see: <http://www.davidheald.com/publications/formula.pdf>.

Q4. Again if the UK moves to fiscal devolution, what would be the appropriate form for Wales? Which tax receipts (if any) should be assigned to Wales and over which tax rates and bases should Wales have some control?

Particularly in the context of Scotland, I have long argued for fiscal accountability at the margin. I do not believe that, within the context of a devolved United Kingdom, there can be ‘fiscal autonomy’ if that means complete self-financing of devolved expenditure. Under different circumstances (ie without loads of money being sent down the Barnett pipeline), there would have been debate in Scotland years ago about the upwards or downwards use of the tartan tax. Instead, this power – and perhaps the administrative machinery to implement it – has been allowed to atrophy.

There is a fundamental distinction between devolved taxes and assigned revenues. In the former, there has at least to be control over the tax rate, perhaps within certain parameters. However the estimated revenue from the Scottish variable rate of income tax – to use the correct name for the tartan tax – depends on decisions taken by the UK Government about tax bands and their widths. The saga of the creation and abolition of the 10p tax rate illustrates this; decisions of the UK Government would affect the incidence across income groups of the tartan tax. Within a closely integrated economy such as the United Kingdom, there are advantages in maintaining harmonised tax bases. It would require a fundamental culture change in UK Government to agree to significant differences in tax rates. Although assigned revenues may have some symbolic importance, they offer no gains in terms of fiscal discretion or accountability. In Germany, where extensive use is made of assignment, that has to be understood in terms of the role that the Länder play in the Bundesrat (the upper House of the Federal Parliament).

If there are to be devolved taxes, attention should be directed towards taxes that generate substantial yield. In practice, that means income tax, corporation tax, Value Added Tax and local property taxes. There has been pressure in Scotland and Northern Ireland (which has a long land border with another EU member state with much lower corporation tax) for concessionary tax rates to promote economic development. There are EU constraints on variations of corporation tax within a member state. The exact nature of these legal constraints is being worked out in the European Court of Justice, with regard to the Azores judgement.¹¹ They hinge on the extent of sub-national autonomy in specific cases, and on whether lower tax revenues from lower tax rates are offset by central government grants. Another consideration is that when the United Kingdom is encountering the relocation of tax domicile by certain listed companies, different corporation tax rates within the United Kingdom would multiply avoidance possibilities.

Similarly, VAT can vary within limits between member states but not within. I have long regarded this as a sufficient reason for VAT not being devolved. The growth of VAT

¹¹ Judgment of the Court (Grand Chamber) of 6 September 2006 – Portuguese Republic v Commission of the European Communities, Case C-88/03, *Official Journal of the European Communities*, 28.10.2006, (2006/C 261/01).

avoidance and evasion, including carousel fraud, provides a further reason not to fragment VAT administration.

This brings the discussion to income tax and to local property taxes, namely council tax and Non-Domestic Rates. On the former, the tartan tax principle could be extended by having wider margins of discretion. In Canadian terms, this would be described as the transfer of tax points. To limit the danger of the power atrophying, the UK basic rate of income tax would be reduced in Scotland, Wales and Northern Ireland by 10 percentage points, with foregone proceeds deducted from whatever grant is receivable from the UK Government. Each Devolved Administration would then have to set its devolved rate of income tax, perhaps within the band 5-15 percentage points. The detailed design would have to take account of the complex operation of the UK benefits system, including tax credits, and a decision would be needed as to whether there would be compensation for shortfalls in relative tax bases.

Wales and Northern Ireland, unlike England and Scotland, have undertaken maintenance of their local domestic property tax (council tax, except in Northern Ireland, where it is the capital value-based regional rate). The combination of 1991 valuations and a freeze of council tax in Scotland are undermining an important part of the devolution finance system. Moreover, the substitution of a uniform Scottish local income tax for council tax has been proposed by the Scottish Government on the basis of a large revenue reduction (ie not on an equal-yield basis). In my view, domestic property taxes form a valuable part of the overall tax system, as well as being suitable for variation at a local level.

Q5 What borrowing powers (if any) should the Assembly Government acquire (a) in the absence of fiscal devolution, (b) in the presence of fiscal devolution? How would these fit into a UK macroeconomic control framework?

In the context of (a), an expenditure-based financing system, I do not see the relevance of borrowing powers beyond those required for handling the different time patterns of revenue and expenditure. Borrowing would score against the Barnett formula or its successor.

In the context of (b), which I will take to mean substantial dependence on devolved taxes or assigned revenues, borrowing powers are essential. The Devolved Administrations would then face much more fiscal risk, its magnitude depending on the nature and extent of the tax devolution and/or assigned revenues and the nature and extent of equalisation. The issue would become unexpected downwards variation in revenues and not just timing differences between revenue and expenditure.

Borrowing by Devolved Administrations would impact on both of the UK Government's fiscal rules: the golden rule (as greater-than-forecast borrowing for resource expenditure would affect UK compliance); and the sustainable investment rule (as borrowing to finance investment would affect the net debt ratio). There are also implications in terms of the UK's international obligations under the Maastricht Treaty and the EU Stability and Growth Pact. In the 1980s, 'excessive' borrowing by certain Canadian provinces

caused macro-fiscal problems for the Federal Government. The UK position would be less exposed because devolution only covers 15% of the UK population.

Nevertheless, UK Governments would have concerns of a political nature about borrowing powers, unless they were tightly constrained. In the context where separatist political parties in office wish to break up the United Kingdom, the UK Government will be reluctant to devolve extensive borrowing powers.

Final Comments

There is a fundamental question that faces both the Holtham Commission in Wales and the Calman Commission in Scotland. The existing Barnett formula system seems to be universally unpopular: according to the standpoint of the speaker/writer, it over-funds or under-funds the Devolved Administrations. Is the underlying purpose of these Commissions – whatever their formal remits – to secure greater funding for Wales and Scotland, or to devise a more satisfactory funding regime?

I have no doubt that system improvements can be made, and I have used this response to suggest some. However, there are no easy solutions to system design once one goes past ‘fiscal autonomy’ as a slogan. With separate states, it is clear what fiscal autonomy means. Within a single state, this is much less clear. Some of the advocacy of fiscal autonomy is either a proxy argument about independence or an argument for a smaller state, with the expectation that resource shortfalls would lead to large reductions in public expenditure. In the context of the United Kingdom, there are powerful factors emphasising the importance of central government as the principal taxing authority. Moreover, given the policy instruments possessed by the UK Government, it is much more able to handle macro-fiscal risk than are the Devolved Administrations.

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