

Governing Scotland: Problems and Prospects

The economic impact of the Scottish Parliament

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4 The fiscal arrangements for devolution

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4.1 Introduction

The United Kingdom is embarking upon a path of asymmetric quasi-federalism. This might more plausibly be denounced as a constitutional outrage were it not for previous experience of such arrangements during the 1921-72 period of devolved government in Northern Ireland and also the various 1979-97 Conservative Government plans for Northern Ireland (Crick, 1995).¹ Reviews of international experience (for example, Hesse and Wright, 1996) in federal-like structures of government have shown that the preconditions for making these both workable and acceptable relate to the building of mutual trust and not to the availability of technical options. The United Kingdom, much remarked upon for its highly centralised polity and fiscal system, faces a sharp learning curve both in terms of digesting technical desiderata and of modifying political and fiscal styles.

This chapter contends that the plans currently being implemented for devolution in Scotland, Wales and Northern Ireland do not embody a fiscal settlement. The word "settlement" conveys the sense of something considered and intended to be enduring. Key features of such a settlement are, in fact, missing, notably a sustainable basis for determining the assigned budget and therefore public expenditure relatives. What are in place are fiscal arrangements, of unknown durability.

On several important issues, what has transpired has rather been a succession of high-level political compromises, sometimes with limited insight into the policy problem. There has been a misguided belief - viewed as a pretence by some commentators - that there can be a continuation of the past. In part this reflects a failure of policy development, in part a set of political calculations: for example, the issue of cross-border spillovers (drawing the attention of middle-England voters to the direction and size of territorial transfers) seems to have been the motivation for Labour's insistence in 1995 that the Scottish Constitutional Convention abandon its 1990 proposal for assigned revenues (Heald and Geaughan, 1996).

Intriguingly, the commitment to have referendums resulted in the Scotland and Wales devolution White Papers being campaigning - rather than reflective - documents. Whereas the two-question referendum in Scotland was widely suspected to be designed to kill off devolved taxation powers, the combined impact of the decisive general election and referendum results in Scotland ended substantive opposition to devolution. In the event, the lack of preparation regarding finance has not created the vulnerability which would have resulted had serious opposition remained.² A

remarkably rapid transformation means that the year 2000 will bring "Home Rule All Round", with elected bodies in Belfast, Cardiff and Edinburgh. On a political level, there is undoubtedly "safety in numbers" for the devolved administrations, giving protection which an isolated Scottish Parliament would not have enjoyed. Paradoxically, there are now opportunities which better Whitehall-led preparation might have closed off. An important task of this chapter is therefore to explore the options available.

For reasons which were entirely predictable and understandable, the pre-referendum debate about the financial aspects of devolution concentrated heavily upon the "tartan tax" and the possible repercussions upon the Barnett formula. The Scotland Bill is itself non-specific about many important financial issues, preferring to leave them to be tackled through administrative mechanisms. The effect of seeking to avoid sensitive issues may be to stoke up unnecessary trouble for the future. Devolutionists, such as ourselves, who draw attention to this are likely to be criticised for rocking the boat. However, such a reaction reflects excessive complacency, as ought to have been clearly signalled by the tone of both the Treasury Committee (1997) evidence session on the Barnett formula and that of the campaign for the Mayoralty of London (Archer and Livingstone, 1998). The nature of fiscal debates will be heavily conditioned by the way in which London-based and Scotland-based newspapers - in some cases, editions of the same newspaper - play to the prejudices of their readerships.³ Moreover, there are some complex agendas being played out in sections of the Scottish press; Marr (1998) observed that *The Scotsman*, which had kept the flag of devolution flying through periods of adversity, "is now being driven by Unionism and Nationalism working hand-in-hand against Labour". Whether intended or not, the effect is to destabilise preparations for implementing devolution.

The chapter is structured in the following way. Section 4.2 broadens the horizon from current UK developments to review certain theoretical predictions about decentralised government. Section 4.3 examines territorial public expenditure relatives and the role which the Barnett formula has played. Section 4.4 reviews the interface between devolved administrations and local government; in Scotland and Wales, though not in Northern Ireland, a large proportion of devolved expenditure will actually be disbursed by local authorities. Finally, section 4.5 charts some of the challenges which lie ahead.

At several points in the chapter, references are made to other papers for detailed support for particular arguments. The case for devolved taxes is made in Heald and Geaughan (1996), whilst a sympathetic exposition of the tartan tax is provided by Heald and Geaughan (1997)⁴ - chapter 5 presents a less favourable treatment. A discussion of the fiscal consequences of devolution for the United Kingdom appears as Heald and Geaughan (1998). An overview of the issues involved in financing UK devolution can be found in Heald et al (1998). What differentiates the present chapter is its direct focus on the issues which have to be addressed after the referendums but before vesting. Inevitably, this means that parts of this chapter are speculative in nature.

Fiscal decisions are political in several senses: for example, in the straightforward party sense of a left-right spectrum on desirable levels of public expenditure; in terms of conflicts within the machinery of government; and in terms of electoral spillovers from decisions made at different tiers of government. One obvious origin of “New” Labour’s highly centralised party management was the damage perceived to have been done in the early 1980s to the Labour Party at UK level by local authorities caricatured in the media as the “loony left”. Accordingly, it is not just the formal tiered structure of government and intergovernment financial relationships which need to be studied, but also the links between tiers which are forged by political parties.

4.2 Propositions about decentralised government

In terms of the substantive effects of UK devolution on public expenditure and public service delivery, there is a marked disjuncture between the expectations of many who have supported devolution and the conventional wisdom of the economics literature on fiscal federalism.⁵ Many writers explicitly link decentralised government to smaller government:⁶

Considering all the federations there have been in the world, I believe that federalism has been a significant force for limited government and hence for personal freedom (Riker, 1996, p. 20).

The extent of decentralization also depends, to some extent, upon the desired magnitude of the role of government in the economy. Typically economists who prefer a smaller role for the government would also favor more decentralization (Jha, 1998, p.466).

In contrast, the UK constitutional reform agenda, in which devolution features prominently, has been mounted largely by those generally hostile to the Thatcherite agenda of free markets and smaller government.

The closest UK counterparts to those - especially in the United States - who view federalism as a protection against big government are the journalists Andrew Neil and Michael Fry. Ever since it became likely that devolution would occur, they have consistently run the argument that the Scottish Parliament should raise all its own money and not be dependent on the UK Exchequer via a block grant. In essence, they have argued for a scheme analogous to that contained in the Government of Ireland Act 1920. Scotland would therefore receive all tax revenues generated in Scotland and would make a contribution for reserved services, but would have no access to UK revenues.⁷ Such an arrangement would be expected to lead to expenditure reductions in any jurisdiction with a below-average taxable capacity and above-average inherited level of expenditure. The fiscal history of devolved government in Northern Ireland (Lawrence, 1965; Gibson, 1996) certainly indicates that expenditure was held at a much lower level than would have been likely under fiscal integration with Great Britain.

The substantive expenditure effects of asymmetric quasi-federalism in the United Kingdom are ambiguous, and likely to be contingent upon the dynamics of party competition. On the one hand, Neil (1997a) has denounced the financing basis for the Scottish Parliament as “a system tailor-made for exploitation to Nationalist advantage”. On the other, Adonis (1998) emphasised that the hitherto implicit territorial transfers are likely to be flushed out and exposed to public gaze. Blow et al (1996) also questioned the extent to which existing patterns of territorial transfer would survive the glare of publicity consequent upon greater transparency. “Political muscle” might either reinforce pressures for lower territorial transfers or attenuate them.

Smith (1996) distinguished between “decentralisation of administration” and “decentralisation of choice” - the same distinction as that between devolved administration and devolved government which was discussed in chapter 2. This is a useful way of conceptualising the transition from administrative devolution (Scottish Office, Welsh Office, Northern Ireland Office and Departments, all headed by Cabinet-rank Westminster politicians) to political devolution (territorial Executives accountable to territorially elected bodies). A move to more local electoral control will have complex effects on expenditure levels, some stimulating and some depressing, therefore leaving doubts about the net effect. However, if the budget constraint is perceived to be harder, there would be more incentive to confront certain politically difficult decisions; an obvious example is school closures in response to excess capacity, which were not made on the necessary scale by Scottish local authorities in the early 1990s, partly to avoid confrontations with local pressure groups. Moreover, when local authorities did attempt to establish school closure programmes, Scottish Office ministers actively encouraged parents to invoke opt-out procedures, thereby generating paralysis and undoubted inefficiency. Elected territorial bodies such as the Scottish Parliament and Welsh Assembly may possess more political muscle, in relation to both the UK Government and local interest groups.

Political debates about the territorial dimensions of public finance do not take place behind a veil of ignorance; the various actors are only too aware how particular arguments and mechanisms affect their interests. Consequently, it should be recognised that there are two levels of discourse which often become intermingled; first, an attempt to specify a set of general principles as to how a system of decentralised public finance should operate; and, second, intense political conflict, often characterised by blatant opportunism, about actual or proposed fiscal arrangements. The effects are to sow public confusion, to make it difficult to hold to transparent ground rules, and to make empirical work more difficult to conduct.

A crucial matter of contextual background is that the UK constitutional reform agenda is in part a reaction against the “free market, strong state” dimension of Thatcherism (Gamble, 1994). The two OECD countries which have most enthusiastically and successfully implemented the free-market agenda have been New Zealand and the United Kingdom, both countries in which there are no effective counterweights to a determined central government. In contrast, policy in Germany has been more tentative and consensual, for which the federal nature of Germany must be a

significant explanatory factor. Political resources play a substantial role in shaping fiscal outcomes. For example, Keating (1998, p.184) observed that:

in Germany the revenue-sharing agreement is negotiated with the Länder and must be approved by the Bundesrat, which represents the Länder governments. This gives the Länder collectively more control over taxation and spending than any other subnational governments in Europe and its adoption in Britain, with its implications for Treasury dominance, would represent a far more radical step than conceding independent tax powers to regional governments.

Moreover, a relevant qualification to Riker's (1996) view of the effects of decentralisation can be detected in another of his propositions:

Governments that are not federations can reorganize the local units at will, destroying old regional units and creating new ones. But in federations the constituent units have agreed with one another that each will retain its identity and its unique functions. [The whole point of federalism is] the tiered structure cannot arbitrarily be revised, or even revised to adjust for changed conditions (p.10).

In the United Kingdom, the Greater London Council and the metropolitan councils were abolished in 1986 and Scottish regional councils in 1996, all by a central government whose party could not win control of these bodies. Such constraints on the power of central government as suggested by Riker would represent a very significant change. Across the UK political spectrum, there is now recognition that the state needs relegitimation, and that forms of democratic participation at subnational level will have a role to play in this (Jenkins, 1995; Select Committee on Relations between Central and Local Government, 1996).

Extending the focus beyond UK developments draws attention to several interesting parallels and differences. There are signs of a new generation of theoretical work on the internal structure of the state, evidenced, for example, by recent work by Tirole (1994) and Seabright (1996). To a considerable extent, this should be interpreted as extending recent developments in the theory of the firm, notably with regard to principal-agent relationships in a world of incomplete contracts, to the analysis of governmental structures. This new work is interesting, not least because the field had become relatively unfashionable since the synthesising work of Oates (1972), who built upon the insights of Musgrave (1959). Some of the factors stimulating such renewed theoretical interest can readily be discerned.

First, the collapse of the centralised economic systems of the Eastern bloc has often been accompanied by dramatic reconstructions in both the configurations of states and their internal organisation. Undoubtedly, this is the principal reason why the International Monetary Fund (IMF) has taken so much interest in intergovernmental fiscal structures during the 1990s (Tanzi, 1996; Ter-Minassian, 1997). In several cases, it really has been a question of redesigning state structures and fiscal systems from scratch.

Second, rapid developments towards European Monetary Union (EMU) raise a plethora of economic, fiscal and monetary issues (Eichengreen, 1997). Crucially, EMU is going ahead with less economic convergence than had been posited as prerequisite and without the enlarged European Union (EU) budget foreseen at the time of earlier deliberations about fiscal structure after deeper integration (MacDougall, 1977). Inevitably, these circumstances have provoked discussions about the mechanisms for securing budgetary adjustments at member-state level following asymmetric macroeconomic shocks.⁸ In turn, the absence of territorial fiscal transfers, both extensive and automatic in all existing federations, has been attracting attention to both sets of circumstances.

Third, there has been a veritable outburst of initiatives in connection with fiscal transparency. On a global level, the International Monetary Fund (IMF) (1998) has proclaimed a code on fiscal transparency, supported by a research study (Kopits and Craig, 1998). This appears to have been prompted by fears about the instability of the world financial system, and the way in which this might be exacerbated by sudden fiscal crises beyond the capacity of the IMF to handle. At the UK level, Gordon Brown, Chancellor of the Exchequer in the Labour Government elected in May 1997, has published *The Code for Fiscal Stability* (Treasury, 1998b) which will be given a statutory basis through the 1998 Finance Act. An obvious, though unmentionable, motive for these UK developments has been the desire to blame the previous Conservative Government for the severity of the last UK economic cycle and for the extent of desynchronisation with the rest of the EU cycle.⁹ There is a curious juxtaposition between vogueish enthusiasm for transparency and the pervasiveness of news management and spin doctoring.¹⁰

Broadening the fiscal canvas beyond the United Kingdom proves useful in two ways. Comparative material brings home the diversity of arrangements and emphasises the importance of making fiscal systems work in particular political and institutional settings. Of perhaps greater importance in the UK context, it shows that most of the troublesome issues confronting UK devolution have their counterparts elsewhere.

4.3 Territorial expenditure and the Barnett formula

Turning to the mechanisms for territorial expenditure allocation as these have evolved in the United Kingdom, the starting point must be to recognise that this is an arena which combines technical obscurity with high political salience.¹¹ Quite apart from the difficulty of establishing a coherent account of either process or outcome, interpretation entails considerable problems. For example, one might ask whether the obscurity is simply a regrettable defect in the system, or whether it has been instrumental.

Midwinter et al (1991) attributed Scotland's "advantage" in public expenditure terms to three factors: social needs; political muscle; and "classical incrementalism".¹² They characterised the territorial public expenditure system, as it affected Scotland in the 1980s, in the following way. Conservative Secretaries of State for Scotland continued to fight the Scottish corner, not taking on board the disrepute in which much of the

Cabinet held public expenditure: "The whole process was conducted with discretion to avoid arousing the jealousy of English ministers and MPs" (Midwinter et al, 1991, p.110).

Nevertheless, Scotland's position had begun to attract hostile attention from the Conservative Government's own backbenches:

The growing gap between the power bases of the major parties has thus added a territorial dimension to the old ideological disagreements over the merits of public expenditure (p.98).

Conservative backbenchers in the late 1980s began to intervene regularly in discussions of Scottish public expenditure, portraying the Scots as "force-fed" with public expenditure and the victims of a "dependency culture", while the Scottish Office budget is described as a "slush fund"...The assault is thus two-pronged, an ideological attack on high levels of public spending and territorial attack on the privileges enjoyed by ungrateful Scots (p.110).

In these circumstances, it was not surprising that the Scottish Office valued the retention of the Barnett formula because it curtailed debate about public expenditure relatives.¹³ A marked difference between the Secretaryships of George Younger and Malcolm Rifkind, and those of Ian Lang and Michael Forsyth, can be seen in the way in which the latter pair simultaneously identified higher levels of public expenditure as a policy problem yet flaunted this as a benefit of the Union. This constituted a "scorched earth" policy which was bound to leave many hostages to fortune.¹⁴ In future, the harshest political criticism of the Barnett formula is likely to come from the Labour Government's backbenches.¹⁵

For accounts of how the Barnett formula has worked, the reader is referred to Heald (1992, 1994), Bell et al (1996), Treasury (1997b,c) and Twigger (1998).¹⁶ A considerable amount of media and political comment seriously misrepresents the formula. Indeed, a considerable proportion of media coverage should be viewed as either government spinning or news invention by journalists to provide a peg for editorial pronouncements.¹⁷ In particular, the formula cannot properly be described as needs-based. However, it plays a crucial role as a regulating mechanism within a system which embodies a commitment to the territorial matching of needs and resources. Accordingly, the 1978 decision to use the formula for governing changes in the Scottish block, with the expectation that this would lead to some degree of convergence of per capita expenditure, was based upon the implied view that Scotland's expenditure relative exceeded its needs relative. Recourse to the Barnett formula, later extended to cover Wales and Northern Ireland, signalled a desire for convergence, without having to decide how much convergence. It is therefore part of a broad-brush fiscal arrangement, contrasting markedly to the fine-grained, highly disaggregated and complex systems used for the distribution of Revenue Support Grant (RSG) to local authorities and purchasing budgets to health authorities.¹⁸

The fundamental point about the future of the Barnett formula is that it will be transformed from a mechanism *internal* to one government to one used for regulating

the transfer of money *between* tiers of government. The intensity of recent political and media interest, together with the extent of both misunderstanding and misrepresentation, gives some indication of what the future holds. Such a non-statutory mechanism, functioning in the absence of an independent body such as a Territorial Exchequer Board (Heald, 1990), will depend entirely upon ministerial discretion. The announcement by the Chief Secretary to the Treasury (Darling, 1997), on 9 December 1997, that there would be annual upratings of population from 1999-2000 was a spoiler to head off the expected critical report from the Treasury Committee.¹⁹

Two interesting insights can be drawn from the Treasury Committee's evidence session on 17 November 1997 (Treasury Committee, 1997). First, Lord Barnett placed great emphasis upon relative income per head as the underpinning for the 1978 adoption of the formula. This contrasts with what has hitherto been drawn from governmental statements. A possible explanation is that Lord Barnett was recounting how this new arrangement was made politically acceptable to the then Labour Cabinet, rather than the reasoning why the Treasury and Scottish Office promoted such a mechanism. Second, academic and media commentators on territorial aspects of public finances had expected that a commitment to devolution would lead to a much more thorough account being placed in the public domain as to how the Barnett formula has worked over 20 years. The answers provided by Treasury witnesses and the inadequate data later provided in a Treasury (1998a) memorandum suggest that such expectations might be ill-founded.²⁰

There is an important sense in which the incessant attention in the 1990s to the mechanics of the Barnett formula has begun to damage what its spirit was intended to achieve. The purpose behind such territorial formulae is to avoid repeated annual controversies about changes in expenditure; once a formula is set it should hold for a number of years. The danger of repeated conflict is that this both undermines the purpose of the formula and raises a set of divisive yet irresolvable territorial controversies.

The crucial point is that the long-term, general equilibrium effects of the structure of government are impossible to pin down authoritatively. Any attempt to quantify these will involve assumptions which are inevitably vulnerable to challenge by those who do not like the conclusions.²¹

In the view of the present authors (Heald et al, 1998), the direction of *current* territorial transfers within the United Kingdom is clear, though there is some scope for argument about size. The "territories" spend considerably more than the UK average and the best available evidence indicates that they generate less than the UK average in revenues; the net flow is therefore from England (Scottish Office, 1997b; Welsh Office, 1997).²²

However, this is a conclusion about the territorial pattern of public finances given the historical development of UK government and the way it has influenced the territorial distribution of economic activity and population. The highly centralised nature of the British state has resulted in London being dominant in almost every aspect of British

life. The United Kingdom is atypical in the close mapping of industrial, financial, political and governmental activity; this is resented especially, though not exclusively, in the territories. This pattern is markedly different from what occurs in federal states such as Australia, Canada, Germany and the United States. If the United Kingdom had not existed in its highly centralised form, the geographical pattern of economic activity in the British Isles would have been markedly different. One telling statistic is that the non-England share of the population of the United Kingdom plus Republic of Ireland fell from 46 per cent in 1801 (the year of the first modern census) to 21 per cent in 1991 (Heald, 1992, p.43). Over the same period, England's share of GB population rose from 76 per cent to 86 per cent. Under different governmental scenarios, both the structure of population and the pre-tax and benefit distribution of income in the United Kingdom would probably have been very different. As was dramatically shown by the geographical pattern of voting in the Welsh devolution referendum, the west-east links connecting Wales with England in both north and south markedly differentiate the context of Welsh from Scottish devolution. There is international evidence that frontiers affect economic development and population trends; obvious examples concern Belgium, Germany and Netherlands, and Canada and the United States. If Wales and England had been separate states, the situation now would probably be quite different; for example, one would speculate that there would have been a markedly different configuration of Welsh transport investments, emphasising the internal cohesion of Wales.

The impact of UK devolution, still more so a fragmentation of the United Kingdom into four independent parts, would be highly uncertain. This allows those on all sides of these constitutional issues to visualise outcomes favourable to their viewpoint. One argument, which has been seized upon by Alex Salmond, Leader of the Scottish National Party, is that the remarkable recent economic performance of Ireland might serve as a model for an independent Scotland within the European Union. In other words, the types of calculation discussed above would be dismissed as largely irrelevant; and the frame of reference would be rejected as the wrong starting point and as misrepresenting the relevant dynamics.

Turning to the case of Northern Ireland, Gibson (1996) used Kornai's (1980) notion of the soft budget constraint as a vehicle for analysing the public finances of Northern Ireland during the periods of devolution and direct rule. The implementation of the financial provisions of the Government of Ireland Act 1920 severely disadvantaged Northern Ireland. Even in the absence of measurement, it clearly suffered from higher-than-GB expenditure needs and lower-than-GB taxable capacity. The Northern Ireland Government was not in a position to provide GB-comparable services after paying the first-charge "Imperial contribution" to the UK Treasury. Complicating matters further, Northern Ireland was not only separated from the Republic but also disengaged from Great Britain in both psychological and financial senses. The realities of the territorial financial system were concealed, and the Northern Ireland Government faced an extremely hard budget constraint. Even when successively relaxed (Gibson, 1996), this remained harsh if compared with the notional position of a "poor" GB region. Moreover, the rigidities of the financial system simultaneously undermined the substance of devolution and created potentially serious economic distortions.²³ A prime reason for the lack of resolution

of these issues has been the contested status of Northern Ireland, and the way in which all developments have been subject to dual interpretation, resulting in ossification. Direct rule from 1972 dramatically relaxed the budget constraint, leading to a remarkable period of expenditure growth as the UK Government expected GB standards of provision to apply. A damaging aspect of these arrangements is that access to the UK Exchequer protected Northern Ireland from the costs of political violence.²⁴ In the long term, the transparency which is likely to accompany devolution might bring back a harder budget constraint.

Perhaps the most significant “lesson” to be derived from the historical experience of Northern Ireland is that long-term effects are extremely difficult to predict. First, one would expect that labour markets would encourage migration from low-income to high-income regions. Such a response to earnings differentials is likely to be intensified by fiscally induced migration if “poor” jurisdictions have to balance their budgets without any equalisation payments for below-average resources and/or above-average needs. As well as securing higher labour earnings, the migrant will receive a higher level of public services for any given tax payment. Solely from an economic perspective, policymakers may doubt whether such trends are wholly beneficial, especially if migration is concentrated among more skilled workers and if there are congestion effects in receiving regions. Second, the political effects of migration can be equally complex and highly contentious in a society marked by sharp cleavages. In Northern Ireland, prolonged political violence has exerted differential effects on migration; most notably, a significant number of students from Protestant households study at GB universities and do not subsequently return. Migration has affected the religious balance of Northern Ireland, just as it has drastically altered the population distribution of the United Kingdom. Third, a lasting peace which brought greater economic prosperity would have complex effects. For example, lower unemployment and an increase in wages in Northern Ireland towards the UK level would bring substantial benefits to the working class in both communities. 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 would be masked by the windfall capital gains as prices rose in response to higher confidence and stronger GDP growth. Fourth, a sustained peace in Northern Ireland would give the Northern Ireland Executive substantial political muscle in UK deliberations about territorial expenditure. During the referendum campaign, the Chancellor of the Exchequer announced a £315 million package (Northern Ireland Information Service, 1998a); Richard Branson chipped in with the promise of more Virgin megastores and cinemas if there were a Yes vote (Northern Ireland Information Service, 1998b).

4.4 The interface with local government finance

Although this chapter has concentrated upon the Scottish Parliament’s relationship with Westminster, it is essential to have some discussion about the interface with local government. However, this discussion is not intended to be comprehensive, but instead focuses attention on key issues. In recognition of the salience of this relationship with local government, the Secretary of State for Scotland has appointed

a Commission on Local Government and the Scottish Parliament; its remit includes "effective relations" between the two but regrettably excludes finance. The Commission, which is now consulting widely (Commission on Local Government and the Scottish Parliament, 1998), has been tasked to present its final report to the First Minister when that person takes office.

Throughout the United Kingdom, local government was seriously damaged during the 1979-97 Conservative Government (Jenkins, 1995). The reasons were complex. First, as a major service provider, local government was inevitably caught up in the Thatcherite project of not only redrawing the boundaries between the market and the state but also of reconceptualising the state as an enabler. Second, there was a partisan motive, especially as the Conservative Party's success in winning four successive UK general elections was accompanied by dramatically reduced local government representation.

Although the change of government in May 1997 was widely expected to lead to a strengthening of local government, the opposite has so far been observed. Because these developments are new, the reasons are just beginning to emerge.

First, and much discussed elsewhere, the "New" Labour project is highly centralist both in substance and in style.

Second, during the 1979-97 Conservative Government, opposition parties in Scotland protested interminably about Scotland being badly done by at RSG settlements when the evidence was clearly to the contrary. Such has been the opacity of the local government financial system that it has been possible to choose a number favourable to one's argument, run that in a misleading way, and then shrug one's shoulders if the number is challenged, secure in the knowledge that few will understand anyway. The opportunity for a serious dialogue about why Scottish local authority expenditure is much higher than that in England and Wales was missed because of bad feeling between Ian Lang, Secretary of State from 1990 to 1995, and the Convention of Scottish Local Authorities. The unilateral commissioning by the Scottish Office of a study by Coopers & Lybrand and Pidea (1997) compounded matters; the context within which the study was commissioned and conducted allowed its findings to be dismissed as politically motivated.²⁵

Third, Scottish local government now seems to have been more damaged than previously realised. The 1996 reorganisation was widely condemned as an abuse of central government power,²⁶ though a consensus-minded Secretary of State for Scotland would have been able to take advantage of the widely held view that devolution would be accompanied by a switch to single-tier local authorities. There seems to have been a strong reluctance among the devolutionist majority to criticise local authorities when they were under explicit attack from the abrasive and media-astute Michael Forsyth (Secretary of State for Scotland, 1995-97). Paradoxically, the change of government put Scottish local authorities into the political spotlight: an attack on alleged local authority sleaze and incompetence is a proxy attack on the Labour Secretary of State. Moreover, local authority accountability has been diminished by intensified central government controls, and their legitimacy has been

undermined by the distorting effects of the first-past-the-post voting system in a four-party context. Notwithstanding institutional differences, many of the concerns articulated by Emmerson and Hall (1998) extend to Scotland. An effective agenda for revitalising Scottish local government would have to address both the electoral system (a move to proportional representation in local government seems an inevitable consequence of its adoption for the Scottish Parliament) and the financial system (where the key issue is not the proportion of local authority expenditure financed by grant, but rather the ability of local authorities to take decisions on expenditure levels).

The toughness of the questions now being asked of UK local authorities confirms that they were treated gently by the Lords' Select Committee on Relations between Central and Local Government (1996).²⁷ In the case of Scottish local authorities, the issues are rendered more urgent by the integral links between the finances of the Scottish Parliament and those of local authorities. Aggregate External Finance (AEF)²⁸ represents in 1998-99 approximately 38 per cent of the Scottish block; a further 4 per cent is accounted for by local authority capital expenditure. Indeed, when health expenditure (33 per cent) is added, the combined proportion of the Scottish block for local government and health is 75 per cent (Scottish Office, 1998, p.15). Moreover, AEF per head of population in 1998-99 is 35 per cent higher in Scotland than in England. A consequence is that the formula consequences (that is, 10.66 per cent) of increases in AEF in England inevitably produce a lower percentage increase in AEF in Scotland, thereby necessitating either a higher rate of council tax increase or a lower rate of expenditure growth. Moreover, there is a warning in the Scotland Devolution White Paper (Scottish Office, 1997a) that an "excessive growth" in Local Authority Self-Financed Expenditure (LASFE) in Scotland relative to England might be scored against the assigned budget.²⁹ The public expenditure target of successive UK governments has been some variant of General Government Expenditure (GGE), which scores total local government expenditure and not just the part supported by central government.

4.5 The challenge ahead

The overwhelming impression is that there has been a sudden releasing of constraints and that, on a wide range of constitutional and fiscal issues, there is a remarkably open agenda. On some key issues, there is latent consensus across a broad political spectrum and considerable harmony between academic and practitioner perspectives. This should not be obscured by the inevitably raucous noise of party competition. Five issues will be briefly reviewed in this concluding section.

First, the institutions of governance need to be relegitimated. Notwithstanding opposing assessments of the substantive direction of the Conservative Government's local government reorganisation, there is widespread concern about the damaged fabric of local democracy. Equally, necessary repairs to that fabric must address both the financial system (81.8 per cent of local authorities in England and Wales budgeted in 1997-98 within 0.1 per cent of their provisional capping limit) (Emmerson and Hall, 1998) and the electoral system (the distorting effects of first-past-the-post were

magnified by the cumulative impact on Conservative local government representation of four successive general election victories). In Scotland, key sections of the media have switched their campaigning from quangos (which had been characterised as full of Conservative Party ciphers) to Labour-controlled local authorities (from whose cupboards skeletons have alarmingly tumbled). The election on the basis of proportional representation of devolved bodies in all three territories, each with financial responsibility for local government, creates opportunities for wide-ranging reform.

Second, much more transparency about territorial fiscal matters is now inevitable. Indeed, that inevitability adds pragmatic backing to the principled argument for transparency; if documents will, in any case, be selectively leaked or spun, it is advisable to place the information in the public domain in an orderly and comprehensible manner. This will require cultural change within the territorial departments, which have tended to justify their monopoly of key fiscal data on the basis that secrecy allowed them to protect territorial interests by stealth. Whether or not this was a genuine or merely self-justifying argument, there will be much greater transparency to both those within, and those external to, the territories. Territorial civil servants and public managers will in future be caught up in a public glare which they have so far in large part avoided. This will often be uncomfortable and sometimes unedifying; however, remedying the democratic deficit must bring greater exposure for holders of such posts to "locally elected" politicians.³⁰

Third, it is the "newness" of the institutions which creates a fleeting window of opportunity before the new political system beds down. Whatever their democratic rhetoric, or what they said in opposition, politicians in government view the control of information flows as a key source of power, maximising their areas of policy discretion. Number generation is not a neutral business; not least, it allows those in office to ridicule the expenditure and tax proposals of others. Although there are complex technical matters for which specialist knowledge is required, the key features can usually be explained in accessible language. Accordingly it is immensely important that the initial budgetary documents presented to the newly elected territorial bodies take advantage of the current enthusiasm for transparency to establish the precedent of openness, clarity and accessibility. Significant gains sometimes come because of timing and individual initiative; for example, Russell Hillhouse, then Principal Finance Officer at the Scottish Office, published the first Commentary on the Scotland Programme (Scottish Office, 1983) when there was doubt about whether the Committee on Scottish Affairs would hold a public expenditure hearing with the Secretary of State for Scotland. In time, this innovation was copied in Northern Ireland and Wales, and was a precursor of departmental reports (which have been published for all UK departments since 1991).³¹

Fourth, though this is a matter which requires more extensive discussion elsewhere, the working assumption behind the design of financial procedures for devolved bodies should be to maximise the delegation of in-year financial discretion to the devolved Executives in return for effective participation in the process of priority formation and prompt disclosure of relevant financial information in a coherent form. Such arrangements are essential because the assigned budgets must be effectively managed

in aggregate and because they feed a vast array of public, quasi-public and private organisations whose own planning and budgeting will affect Value-for-Money.

Fifth, there are several new Treasury initiatives which will affect the territorial fiscal system. For example, the operation of the Barnett formula will certainly be affected by the introduction of Resource Budgeting, under which there will be two aggregates: the resource budget (accruals) and the total financing requirement (cash). Moreover, the introduction of three-year expenditure planning within the new fiscal framework (Treasury, 1998b,c,d) is likely to have (predictable and unexpected) effects on the dynamic properties of the formula.³² It will be essential to voice the fundamental proposition that the extent of fiscal equalisation must be decoupled from the choice of system of government within the United Kingdom (Quigley, 1996). Having established that principle, the devolved Executives will have to develop sufficient technical expertise to sustain their cases in arguments with the Treasury, especially in the absence of buffer institutions such as a Territorial Exchequer Board.³³

Notes

1. Moreover, the Conservative Government would “reaffirm that they will uphold the democratic wish of a greater number of people of Northern Ireland on the issue of whether they prefer to support the Union or a sovereign United Ireland” (Northern Ireland Office, 1995, p.27). This contrasted markedly with the attitude taken towards the proposals for devolution developed by the Scottish Constitutional Convention (1990, 1995) and the Scottish National Party’s plans for independence.
2. Indeed, the Government has made a virtue out of necessity, convening the broad-based Consultative Steering Group (CSG) chaired by Henry McLeish, Minister of State at the Scottish Office. The Financial Issues Advisory Group (FIAG) is one of the sub-groups reporting to CSG.
3. On 15 April 1998, the *Scottish Mirror* ran a front-page story, “You want £2bn from Scotland? Get Lost! Fury over cash demand from man who would be Mayor of London” (Fletcher, 1998), supported by an inside article and an abrasive editorial (“Ignore the rantings of one silly man”). The main edition of the *Daily Mirror* ignored the story.
4. Those papers set out why, notwithstanding the comparatively small revenue yield of the “tartan tax”, it was extremely important that the commitment to devolved taxes held firm.
5. It should be recognised that, for many of the key policy propositions derived from the fiscal federalism tradition within public economics, there are counter propositions derived in the public choice literature (Jha, 1998, p.464).
6. Notwithstanding such theoretical arguments, the empirical evidence is mixed. Anderson and van den Berg (1998, pp.183-84) concluded that “our results offer no evidence of a link between fiscal centralization and government size, within the forty-five countries covered in our world sample”.
7. Heald et al (1998) explicitly rejected this view. It is important to recognise that there can be two variants of this argument. In the first, the United Kingdom keeps control of tax rates, so that the Scottish Parliament would have to adjust its expenditure downwards in order to balance its budget. In the second, control of all tax rates would also be devolved, meaning that there would be a trade-off between expenditure reductions and Scottish tax increases.
8. Goodhart and Smith’s (1993, p.443) closing of their retrospective on the MacDougall Report is worth quoting: “it is arguable that [it] provided all the necessary and appropriate analysis on Community stabilization issues. The fact that the Report has been pigeon-holed, with none of its recommendations implemented, is not a commentary on its economic analysis, but perhaps, on two failures. The first was a failure to distinguish sufficiently between stabilization and redistributive measures, and the second, crucial, failure was its inability to address the political, and also some of the economic, problems that any such redistributive transfers would involve”.
9. This motivation is at its most blatant in the Treasury’s (1997a) analysis of UK public finances during the last economic cycle.
10. Although it is not fashionable to have public doubts about the desirability of transparency, it is clear that attitudes in practice are ambivalent. There seems to be a presumption in some Finance Ministries, most notably in the New Zealand Treasury, that greater transparency will lead to lower spending. Moreover, it is difficult to take

the UK Treasury's new-found enthusiasm for transparency at face value when there is so much pressure to use the Private Finance Initiative as a vehicle for off-balance sheet finance. Furthermore, the effect, so far, of the Comprehensive Spending Review has been to bring even more obscurity to public expenditure numbers (Heald, 1995, 1998).

11. However, there is a marked asymmetry in that territorial allocation is hugely important for the territorial departments but much less important for the Treasury, as even the three territorial blocks constitute a relatively small part of total public expenditure. Indeed, Barnett's (1982) autobiographical account of his work at the Treasury does not mention the Barnett formula.

12. Of course, these three factors are not necessarily mutually exclusive; for example, it might be that territorial political muscle and classical incrementalism were factors working against attempts to reduce expenditure relativities, whether or not the expenditure differentials had justifications in differential needs.

13. How particular commentators interpret these events depends crucially upon their substantive policy preferences. Whereas Midwinter (1997) viewed them as evidence of a more effective defence of public services in Scotland, Neil (1997b) considered them as yet more evidence of the "out-of-date collectivist consensus" which he believes inflicts severe damage upon Scotland.

14. McLean (1997, p.80) remarked: "the Forsyth plan is to warn the Scottish electorate that, once these numbers become generally known, they will be unsustainable. By bringing them into the open, devolution will bring Scotland's favourable treatment to an end (Note the Forsyth plan depends on the English not reading what he writes for Scottish eyes)". This assumption that the Secretary of State did not intend others to read his words is a serious misinterpretation of events.

15. Questioning Lord Barnett at the Treasury Committee evidence session on 17 November 1997, Brian Sedgemore (Labour MP for Hackney South and Shoreditch) asked: "whether you think I would be correct in thinking that, as applied to the current situation, this means that the Government is in fact ruled by a Scottish hegemony that English Cabinet ministers cannot smash, and that is replicated in the Treasury because the Chancellor, the Chief Secretary to the Treasury and the Economic Secretary to the Treasury are all Scottish MPs. Does that not sum it up? Is that not why this is something that is going to be pushed into the long grass?" (Sedgemore, 1997, Q.7).

16. Briefly, the formula provided that increases in public expenditure in Scotland and in Wales for specific services within the territorial blocks would be determined according to the formula consequences of changes in equivalent expenditure in England. Initially, Scotland received 10/85ths and Wales 5/85ths of the change in England. A parallel formula allocated 2.75 per cent of the change in equivalent 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 relatives would in the long run converge on the UK per capita average. However, the intention was to seek a better alignment of expenditure and needs relatives, not full convergence (Mackay, 1996). In practice, convergence has been substantially frustrated by formula bypass, and in Scotland by relative population decline. In 1992, the formula was recalibrated (10.66:6.02:100.00 and Northern Ireland 2.87 per cent) in recognition of the results of the 1991 population census.

17. A comment in *The Herald* (Dinwoodie, 1998) about the previous day's lead story (MacMahon et al, 1998) and editorial in *The Scotsman* (1998) illustrates the general point well: "[Mr Dewar] hated this week's headlines about big spending to come, not just because *the figures were essentially manufactured* but because as a lawyer he realised that in months to come they would be taken down and used in evidence against him" (Dinwoodie, 1998, emphasis added). It is a matter of guesswork whether this particular instance of manufacturing was done by Scottish Office spin doctors or journalists.

18. Heald (1990) set out the advantages of using a broad-brush formula such as Barnett, in the traditions of the Goschen formula (announced in 1888 and of which use was still made in the late 1950s). There are powerful arguments against drawing the territories into a UK-wide annual needs assessment exercise such as that used for the distribution of RSG in England. In the territorial context, needs assessments should be periodic, and then used to inform the calibration of the territorial formula for the next period.

19. The effects of annual upratings of population are likely to be minimal, as these will effect only the increment. The significance of Scotland's relative population decline is that it offsets the convergent properties of the Barnett formula: it is always actual population in that year which is used as the denominator in calculations of per capita expenditure. Apart from the danger of being seen to politicise the mid-year population estimates, this change will heighten the political sensitivity of relative population trends.

20. It seems unlikely that systematic information about the past operation of the Barnett formula will ever become available. Replying to questions about English equivalent expenditure to Scottish and Welsh block expenditure, Treasury witnesses made the following observations: "We do not have the information collected anywhere. If you are asking for figures going back for 20 years, it would be quite a major exercise" (Gieve, 1997); and "We can do it [current figures] but it is not a trivial exercise, and if you are talking about a note next week, the answer is no. If you are talking about something maybe in a month or two, yes" (Ritchie, 1997). The Treasury (1998a) provided data which make possible the calculation of the following per capita figures in 1995-96 for English equivalent expenditure in relation to each of the territorial blocks: Scotland 132 (England = 100); Wales 125 (England = 100); and Northern Ireland 132 (England = 100). However, the indexes cannot be compared across the territories because the compositions of the blocks differ. At this level of aggregation, the new numbers are not particularly helpful.

21. There is another danger, illustrated by debates over Economic and Monetary Union: the less secure is economic knowledge, the more strident are pronouncements.

22. The data on identifiable expenditure should always be read with awareness about the impact of non-identified expenditure on services such as defence. Debates about the territorial pattern of defence expenditure are a telling reminder that political concerns are as often about inputs (hence employment effects) as about outputs. When the focus is upon both expenditure and revenue, tax expenditures (for example, on owner-occupied housing) cancel out because regional revenue is correspondingly depressed. Historically, North Sea oil revenues (which are attributed to the UK Continental Shelf which is part of the United Kingdom but not part of any region) have been large. The Scottish National Party's argument that Scotland subsidised the United Kingdom by £28 billion during the years 1978-79 to 1994-95 is discussed in

Heald et al (1998). Whatever view is taken about the past, oil revenues have much less significance for the future. Some of the income tax figures are puzzling, possibly reflecting issues of sample size and methodological changes. The present authors believe that recent Scottish Office work provides a reasonably robust picture of Scotland's public finances. In 1995-96, the General Government Borrowing Requirement in Scotland is estimated as 12.5 per cent of GDP, compared with 5.25 per cent for the United Kingdom (Scottish Office, 1997b).

23. On the former, the financial incentives for the Northern Ireland Government to follow GB policy acquired overwhelming importance. On the latter, Gibson (1996, p.45) posed a series of questions: "A critical question which seems to have gone unanswered was the effect parity of services, especially cash social services, would have on the functioning of the regional labour market, where average earnings were substantially lower and per capita income barely 70 per cent of that of the UK... Might the pursuit of parity, through the provision of better public services and by effectively putting a floor to wages, inhibit certain forms of economic development, accentuate some types of unemployment and affect migration? And might it also lead to the concentration of unemployment amongst the unskilled and relatively deprived members of society? With many of these to be found in the Nationalist community might it exacerbate social divisions?" However, parity of cash benefits with Great Britain acquired a symbolic importance as a sign of membership of the United Kingdom. Like many other public expenditure issues in Northern Ireland, it would have been interpreted in terms of which community was most affected. Moreover, a breach of parity in cash benefits in the case of Northern Ireland would have been predicted by low-income GB regions to have repercussions for themselves.

24. "...of especial importance to Northern Ireland is the soft budget constraint and the costs of violence; security costs, compensation for destruction of property, loss of business, human injury and loss of life...who bears security and related costs may be highly significant for how a society responds to violence" (Gibson, 1996, p.81). The costs of the conflict in Northern Ireland were extremely unevenly spread over the population; those unaffected had no fiscal incentive to take these costs into account, either in their voting behaviour or in their decisions about whether to participate in the political process.

25. There had been discussion about the possibility of a study being jointly commissioned by the Scottish Office and the Convention of Scottish Local Authorities (COSLA). Consequently, the unilateral issuing of tender documents by the Scottish Office was viewed by COSLA as a hostile move. The terms of reference bizarrely "expressly prohibited the appointed consultants from involving local authorities or local authority associations in England and Wales or to collect information from them" (Coopers & Lybrand and Piedad, 1997, Appendix 1). Inevitably, these circumstances made likely a hostile reception for the report when it was published in February 1997 on the eve of the general election. Following the change of government in May 1997, the second phase of the study, which had been recommended by the contractors, was cancelled. Nevertheless, the expenditure differentials calculated in the study have been widely quoted.

26. Midwinter (1993, p.53) described Scottish Office policy, including the local government review, as "narrowly partisan and lacking in adequate diagnosis and understanding of the current system".

27. These circumstances have left local authorities ill-prepared for the aggressiveness of the attacks which are now being made on their role. The journalist, Andrew Neil, consistently returns to his theme: "A revolution in Scottish local government - whose general efficiency is currently on a par with a steel mill in Stalinist Russia - would be a crusade worth launching. However, the Government has no stomach since it is unwilling to upset its friends on the Labour-controlled Convention of Scottish Local Authorities, a cosy cartel which represents the interests of the complacent, comatose and the corrupt" (Neil, 1998). The fact that such extravagant language is not matched by evidence is not necessarily the point; the Major administration was mercilessly and unfairly caricatured as "sleaze-ridden".
28. AEF is defined as the "envelope of external support for local authorities which are also funded from the council tax. It comprises Revenue Support Grant, payments from the yield of non-domestic rates, and certain specific grants" (Scottish Office, 1998).
29. "Should self-financed expenditure start to rise steeply, the Scottish Parliament would clearly come under pressure from council tax payers in Scotland to exercise its [capping] powers. If growth relative to England were excessive and were such as to threaten targets set for public expenditure as part of the management of the UK economy, and the Scottish Parliament nevertheless chose not to exercise its powers, it would be open to the UK Government to take the excess into account in considering the level of their support for expenditure in Scotland" (Scottish Office, 1997a, para.7.24). There is no guidance on what would constitute "excessive" growth.
30. On technical financial issues, Committees of the devolved bodies should, when appropriate, take evidence from officials separately from ministers; ministers give political answers and their presence often inhibits officials' efforts to explain the technical issues.
31. Some of the possibilities for technical improvements to improve clarity are obvious: a better alignment of PES and Estimates coverage; transparent treatment of European Union funds; clearer exploration of External Financing Limit controls; and transparent accounting for Private Finance Initiative assets.
32. An excellent example of how changes in the public expenditure control system can affect the results of formula operation can be found in the conversion from volume planning to cash planning in 1982-83 (Heald, 1994, p.163). This change reinforced the convergence effect.
33. An obvious issue is that LASFE in the territories, and expenditure financed by the "tartan tax", will be included within the Treasury's new category of "Annually Managed Expenditure", separated from the Departmental Expenditure Limit (now labelled "Scottish Office" but presumably soon to be relabelled "Assigned Budget") (Treasury, 1998c, pp.30-31).