

DEVOLUTION IN PRACTICE

PUBLIC POLICY
DIFFERENCES
WITHIN THE UK



edited by John Adams
and Peter Robinson

10. Beyond Barnett? Financing devolution

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Although there are now Devolved Administrations outside England, the United Kingdom is still essentially a unitary state, not a federal one. This is a distinction which matters. Moreover, in comparison with other unitary states, there is highly centralised and unified control over public expenditure and taxation, exercised directly by, or on behalf of, the Treasury. Whatever the nominal autonomy of public authorities, whether at different tiers (for example, Devolved Administrations and local authorities) or within central government (departments, executive agencies and Non-Departmental Public Bodies), very little fiscal activity eludes this highly centralised overall control. Any exceptions are usually either accidental or tolerated specifically to promote certain kinds of centrally approved behaviour by public authorities.¹

A consequence for UK devolution finance is that the expenditure basis is paramount. There is thus no guarantee that tax increases by sub-national governments would necessarily enable higher expenditure. Only the Scottish variable rate of income tax (tartan tax) is excluded from this rule (Treasury 2000a). This centralised context is the one within which the arrangements for UK devolution finance will have to evolve.²

The United Kingdom may be thought of as having a public expenditure system characterised by a division between two types of expenditure. The first is expenditure undertaken on a UK basis, either on 'national' programmes, such as Defence (all UK residents and non-resident UK citizens are presumed to benefit), or on 'uniform' programmes, such as Social security (uniform benefit scales lead to geographically differentiated expenditure).³ The pattern of demography and economic activity means that an inevitable result of uniform UK policy is substantial implicit territorial equalisation in terms of benefits.

The second type of expenditure is undertaken on a country basis,⁴ with well-defined and separate systems for Scotland, Wales and Northern Ireland. England is also treated separately, though this is often obscured by the frequent assumption, particularly by London-based commentators, that England and the United Kingdom are geographically coterminous. UK departments, generally based in Whitehall, have had substantial difficulty in managing the fact that they usually act for England, but sometimes act for Great Britain or the United Kingdom. The greater confidence enjoyed by Devolved Administrations compared to that of their territorial office predecessors means that Whitehall departments can no longer take their UK policy

leadership for granted, as Keating notes in Chapter 1. Evidence of this has already appeared on student fees and care for the elderly.

On this second type of expenditure, the expenditure systems in the three territories are semi-detached from those applying to England. As explained in the next section, the most important part of the funding of the Devolved Administrations is the Assigned Budget, a system representing a continuation of the pre-devolution system which had been in place for 20 years.

There is no formal system of explicit equalisation among countries, whether for resources or needs, of the kinds familiar in federal countries such as Australia, Canada and Germany. Since England constitutes 84 per cent of the UK population, there is clearly a substantial danger that English policy will drive policy elsewhere. The Barnett system is best viewed, first, as a political accommodation (the Devolved Administrations are largely unconstrained on how they spend existing and additional resources) and, secondly, as a means of containing political conflict (asymmetrical structures and differences in country population make conventional 'federal-provincial' negotiating machinery difficult to envisage). Much of the political attention currently paid to the Barnett formula hinges on the contradictory assertions that it is extravagantly generous to the Devolved Administrations, or that it is imposing destructive financial pressures upon them.

Within each country, there are parallel and complex systems of territorial allocation which distribute the resources that have accrued through the Barnett system. These systems operate autonomously, though in parallel. Differences in structure, policy and financial mechanisms make it extremely difficult to draw comparisons between how a public authority in one country would have fared on the funding allocation system of another.

The lack of transparency is partly a consequence of a general lack of understanding of how the territorial system operates. This obscurity afforded protection for the policy and financial autonomy of the territorial offices which preceded the Devolved Administrations. There is a considerable literature on the reasons why there was limited policy variation pre-devolution, in spite of financial freedoms to switch expenditure (Midwinter *et al* 1991). The Secretaries of States' membership of the UK Cabinet was an obvious constraint.

The discussion in this chapter is almost exclusively about the expenditure side of the public budget. The only systematic data on revenue at a sub-national level are found in *Government Expenditure and Revenues in Scotland* (GERS) (Scottish Executive 2001), published annually over the last decade. The Welsh counterpart (Welsh Office 1996; 1997a) was abandoned by the present Government after two issues, and there has never been a comparable document for Northern Ireland. In Scotland, political debate about GERS frequently revolves around how oil revenues from the UK Continental Shelf should be treated in discussions about Scotland's viability as an independent

state. The UK convention is to attribute oil revenues to 'Extra Regio', part of the United Kingdom but not of its constituent regions.

In this chapter it is argued that, under devolution, the expenditure basis will remain; this is the UK tradition and the absence of a proper federation makes a formal revenue-based system difficult to envisage. Realistic reform should aim to increase fiscal accountability at the margin (Bell *et al* 1996, Blow *et al* 1996) by allowing some tax variation within defined limits.

The territorial level

Description of the devolved funding system

There are many complexities to the UK devolved funding system, but the basic outline can be readily explained. The budgets of the Devolved Administrations are determined in three ways: an unconditional block ('Assigned Budget'),⁵ covering most of their activities; specific allocations for services operated according to UK or EU policy; and the amounts raised by the Devolved Administrations and their local authorities and public bodies from taxes and charges under their control. Expenditure in the first two categories is financed mainly, but not exclusively, by transfers from the UK government.⁶

Changes to the levels of the Assigned Budgets are determined primarily through the mechanism known as the Barnett formula, established in 1978.⁷ This formula operates only on increments, not on the base, allocating to each country a population-based percentage of the increase in comparable expenditure in England. Specific allocations are negotiated bilaterally. The Devolved Administrations have limited control over total budget size, but have extensive discretion over expenditure composition.

Accountability for spending rests with the Devolved Administrations, which are accountable to the devolved Parliament and assemblies. Audit is undertaken by the public official (Auditor General for Scotland, Auditor General for Wales and Comptroller and Auditor General for Northern Ireland) who heads the respective territorial audit offices.

The idea of a formula determining part of territorial expenditure is not new. The Goschen formula (allocating 11/80ths of English expenditure) was used to determine part of Scottish expenditure from 1888 until the 1950s. The Barnett formula was first introduced at the time of the previous devolution (to Scotland and Wales) legislation in 1978. The intention was to set up, in consultation with the devolved Assemblies, a system whereby a formula was settled for each four-year period, giving each devolved Assembly a fixed proportion of English expenditure on comparable services (Cabinet Office 1977). The proportion would have been fixed on the basis of a needs assessment. The Barnett formula seems to have been an interim arrangement, pending the introduction of that system.

In the event, devolution did not proceed at that time, but the Barnett formula remained. It was continued by the incoming Conservative Government, possibly because it eliminated disproportionate argument over settling a small part of overall UK public expenditure totals.

The existence of the formula became public knowledge in 1980 (Committee on Scottish Affairs 1980), although the details of its operation remained opaque until the 'block rules', first produced in 1984,⁸ finally reached the public domain on 30 March 1999 (Treasury 1999), just before elections to the devolved Parliament and assemblies.

Applied systematically, the Barnett formula would result, in time, in equal expenditure per capita, on devolved services in aggregate, across the United Kingdom (expenditure indexes converge asymptotically on 100). The expenditures on individual services would not necessarily converge since the Devolved Administrations can decide to give priority to particular services, though that would be at the expense of other services (unless Scotland levied the tartan tax). The speed of convergence depends upon the rate of growth of nominal public expenditure.

However, population relatives change through time, and this brings about different convergence limits for each country. Cuthbert (2001) proves this mathematically; the limiting value becomes a function both of the rate of change of relative population and of the rate of change of nominal expenditure.⁹

A formula, such as Barnett, which distributes equal per capita increments to each country automatically delivers smaller percentage spending increases to those territories with the highest starting values of the index. In consequence, Scotland's expenditure rises faster than Northern Ireland's, but rises slower than England's. Particularly in Northern Ireland and Wales, such comparisons of 'headline' year-on-year increases have brought discomfort to the Devolved Administrations, even in times of 'plenty'.¹⁰

The Barnett formula has not, in fact, been operated on this 'clean' basis; instead, a number of important factors have combined to qualify the analytical results. First, there have been changes in the public expenditure framework within which the formula has operated. The most important of these is that the formula originally operated in a volume-planning environment, and thus only operated on real terms increments. Even after the advent of cash planning, echoes of volume planning remained in that new baselines for the horizon year (that is to say, the year coming into the Survey for the first time) were constructed with an uplift giving some allowance for inflation (Thain and Wright 1995). This uplift procedure ceased in 1993, though this fact was not made public until 1997 (Treasury 1997b). Second, formula bypass¹¹ seems to have occurred in the 1980s and early 1990s, but has become less important as the formula has been more strictly applied. The third point is not about the operation of the formula but about demographic change: Scotland's relative population has continued to fall, thereby mitigating the predicted falls in the expenditure index.

There are two popular misconceptions about the Barnett formula. Contrary to some claims, it was never intended to equalise spending per head across the UK. The formula, initially an interim arrangement, operated at first only on real terms changes, thus making convergence extremely gradual. After the change to full cash planning, the territorial Secretaries of State understood that they could call for a successor needs assessment to that published in 1979 (Treasury 1979), should they feel it necessary. The fact that this was never done suggests that they calculated that such a needs assessment would not be in their interests.

Despite recent ministerial statements, there was never a formal allocation based on need; the Barnett formula is a *population-based* mechanism to allocate increments of public expenditure, not a *needs-based* formula as it is sometimes described. Perceptions of differential need played some part in shaping the public expenditure allocations before the 1978 establishment of the Barnett formula. These allocations formed the original baseline on which the system is built. But political bargaining had also been important in determining those allocations (Midwinter *et al* 1991).

There are two principal advantages of such a system to the Devolved Administrations. First, they are not constrained to spend formula consequences according to the pattern set in Whitehall. They enjoy the expenditure-switching discretion previously much valued by territorial Secretaries of State, without some of the political inhibitions on its use. What matters crucially to the Devolved Administrations is how the UK government prioritises, say, Education and Health against Defence and Social security. The UK government's decisions on the composition of 'English comparable expenditure', say, between Education and Health, is of no direct concern. Second, this insulates the Devolved Administrations from the Treasury, which has used techniques such as Public Service Agreements and Cross-Cutting Reviews as instruments for strengthening policy control over Whitehall departments. Those who believe that such centralised control will lead to better policy making will regard this as a disadvantage. Those, like the present authors, who do not share this view will recognise this insulation as one of the crucial advantages of the Barnett arrangements to the Devolved Administrations.

Formula consequences

Although there is now much more detailed information in the public domain about the operation of the Barnett formula (Treasury 2000a), it has hitherto been impossible to replicate from data in the public domain the calculation of formula consequences. This can now be done for Scotland, with regard to the Spending Review (SR) 2000 settlement (Treasury 2000b), using data published by the Scottish Affairs Committee (Scotland Office 2002).

Table 10.1 shows the formula consequences for the years 2001-02, 2002-03 and

2003-04, with the total for 2003-04 being £3,000 million. The first three columns show changes in comparable expenditure in England, with the third column referring to 2003-04. The fourth column shows the weighted comparability percentage for each main programme; the derivation of these weights is detailed in the Funding Policy document (Treasury 2000a). The fifth column shows the Barnett formula proportion, based on population shares, which was then 10.34 per cent of England. Strikingly, 97 per cent of Scotland's formula consequences were derived from changes in six main programmes: Education and employment; Health; three then Department of the Environment, Transport and the Regions (DETR) programmes; and the Home Office.

The formula-driven Assigned Budget is the principal, but not sole, part of the funding available to the Devolved Administrations. Figure 10.1 shows the funding scheme for the Scottish Parliament; there are also parallel diagrams for the National Assembly for Wales and the Northern Ireland Assembly in the July 2000 Funding

Figure 10.1 The funding regime for the Scottish Parliament, 1999-2000 onwards

Assigned budget	Non-assigned budget	
Departmental Expenditure Limit (DEL)	Annually Managed Expenditure (AME)	
Barnett formula determined	Non-Barnett determined	Main programme spending
Secretary of State's/Advocate General's office		
Education and arts	HLCAs (now renamed LFASS)	CAP
Health and social work		
Industry, enterprise and training		
Transport and roads	Welfare to Work (now transferred into the Assigned Budget)	Housing support grant
Housing, Scottish Homes external finance		NHS and teachers' pensions
Law and order		
Crown Office		
Domestic agriculture		Other AME: Certain accrual items such as capital charges and depreciation charges
Environmental services		
Forestry		
CalMac and HIAL's External Finance Requirements		Local Authority Self-Financed Expenditure (LASFE)
Student loans: implied subsidies and provision for bad debts		Scottish Non-Domestic Rates
Capital Receipts Initiative		
Trust Debt Remuneration		Scottish Variable Rate of Income Tax
Scottish Renewables Obligation		
Bus Fuel Duty Rebates		
Other expenditure outside DEL: Police Loans charges		

Source: HM Treasury (2000a) p27

KEY: CAP = Common Agricultural Policy; HIAL = Highlands & Islands Airports Limited, a public corporation which runs certain small airports; and HLCA's = Hill Livestock Compensation Allowances (now renamed Less Favoured Area Support Schemes).

Table 10.1 Derivation of Spending Review 2000's Change in the Scottish Parliament's Assigned Budget DEL (£ million)

	Changes to comparable expenditure in England			Weighted comparability	Barnett proportion	Formula consequences		
	2001-02	2002-03	2003-04	(%)	(%)	2001-02	2002-03	2003-04
Education and employment	1,600	3,770	5,960	93.3	10.34	154.36	363.70	574.97
Health	2,760	7,740	12,310	99.7	10.34	294.53	797.92	1,269.04
DETR - Transport	1,000	2,450	4,100	71.2	10.34	73.62	180.37	301.85
DETR - Housing & other environmental services	260	1,130	1,820	96.5	10.34	25.94	112.75	181.60
DETR - Local Government	650	3,090	5,710	56.4	10.34	37.91	180.20	332.99
Home Office	1,560	2,240	2,580	92.3	9.77	140.68	202.00	232.66
Legal Departments	310	370	390	97.8	9.77	29.62	35.35	37.26
Trade & Industry	1,020	710	650	20.2	10.34	21.30	14.83	13.58
Domestic Agriculture	210	300	330	84.3	10.34	18.30	26.15	28.76
Forestry	10	10	10	100.0	10.34	1.03	1.03	1.03
Culture, Media and Sport	80	130	200	95.3	10.34	7.88	12.81	19.71
Chancellor's Departments	350	550	580	2.1	10.34	0.76	1.19	1.26
Cabinet Office	120	120	190	0.1	10.34	0.01	0.01	0.02
Total formula consequences as per calculations								
Total formula consequences as per Scotland Office (2002)						795.95	1,928.32	2,994.73
Rounding error						800.00	1,940.00	3,000.00
						4.05	11.68	5.27

Notes:

1. Rounding errors originate in the change to comparable expenditure in England being published to the nearest £10 million.
2. England and Wales population proportions apply to Home Office and to Legal Departments.

Source: Scotland Office (2002)

Policy document (Treasury 2000a p27). There is a common structure to the funding system in all three territories, though there are some differences in the kinds of functional expenditure devolved. For example, Scotland alone has 'Law and order' (though this could be devolved to the Northern Ireland Assembly should the security situation make this possible), and the Northern Ireland Assembly alone has responsibility for the social security system (though this is best seen as an agency arrangement, as there is no policy discretion).

Embedding within the UK Public Expenditure System

The exposition above has highlighted how deeply the Devolved Administrations are embedded into the UK public expenditure system. The 1998 Comprehensive Spending Review saw the introduction of a new public expenditure control system, focusing upon Total Managed Expenditure (TME), itself composed of Departmental Expenditure Limits (DELs) and Annually Managed Expenditure (AME). From 2001-02, government accounting switched from a cash basis to an accruals basis, under the project known as Resource Accounting and Budgeting (RAB) (Treasury 2001b).¹²

When the devolution funding scheme was determined in 1997, it was not known that the Treasury would, in 1998, revamp public expenditure control aggregates and move to a biennial survey. The Assigned Budget is classified as DEL, as are certain other items of expenditure which, for various reasons, are not formula-controlled. An example is Hill Livestock Compensation Allowances (now renamed Less Favoured Area Support Schemes). Until recently, Welfare-to-work (a programme originally financed out of the windfall tax on privatised public utilities) also appeared here, but has now been absorbed into the Assigned Budget. At the time of a Comprehensive Spending Review, namely in 1998, 2000 and 2002, DELs are set three years ahead. Changes to the Assigned Budget are controlled by the Barnett formula, with the costs of running the residual territorial offices top-sliced in the cases of Scotland and Wales.

In contrast, AME is set one year ahead, largely on the grounds that these items are more difficult to control and forecast. AME covers three distinct types of expenditure. The first is for the agency-type functions over which the Devolved Administrations exercise almost no discretion. Expenditure on the Common Agricultural Policy has to be negotiated bilaterally with the Treasury, since this is a demand-led programme. The second type is a temporary one; the non-cash items such as capital charges and depreciation, consequent upon RAB, will be scored as AME until they are integrated into DEL, as from 2003-04. The third type represents the revenue-raising sources under the control of the Devolved Administrations, namely Non-Domestic Rate revenue, Local Authority Self-Financed Expenditure and the proceeds, if any, of the tarran tax in Scotland. Treatment as AME is a practical mechanism for allowing

discretion to the Devolved Administrations. However, this discretion is not guaranteed except in the case of the tartan tax.

Although there is greater transparency post-devolution about the *system*, largely thanks to the publication of the hitherto secret 'block rules' (Treasury 1999; 2000a), there is not transparency about the *numbers*.¹³ An indication, however, of the predominance of Barnett formula-determined DEL is that, for 1999-2000 plans, this accounted for 79 per cent (Scotland), 87 per cent (Wales) and 84 per cent (Northern Ireland, excluding Social security benefit expenditure).

The Treasury controls, directly or indirectly, all borrowing on programmes controlled by the Devolved Administrations, which themselves can only borrow temporarily for timing reasons. Moreover, the 'consent' counterpart of (borrowing for) capital expenditure by local authorities and public corporations is scored against the Assigned Budget. One of the reasons why the Private Finance Initiative (PFI) (a Treasury programme to bring private finance and management into asset provision in, for example, transport, education and health) has been embraced in Scotland is that it is an approved route to evade borrowing restrictions. This is despite the fact that there remain ideological and Value-For-Money (VFM) doubts. The standard justification offered politically in Scotland for the adoption of the PFI route is one of capital starvation and the non-availability of public funds ('only show in town'); this sits uncomfortably with concerns that the Barnett formula will in future bring convergence.

Contrary to the purposes of various EU programmes of regional support to less prosperous regions, the award of funds from the European Regional Development Fund (ERDF) generally does not bring additional resources to the beneficiary UK country or region. Despite EU pressure, UK governments have consistently argued that there is additionality in aggregate, namely that public expenditure as a whole is higher than could have been afforded in the absence of ERDF receipts. The most politically dramatic event connected with devolution was when Alun Michael, having been parachuted into the Welsh Labour leadership by the Blair Government to stop Rhodri Morgan being elected First Secretary, had to resign in February 2000 because he failed to deliver extra money following the acquisition of Objective 1 status¹⁴ by West Wales and the Valleys (a geographic construction covering 63 per cent of the area and 65 per cent of the population of Wales). Subsequently, Rhodri Morgan became First Secretary, the Treasury allowed funding 'above Barnett', and the minority Labour administration in Wales followed the Scottish precedent and went into coalition with the Liberal Democrats.

The formula bypass, obtained by the National Assembly for Wales to provide cover for Objective 1 ERDF receipts, received media and political attention beyond its importance. It was described as blowing a hole in the Barnett system. This Welsh exceptionalism provoked outrage in the Scottish media, always keen to spot offence,

until someone pointed out that an extension of this concession to Scotland (which was losing ERDF funds) would have meant a reduction in the Scottish Parliament's Assigned Budget. Including European Social Fund transfers, Wales received an additional £420 million over the three years of SR 2000; the matching requirements of ERDF had to be met out of either the existing expenditure base or the Barnett formula consequences. Even without the intense politics surrounding EU funding, there was a case for exceptional treatment, as indeed there would have been if, say, Wales had been the only part of the United Kingdom to suffer from BSE or foot and mouth disease.¹⁵

As the operation of the formula becomes more transparent, with the numbers entering the public domain, cases of formula bypass will attract more attention. If the bypass is favourable to the Devolved Administrations, this will reduce the amount of convergence which takes place. Contemporary examples of bypass include parts of the 'Reinvestment and Reform' package announced for Northern Ireland by the Prime Minister and Chancellor of the Exchequer on 2 May 2002 (Treasury 2002b), and elements of the write-off of Glasgow City Council housing debt as part of the transfer of municipal stock to a housing association.

Comparative expenditure statistics

There are severe limitations to existing territorial and regional analyses of public expenditure (Heald 1994, Heald and Short 2002). Much misunderstanding has been created by looking at the wrong expenditure aggregate (for instance looking for convergence at the level of identifiable expenditure) and by comparing expenditure in an English region with expenditure in the territories, without adjusting for unallocated expenditure in England.

The starting point for identifiable expenditure analysis is Total Managed Expenditure on Services (TMES). From TMES are then deducted those items of public expenditure held to be of general benefit to UK citizens, and thus not identifiable to countries or regions. Territorial analysis into country can then be undertaken on Identifiable TMES. In 1999-2000, Identifiable TMES constituted only 77 per cent of TME, the Treasury's current control aggregate (itself one step removed from General Government Expenditure, the international definition).

In the absence of better and more relevant data, inter-country comparisons fall back on the figures for identifiable public expenditure published annually by the Treasury in *Public Expenditure: Statistical Analyses (PESA)*.¹⁶ Taking data primarily from the 2001 issue (Treasury 2001d), the top half of Table 10.2 shows public expenditure indexes for Scotland, Wales and Northern Ireland, on the base UK = 100. Although these are imperfect proxies for devolved expenditure (against which comparative data for England are not published), the indexes for identifiable expenditure less Social security

are interesting. The striking point is that the index, when Social security is excluded, is much higher for Scotland and Northern Ireland, but not for Wales.

There have been longstanding complaints about the poor quality of expenditure data for the English regions (Treasury and Civil Service Committee 1989). One aspect of this has been a large amount of expenditure identified to England but not to individual regions. One of the improvements in *PESA 2001* (Treasury 2001d) was that the analysis of English regions is now integrated into the country analysis, so that the England Total disaggregates fully into regions.¹⁷ The data for 1999-2000 are tabulated in Table 10.2 (overleaf). When interpreting the indexes on individual programmes, attention should be paid to the UK weight, indicating the percentage of total expenditure accounted for by that programme. The entries for Totals in each column are weighted averages. These figures show marked variations in levels and compositions among countries and regions. Certain figures should be interpreted with caution. For example, the figures for 'Housing' in some prosperous regions are clearly affected by the netting off of the proceeds from council house sales. There are grounds for concern about data quality, particularly for programmes which are identifiable but not devolved, and for the within-England analysis. Much greater expenditure disaggregation is a precondition for analytical work on these differences.

There has always been a lack of transparency to the operation of the Barnett formula. A crucial point is that there are no published data for 'comparable English expenditure' on the same definitions and coverage as the Scottish, Welsh and Northern Ireland Assigned Budgets. Because of different functional responsibilities, three separate series of data are needed. The Treasury takes a proprietary view of its public expenditure database and refuses access to this even to the pre-devolution territorial offices and the Devolved Administrations. There has been so much recent change to the definition and measurement of public expenditure aggregates that do-it-yourself calculations are likely to be inaccurate. It will become increasingly difficult for the UK government not to publish counterparts to Table 10.1 (formula consequences), immediately after settlements such as SR 2002. However, what are really required are systematic time series data.

When better data become available, the Devolved Administrations will have to be ready to resist pressures to replicate the changes in English comparable programmes. As the levels of comparable expenditure in England are not published, it is not possible to express the changes by main programme, as shown in Table 10.1, as percentage increases. However, it can be seen that the formula consequences for Education and employment accounted for 19 per cent of increases in the Scottish Assigned Budget DEL in 2003-04, with Health accounting for 42 per cent. Suggestions that, for example, Health in Scotland should therefore take 42 per cent of the formula consequences have to be firmly resisted. Quite apart from denying devolved policy choice, the base positions of programmes are different.

Table 10.2 Indexes of identifiable expenditure per capita, by territory, region and function 1999-2000
 1999-2000 data, expressed as £ per capita (cash), relative to UK = 100

	UK weight	Scotland	Wales	N Ireland	England								
						East Midlands	West Midlands	South West	Eastern	London	South East		
Education	15.4%	126	100	136	96			92	96	108	82		
Health and personal social services	24.1%	119	110	111	97			91	92	121	85		
Roads and transport	3.1%	130	112	89	96			88	95	122	105		
Housing	1.1%	176	145	325	82			35	4	304	25		
Other environmental services	3.2%	131	168	106	93			79	76	126	94		
Law, order and protective services	7.1%	96	96	206	97			85	75	144	83		
Trade, industry, energy and employment	2.6%	149	113	255	90			87	86	94	76		
Agriculture, fisheries, food and forestry	1.7%	267	155	283	73			75	73	72	73		
Culture, media and sport	2.0%	99	157	60	99			83	75	176	76		
Social security	38.7%	108	115	120	98			97	89	97	84		
Miscellaneous expenditure	1.0%												
Total	100.0%	118	113	133	96								
Total excluding social security		125	112	142	95								

	England weight	North East	North West	Yorkshire & Humberside	East Midlands	West Midlands	South West	Eastern	London	South East	
Education	15.4%	100	101	96	93	101	92	96	108	82	
Health and personal social services	24.3%	102	100	98	88	92	91	92	121	85	
Roads and transport	3.1%	96	97	74	85	89	88	95	122	105	
Housing	1.0%	57	90	71	35	37	35	4	304	25	
Other environmental services	3.1%	117	106	45	90	92	79	76	126	94	
Law, order and protective services	7.1%	104	101	93	90	88	85	75	144	83	
Trade, industry, energy and employment	2.4%	103	94	91	96	90	87	86	94	76	
Agriculture, fisheries, food and forestry	1.3%	75	73	75	73	69	75	73	72	73	
Culture, media and sport	2.1%	143	88	87	81	82	83	75	176	76	
Social security	39.3%	119	112	101	94	99	97	89	97	84	
Miscellaneous expenditure	1.0%										
Total	100.0%	109	104	95	90	94	92	88	113	84	
Total excluding social security		102	99	91	88	92	88	87	123	84	

Source: Treasury (2001d), Tables 8.6B and 8.12.

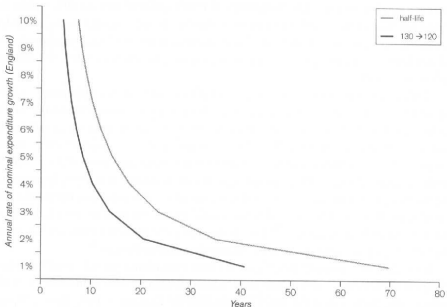
Note: An index of miscellaneous expenditure is not calculated since the administration costs of departments other than in the territories are not separated from functional expenditure. Such an index would be misleading.

Possible technical developments

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

The annual rate of nominal expenditure growth in England obviously has an impact upon convergence. This is explored in Figure 10.2, the horizontal axis of which represents years over which the Barnett formula is strictly applied. No allowance is made in Figure 10.2 for the effect of relative population change, as a result of which indexes converge asymptotically on 100, meaning that they will never precisely reach 100. Practical measures of the rate of convergence are therefore required, and it may be useful to borrow the concept of half-life from nuclear physics. The half-life indicates the number of years it takes for the activity of a radioactive particle to decay to half its original value. If the Barnett formula is strictly applied, with no bypass, with an annual rate of nominal expenditure growth of two per cent, it would take 35.0 years for half

Figure 10.2 The convergence effect of the Barnett formula



the differential (upwards or downwards) from 100 to be eliminated, for example to move from 120 to 110, or from 110 to 105. With a nominal annual expenditure growth rate of eight per cent, this half-life becomes nine years.

It is also possible to consider how many years it takes for the index to fall from one value to another. For the index to fall from 130 to 120 would take 20.5 years at two per cent growth, and 5.3 years at eight per cent growth. Comparable figures can be calculated for any pair of index values, and both the 'half-life' and the '130→120' functions of Figure 10.2 are steep when there are annual rates of nominal expenditure growth above six per cent.

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

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

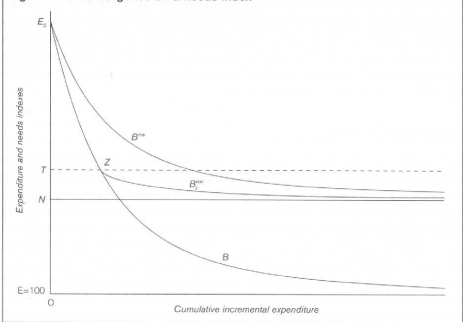
High rates of growth of nominal expenditure, and stricter application of the Barnett formula (there is less opportunity for formula bypass favourable to the territories), may now bring considerable convergence. This necessitates thought as to how the convergence process should be managed as the expenditure index comes closer to the needs index. Figure 10.3 plots expenditure and needs indexes on the vertical axis (England = 100). The horizontal axis measures cumulative incremental expenditure, which begins at zero and increases along that axis. The horizontal axis can also be thought of in terms of years, provided that the annual rate of growth of nominal expenditure is known.¹⁸ Line B represents the Barnett formula convergence on 100, in the case where there is no relative population change.¹⁹

There has been concern that rapid nominal expenditure growth would produce excessive convergence, with a Devolved Administration 'crashing through' its needs index as the Barnett formula drives convergence on England = 100. Thus a 'needs-

weighted' formula, following the path of B^{nw} , could be adopted: instead of incremental expenditure being allocated on the basis of population, it is allocated on the basis of weighted population (population multiplied by the needs index, possible only after the conduct of a needs assessment). Convergence would then be upon N , the needs index of that Devolved Administration. It would be possible to adopt B^{nw} either immediately (when expenditure is at E_0) or when the expenditure index reaches some threshold value above N . In Figure 10.3, the threshold is represented by T and the horizontal dotted line. The convergence path from Z (the intersection of B with the threshold) is labelled B_z^{nw} .

The adoption of either B^{nw} or B_z^{nw} would be more favourable to the Devolved Administrations than using B , on the assumption that their needs indexes were above 100, and would therefore be more expensive to the Treasury. Regardless of the political importance of devolution, territorial funding remains a minor part of the Treasury's portfolio of activities. An advantage from the Treasury's viewpoint would be that, by avoiding the risk of overshooting the needs index, there would be less risk of excessive strain on the devolved funding system. A possible consequence of excessive strain would be large amounts of *ad hoc* formula bypass. Consequently, the cushioning of convergence, as shown in Figure 10.3, might increase the resilience of the formula system.

Figure 10.3 Convergence on a needs index



Resource allocation within countries

Whereas there has not been any formal equalisation scheme across the United Kingdom, highly complex systems exist within each of the four countries. Important examples are: National Health Service (NHS) funding allocations; the allocation of Aggregate External Finance to local authorities; and the formula funding of universities and higher education institutions. Even before devolution, developments often took place in each country largely in isolation from developments in the other countries. Post-devolution, these internal allocations have begun to attract more attention, particularly in relation to the NHS. In England, the formula funding of schools and further education colleges has attracted a great deal of attention.

There has been pioneering work in all parts of the United Kingdom on the use of performance indicators, and not solely needs indicators, within such funding formulae (Carr-Hill *et al* 1994, Smith *et al* 2001). Much of the literature is prescriptive about how funding systems should operate. Particularly in the local government sphere, there has been concern about the extent to which such formula mechanisms are used to exert central control rather than simply to fulfil their equalisation role. Peter Smith (1988) noted the potential for gamesmanship in the context of the local government finance distribution system in England. Moreover, Stephen Smith (1999) noted the danger that, after many years of tight central government control over English local authority spending, the regressions run for Standard Spending Assessments now pick up the effect of controls in earlier years, not just variations in local preferences and expenditure needs. This is a powerful argument against bringing the Devolved Administrations within existing English mechanisms for resource allocation, as proposed by Davies (1997). Such penetration 'through the veil' of the Devolved Administration tier to the constituent local authorities and NHS bodies would unleash strong pressures for spending in the territories to conform to the English pattern.

Institutional machinery

UK government has been very top-down, with a hierarchical relationship between central government and local authorities, even before the 1980s saw a removal of functions, the imposition of compulsory competitive tendering, and the diminution and restriction of revenue raising. Even within the territories, with their separate territorial offices, political authority came through the Secretary of State from the Prime Minister and the UK Cabinet. On a constitutional level, devolution does not necessarily change this. The Scottish Parliament was established by Westminster legislation, which any future government can repeal, and the funding basis is only contained in the devolution White Papers (Scottish Office 1997, Welsh Office 1997b) and non-statutory Treasury guidance (Treasury 1999; 2000a). There can be no such

thing in the United Kingdom at present as a constitutional assignment of powers.

Nevertheless, the political reality is quite different. Devolution 'all around' fundamentally alters the politics; between them, the three territories elect about one fifth of the UK Parliament.²⁰ The withdrawal of devolved powers is unlikely to be attempted by a UK government unless it enjoyed significant support for such a policy in that territory. Although the UK government can exercise the power to suspend the Northern Ireland Assembly, it is far less likely that this could be done in the case of Scotland and Wales, where primary legislation would be required. There are now credible alternative political mandates, with Devolved Administrations looking to their own electorates, whose behaviour in UK elections may differ from that in devolved elections. A further complication arises from proportional representation to the devolved bodies, together with coalition government which is a likely consequence. In Scotland and Wales, this has facilitated a revival of the respective Conservative Parties, making UK commitments to roll back devolution highly problematic for a UK Conservative leader.

External to the Devolved Administrations

Various bodies and processes are in place to facilitate close working relationships between the UK government and the Devolved Administrations, such as the Joint Ministerial Committee, the agreement of concordats on various topics, and the role of the Judicial Committee of the Privy Council. What remains unclear is how financial disputes would be resolved, especially given the highly centralised system of public expenditure control and the limited own revenues of the Devolved Administrations.

The aborted devolution plans of the 1970s produced a needs assessment conducted by an interdepartmental committee chaired by the Treasury (1979). This work provided the context within which the Barnett formula was adopted. Although nothing has ever been published, the Treasury has periodically updated its assessments of the relative needs of Scotland, Wales and Northern Ireland. Understandably, the Devolved Administrations do not trust either the Treasury's ownership of public expenditure data or the potential uses to which its private estimates of relative need might be put. Such concerns will have been magnified by the Deputy Prime Minister's promise during the 2001 General Election campaign that there would be 'blood on the carpet' about the Barnett formula (Hetherington 2001). Sensationalised reports about threats to the Barnett formula frequently appear without the source being identified.

Given this context of suspicion and of poor data, only a body independent of the UK Treasury would command consent in any future needs assessment. There is presently a remarkable amount of confusion about even basic facts, stemming in part from an apparent failure to understand the difference between relative and absolute

changes. The Barnett formula is regularly portrayed in Scotland, Wales and Northern Ireland as a means of depriving them of equal percentage increases to those in England, whilst in England it is regarded as feather-bedding the territories, particularly Scotland (McLean 2000; 2001). Politicians and the media work themselves up into a lather, sometimes about things which are unimportant or irrelevant. To what extent this is playing political games, and to what extent genuine ignorance, is sometimes difficult to assess.

What the United Kingdom will need is some kind of forum for minimising areas of conflict over factual matters, and a mechanism for resolving disputes about financial questions. Different federations deal with this matter in various ways: for example, the Commonwealth Grants Commission in Australia plays an important role in the operation of fiscal equalisation among the states, and the Supreme Court has regularly been involved in taxation disputes. Machinery, such as a Territorial Exchequer Board to undertake the data collection and statistical analysis, will be required if there is to be a needs assessment, the technical and political difficulties of which should not be underestimated.

Prior to a needs assessment, clear rules for its conduct would have to be established. These might cover, for example, whether there is a universal entitlement to use the NHS and public education, and whether the existence of two languages in Wales, and parallel Catholic and non-denominational secondary school systems in Scotland, is a 'topographical' feature or a matter of policy choice. Similarly, it would have to be established that needs indicators must relate to services actually devolved, rather than to indicators of economic activity such as GDP per head. Controversial issues are likely to include the treatment of tax expenditures and of forecast relative population change.

There is an obvious temptation for all countries and regions to believe that their needs are above average. It would be better to adopt the term 'comparative expenditure needs assessment' in order to emphasise that what is involved is a relative measure. Otherwise, such exercises are plagued by the ingenuity which can be exercised to demonstrate that every country and region has above-average needs. An assessment of this type attempts to judge the amount of expenditure required to provide an equal level of public services, taking account of factors such as differential rates of morbidity, for the same level of 'local' fiscal effort. It does not attempt to assess *absolute* need; that would be impossible since it is dependent on political judgements about desired outcomes. It is not advisable at present to guess, other than in very general terms, what the results of a needs assessment would be. Particularly, the frequent presumption that Wales has fared very badly from the Barnett formula system (MacKay 2001, Morgan 2001) might not be upheld.

Within the Devolved Administrations

Albeit in different ways, all three Devolved Administrations have experienced a politically fraught beginning: there have been three First Ministers in Scotland; two in Wales; and three Assembly suspensions in Northern Ireland. In Scotland in particular, the media have been hostile and impatient.

Pre-devolution, the territorial programmes were the sole responsibility of the respective Secretary of State, to whom in Scotland and Wales the Principal Finance Officer latterly reported directly through the Permanent Secretary. In Northern Ireland, the Department of Finance and Personnel functioned as a mini-Treasury for both Northern Ireland Departments and the Northern Ireland Office. Compared with Whitehall, individual departments were relatively weak in relation to the territorial 'corporate' centre, and junior ministers usually had limited authority. Two changes seem to have been happening post-devolution. First, there is some replication within the Devolved Administrations of the conflict between No 10 Downing Street (Prime Minister) and No 11 (Chancellor of the Exchequer and Treasury), which is often said to be a distinguishing feature of the Labour Government. In the case of the Devolved Administrations, the building up of the 'centre' is combined with some indications that 'Finance' no longer has the status or leverage which it possessed under the Secretary of State system. Second, Finance may now be weaker relative to individual departments, in part because of reduced status but also because of changes in the nature of the political Executive. The nature of the change is particularly marked in Northern Ireland, where Direct Rule ministers with no local political affiliations have been replaced by ministers from four parties, with portfolios allocated by means of the d'Hondt system (Northern Ireland Assembly 1999). Spending ministers do not have the same bonds to the First Minister and Finance Minister which would be customary under Cabinet government. This structural vulnerability of Finance might be offset by the political influence of particular Finance Ministers; for example, Edwina Hart has held the Finance portfolio in the National Assembly for Wales since May 1999.

These developments may not attract great attention when resources are plentiful and the problem is one of unprecedented underspending.²¹ The expenditure-based Barnett system imposes hard budget constraints on the Devolved Administrations, with underspendings indicating that they have recently been operating well within those constraints. The growth in real resources may have protected the Devolved Administrations, at least in the short term, from the consequences of poorly costed initiatives (Mitchell and the Scottish Monitoring Team 2001). Such a situation will certainly not continue indefinitely, at which time the diminished status of Finance may prove costly. Some policies are undoubtedly difficult to cost, whether because they break new ground or because there are uncertainties as to what will happen to policy in England (and therefore to formula consequences). If the Devolved

Administrations adopt expensive policy options across a broad range of services, and England subsequently follows, there are obvious implications for the Treasury.

Assessment

This final section concentrates on six points. First, it is essential to recognise where the UK devolved funding system is coming from and not to criticise it on the grounds that it would not have been invented in that form had there been a clean slate. Devolved government in Scotland and Wales is only three years old and the restoration of devolved government in Northern Ireland has suffered 24-hour suspensions for reasons unconnected with the subject matter of this Chapter.

Secondly, the economic theory of fiscal federalism is helpful in constructing an analysis of a particular country in terms which resonate elsewhere. However, prescription ought to proceed with great caution. The mainstream literature on fiscal federalism has a strongly normative orientation, relating to the optimal tiering and spatial design of government. Much of its development predated the influence of public choice theorists, a factor which probably explains the relatively optimistic view of government characteristic of this tradition. Clearly, those who start with a Leviathan model of government are likely to reach different conclusions from those making more benevolent assumptions (Boadway 2000). Moreover, the trade-offs between efficiency, equity and broader political considerations (such as sustaining territorial integrity) will crucially depend on context. In some cases, the units of a devolved or federal structure are themselves open to negotiation; in others, they are historically and culturally determined. Similarly, traditions about the degree of completeness of fiscal equalisation can be deeply embedded, as illustrated by the contrasts between Germany (high) and Spain (low), and between Australia (high) and Canada (low).

There is an urgent need for the United Kingdom to be open to learning from other jurisdictions, though this would be contrary to inclination and history. There is clearly relevant experience in countries such as Canada and Australia (where there is a shared institutional heritage) and Germany and Spain (where EU membership provides common context). As the literature shows, policy transfer and lesson-drawing are not simple matters (Dogan and Pelassy 1990, Rose 1993). However, that difficulty does not justify insularity. Fortunately, such attitudes will be more difficult to sustain in a more integrated world and with devolved institutions in place. However, there are no secret maps detailing instant solutions; each governmental system has to navigate its own course.

Thirdly, one possible line of constitutional development would see Wales and Northern Ireland converge on the Scotland model, at the same time as the Scottish Parliament sought to expand its fiscal powers. By far the greatest uncertainties attach to developments in England, where the Labour Government's commitment in

principle to regional government did not produce much action between 1997 and 2001. The White Paper (Cabinet Office/DTLR 2002) was published in May 2002, and this will have to be followed by primary legislation, first to authorise referendums and then to implement regional reforms. This leisurely approach has been indicative of different views within the Government, in relation to, *inter alia*: the interface with local authorities; the electoral system; the possible effect on the Government's centralised approach to public service delivery (perhaps the highest-profile priority of its second term); and the interface with the business-led Regional Development Agencies (the highest-profile English regional measure of its first term). It remains unclear whether the long-term response to devolution in the territories will be a new emphasis on England as a unit, or a focus on at least some regions. In turn, uncertainties about how to deal with England may have ramifications for the Devolved Administrations. The November 2001 Pre-Budget Report (Treasury 2001a, para 6.56) noted:

the Government has set a long-term regional economic ambition to reduce the gap in performance between the regions. To advance this ambition, the 2002 Spending Review will assess how departments' policies impact on different regions and seek to ensure that spending is fairly distributed and targeted at those areas where it is needed most and will be most effective. This will include an examination of rural priorities to ensure an equitable balance in allocations.

This review has been a within-England exercise, though there must be potential for it to spill over to the devolved funding arrangements. In future, the existence of grants to English regional assemblies, over which expenditure flexibility is conditional upon meeting 'certain specific targets' set by central government, may encourage attempts to conditionalise the Assigned Budgets.²²

Fourthly, it will always be possible to construct scenarios which test the devolved funding arrangements to destruction (Hazell and Cornes 1999). For example, a UK government, hostile to devolution, could substitute tax expenditures for private healthcare for public expenditure, thereby starving the Devolved Administrations, which would suffer negative formula consequences. In such a case, either the Devolved Administrations would have to follow the UK government's policy, or the United Kingdom might break up. No system for devolved funding in the United Kingdom could possibly cope with such policy divergence, especially if it were intentionally destabilising. Those supporting devolution (Heald *et al* 1998) recognised the strains on the Barnett formula-controlled Assigned Budget which might arise after devolution. The public expenditure situation was expected to be restrictive, with the surge in spending coincident with devolution not being anticipated. A longer-term fear

has been that a collapse of public service quality in some parts of inner London might take opinion formers and the middle class further out of public provision. This would reduce the need, and weaken political support, for the increases in expenditure in England which then generate formula consequences for the Assigned Budgets.²³ Intergovernmental conflict over resources has been minimal, probably because of the lubrication of unexpectedly large real expenditure growth. This is one of the factors which have, thus far, falsified Midwinter and McVicar's (1996a; 1996b) predictions of conflict.

Fifthly, whilst there is devolution in the United Kingdom, some mechanism which is recognisably a descendant of Barnett is likely to be in place, even if the name were to be dropped because of adverse connotations. There needs to be much more transparency about the numerical workings of the formula, including the derivation of formula consequences being in the public domain immediately after public expenditure announcements. Moreover, discussion is needed as to how the Barnett formula could be amended after a needs assessment, for which new institutional machinery is essential.

Devolution has undoubtedly raised the profile of territorial funding mechanisms (Edmonds 2001), with territorially based politicians and media all claiming that their country or region is badly treated. A formula with convergence properties would not have been adopted in the late 1970s had there not been an implicit judgement that the territories were then over-funded.²⁴ The Barnett formula, apparently a transitional arrangement pending the introduction of a more formal system, has proved remarkably durable. As Bell and Christie (2001) observed, it is now orphaned, as 'Nobody's child'. Nevertheless, the formula's notoriety is based on totally contradictory understandings of how it works and interpretations of what is currently happening. Some evidence of convergence would be advantageous in sustaining the formula mechanism.

Unexpectedly, the post-devolution challenge to the Barnett formula system does not relate to the automatic generation of formula consequences but to the expenditure-switching discretion of the Devolved Administrations. The build-up to SR 2002 announcements in July 2002 has been depressingly marked by planted media items from Whitehall departments, typically using 'failure' or 'catastrophe' to bid for greater inputs over the head of the Treasury. The drip-feeding of extra money to the NHS in England, at Pre-Budget and Budget announcements, has begun to erode this discretion. Some of these changes have been in-year allocations of the Reserve, and some have been transfers from DEL to AME within a constant TME. This danger has become more obvious in the aftermath of the 2002 Budget. There was clearly an expectation that the Devolved Administrations would devote the formula consequences of the increases in Health spending in England to their own Health programmes. The Budget Report (Treasury 2002a, para 1.13) provides figures for UK

Health expenditure on that assumption. Indeed, the Scottish Executive appeared to announce the next day that this would be done, though many would dispute whether this will be the most effective way of responding to Scotland's health problems.

Sixthly, the 'official' Treasury has long been suspicious that the territories are over-generously funded, and also too far out of reach. However, the 'ministerial' Treasury has been hesitant about opening up territorial political issues, especially as the achievable public expenditure savings are likely to be limited (Midwinter 1997) because of relative population size and the potential macroeconomic effects on the territorial economies of any sudden downward adjustment. Paradoxically, this makes the Treasury an unlikely ally of the Devolved Administrations, in attempting to build on the Barnett system, rather than attempt anything radical. Above all, the Treasury would resist attempts to breach its highly centralised control of revenue. The approach of the 2003 elections will bring more attention, particularly in Scotland, to the issue of 'fiscal autonomy' (Muscatelli 2001), amidst renewed concerns about divergent regional economic performance. The Treasury is likely to resist the 'Stormont model', by which the Devolved Administrations would pay (what used to be called) the 'Imperial' contribution for non-devolved services. Not least, such an arrangement would give the Devolved Administrations legitimacy in challenging central government expenditure. The impact of the 1999 Budget changes on the tartan tax is a reminder of the vulnerable position of the Devolved Administrations on revenue raising, whatever their precise powers, when control over the definition of tax bases and bands remains with the Treasury.²⁵ The most promising area for relatively early development is perhaps in local government taxes, which are fully devolved in Scotland and Northern Ireland, and in charging policy.

Endnotes

- 1 One example is not counting the borrowing of housing associations, putting local authorities in a position whereby the only way that council house renovation can take place is to transfer the stock to a housing association, classified into the private sector and therefore excluded from public sector net borrowing (Hetherington 2002).
- 2 Issues concerning revenue-raising and tax sharing are discussed in Heald and McLeod (2002). A symposium within the November 2002 issue of *Scottish Affairs* will examine the topic of fiscal autonomy.
- 3 In practice, some functions are managed on a GB basis, rather than a UK basis. Social security is one of these. However, the Northern Ireland social security system, separated for historical reasons, is almost entirely the same as the GB system.
- 4 There is much political sensitivity in labelling the component parts of the United Kingdom: for example, 'nation' and 'region' may be seen to carry implications for

the nature of governance. When discussing England, Scotland, Wales and Northern Ireland, the Treasury's current practice of describing these as 'countries' (Treasury 2001d) is followed. Formerly, it used the term 'territories'. In this Chapter, the term 'territories' is applied collectively to Scotland, Wales and Northern Ireland. The internal components of England are described as 'regions'. The analysis of public expenditure by country and region is referred to as 'territorial analysis'.

- 5 The Assigned Budget is often described as a block grant. Used in this way, the term 'block grant' is not synonymous with transfers from the UK Exchequer.
- 6 The Assigned Budget is determined irrespective of the means of financing. It includes expenditure funded by borrowing by local authorities or other bodies within the Devolved Administration's sphere of influence, whether or not that borrowing is from the Administration; and it includes some expenditure funded by the EU.
- 7 The non-statutory Barnett 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 comparable 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 comparable expenditure in Great Britain to Northern Ireland. The essential distinction is between base expenditure, whose current levels are carried forward, and incremental expenditure, which is determined by the formula (Heald 1994). As of Autumn 2001, the percentages, all now expressed relative to England and updated annually, were: Scotland 10.23 per cent; Wales 5.89 per cent; and Northern Ireland 3.40 per cent.
- 8 These were never formally 'signed off' by the Treasury and the territorial offices.
- 9 Strictly, it is also a function of the lag between actual population change and this being incorporated in the calculations; this effect is not significant.
- 10 A fuller exposition of these properties of the Barnett formula, including diagrams, can be found in Heald (1996).
- 11 First, there appears to have been a considerable amount of formula bypass, in the sense that not all incremental expenditure has gone through the formula. Heald (1994) provided several illustrations, later to be confirmed by Treasury (1997a, 1997b) evidence to the Treasury Committee. There has been no quantification of the numerical importance of bypass, though it would appear that this now occurs less frequently than in the 1980s. Most of the identified cases of bypass seem to have benefited, rather than disadvantaged, the territories. When, as on health, the territorial expenditure index is substantially above UK = 100, this is likely to reflect in part a higher per capita employment of nurses. If the Treasury were to underwrite the full cost to each health department of a UK nurses' pay settlement, the territories would receive more than if the total UK cost of the award were to be distributed through the Barnett formula. Second, and much less publicly documented, the Treasury has on at least one occasion implemented an across-the-board percentage reduction in departmental baselines, before applying the formula. Whether by

accident or design, this procedure allows ministers to state that the Barnett formula has been implemented, even though it erodes the protection afforded by the formula to inherited expenditure. Money 'saved' by applying a constant percentage cut to the territorial blocks and to comparable expenditure can then be passed through the Barnett formula, generating formula consequences supplementary to those generated by year-on-year increases in comparable expenditure. Naturally, the arithmetical effect is disadvantageous to the territories because the constant percentage cut generates more 'savings' from their blocks than they subsequently receive back in these 'artificial' formula consequences. There have been no across-the-board reductions to the Assigned Budgets of the Devolved Administrations.

- 12 Comprehensive explanations of the present system are available in the annual *Public Expenditure: Statistical Analyses* (Treasury 2001d).
- 13 In consequence, it is not possible from data in the public domain to put precise values in the cells of Figure 10.1.
- 14 Objective 1 is the classification which brings eligibility for the highest level of ERDF support. On the role of EU funding in Wales, see Blewitt and Bristow (1999).
- 15 The strength of such a hypothetical case would be affected by judgements as to whether public policy failures had played a part. In practice, the territorial agriculture departments seem to be emerging better from the inquiry processes than the (former) Ministry of Agriculture, Fisheries and Food.
- 16 The data on identifiable expenditure should always be read with two points in mind. The first is 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. The second is the impact of tax expenditures (eg on owner-occupied housing). When the focus is upon both expenditure and revenue, these cancel out because regional revenue is correspondingly depressed. However, they do affect the comparability of expenditure.
- 17 However, the basis of the allocation of the previously unallocated expenditure is not known.
- 18 Strictly, the annual rate of nominal expenditure growth must be constant, or the average rate up to a specific date must be known.
- 19 With higher levels of nominal public expenditure growth and thus convergence over shorter time periods, relative population change becomes less important.
- 20 At present, Scotland, Wales and Northern Ireland account for 130 (20 per cent) of Westminster constituencies, with that percentage likely to fall to 18 per cent.
- 21 In 2000-01, the first full financial year of devolution, the Northern Ireland Departments underspent by 3.87 per cent against the final DEL, and the Northern Ireland Office underspent by 3.85 per cent. Underspending was greater than in Wales (3.22 per cent), though lower than in Scotland (4.23 per cent) (Treasury 2001c).

- 22 Strictly, this would require new legislation, as there is no power for the UK government to set conditions on the Assigned Budgets. However, the power of the paymaster is strong, given the dependence of the Devolved Administrations on cash transfers determined by the UK government, and there is clearly scope for administrative and political pressure.
- 23 The issue of there being no English counterpart to generate formula consequences already arises in the case of water and sewerage, privatised in England and Wales but not in Scotland and Northern Ireland.
- 24 If they had then been thought under-funded, one would have expected arguments to be made for a step increase in resourcing. Without access to unpublished papers, it is not known when the convergence properties were first understood. Attention was drawn to these by Heald (1980), who also noted that, in periods of expenditure reduction, there would be divergence. The fact that the territorial offices received less under the Barnett formula than they would have done under a flat percentage increase would certainly have been understood from the beginning.
- 25 The UK Government made major changes to the structure of income tax in the 1999 Budget (by lowering the starting rate but reducing the size of the starting band, while extending the basic rate band). These changes would have had the effect of raising the potential yield of the Scottish tax-varying power to £230 million per percentage point. Accordingly, the tartan tax would now generate more revenue than was initially expected, but the lower starting point makes the power more politically difficult to use.

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