

16 May 2002]

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Examination of Witnesses

PROFESSOR DAVID HEALD, Professor of Accountancy, University of Aberdeen, and PROFESSOR DAVID BELL, Professor of Economics, University of Stirling, examined.

Chairman

499. Today we have with us Professor David Bell from the University of Stirling and Professor David Heald from the University of Aberdeen, both acknowledged experts in the field of finance, with particular expertise, for our purposes, on the Barnett formula. Those are the areas we would like to explore this morning. We are extremely grateful to both of you for being with us this morning and for giving us the benefit of your advice and, indeed, for the paperwork that has already come in. Could I begin by putting a general question: What are the implications of the Barnett formula and how equitable is the formula as it is applied in the context of devolution?

(Professor Bell) The final implications of the Barnett formula, if carried on for a very long period of time, would be that in the devolved territories there would be equal per capita spending on the areas for which the devolved authorities have expenditure powers. This is a process which is known as the Barnett squeeze. The best way to explain it is to assume—and I know this is an economist's approach—that there is only one inhabitant of Scotland and there is one inhabitant of England. The Scot receives, let us say, £120 per year to spend on public services and the English person £100. The way that the Barnett formula works is that each might receive the same absolute increase, so a decision is made really about the amount of additional services that is required for the person in England. Let us say that to service these additional requirements—and these may be health spending, education spending, transport spending, whatever—an additional £10 is needed. That £10 is added to the budget to be spent in England and an equivalent £10 is added in Scotland. Let us suppose that the English person hires one man or woman to supply all of the services and the same happens in Scotland, in England the person buying the services is able to offer the supplier a 10 per cent rise, because the budget has gone up from £100 to £110, but in Scotland, because it has only gone up by the same absolute amount but a smaller percentage amount, the percentage rise that can be offered to the supplier of services is smaller. That is how the Barnett squeeze operates. That is why, for example, at the moment, with a large increase in health service budgets, the proportionate rise in health service budgets in England is going to be somewhat greater than the proportionate rise in health service budgets in Scotland, so there is a worry that, for example, doctors and nurses might be attracted from Scotland to England—and obviously the same applies to Wales and to Northern Ireland. That is essentially how the Barnett squeeze works. Is that equity? I have never seen any economics text book that suggests that everyone should get the same amount spent on them in terms of public services. What is much more common is that people should have access to the same level of services and there is a realisation that that might cost different amounts to deliver in different parts of the country. The ultimate outcome of the Barnett formula seems to me to be

not one that is easily defensible in any state of the world because it is absolutely clear for a variety of reasons that it costs differential amounts to deliver public services across different parts of the country. Now, some of these are for reasons which no human influence can make any difference (like, for example, the problems of geography in Scotland, which would be a reason for higher costs in Scotland), but there are others where that argument is perhaps a little less strong. For example, you might say, "Well, the health problems of West Central Scotland are really partially self-inflicted and therefore why should that be accommodated within our spending formula?" There are different reasons why services cost more to deliver in different parts of the country. I would say that, looking at a wide spectrum of countries, there is no country that follows any formula similar to the Barnett formula. Now that may mean that we are uniquely correct; it may also mean that we ought to think very carefully about what it is that we are doing.

(Professor Heald) The point I would stress is that it was never intended to use the formula to drive indexes to 100 in all the countries, so, in a sense, the formula is pushing the indexes of relative expenditure in a direction that is believed to be desired. Logically, mathematically the formula leads there eventually, but it takes quite a long time, and there is never any presumption that it would actually go that far. Certainly during the 1990s it was fairly clear that the territorial Secretaries of State had an agreement with the Treasury that if they thought the convergence was going too far, they would actually call for a needs assessment, and nobody actually ever did. But, coming back to the questions you asked at the beginning, to some extent you cannot answer those questions from information in the public domain. The convergence mechanism has been in place for 20 years and there has not been that much convergence in terms of the data that we can see. We run into very big problems here because the Treasury only publishes data that the Treasury thinks are useful to it. There are two problems. One is that they do not necessarily collect data which are not actually relevant to present policy—and I had great difficulties as Treasury Committee advisor during the 1980s and 1990s persuading the then Treasury to publish anything on regional analysis of public expenditure in England because it just was off the policy map. The second point is that, even when the data exist (as, for example, comparable expenditure in England to devolved services in Scotland, Wales and Northern Ireland), the data are not published in a form from which one could actually do sensible analysis, so people tend to get reduced to trying to find proxies (for example, by taking the social security spend out of identifiable public expenditure). To some extent, the data are not in the public domain that would enable you to make a firm judgment on that. Devolution has made the operation of the Barnett formula more transparent than it was in a procedural sense: there is now the funding book which existed privately but was not published before 1999. On the other hand, the numbers have never

16 May 2002]

PROFESSOR DAVID HEALD AND PROFESSOR DAVID BELL

[Continued]

Chairman *contd.*]

been transparent. In a sense, the process is transparent now but actually the numbers have not been transparent. That actually matters because over the last 20 years there have been significant issues of formula bypass. The best example people will actually speak about is when Kenneth Clarke was the Health Secretary and there was a very large nurses' pay settlement in 1988. If the territories had got the money on the Barnett formula basis, they would not have had enough money to pay this national settlement. So, you can see, this is a nice little example which people actually talk about, but there were clearly more cases of bypass in the 1980s, and my impression—and this is only impression because the data are not in the public domain—is that since 1992 the system has been applied rather more strictly. 1992 and the top-down approach to public spending have actually produced a shift change in the extent to which there was actually formula bypass. The other point to make in terms of convergence is that Scotland's relative population keeps falling and that seriously affects anything that uses population as a denominator. So even though the mathematical properties of the formula lead to convergence, there are other things going on in the background where we do not, in a sense, have the data or are not clear as to exactly what is happening. On the point about whether it is fair, I am much more willing than David to defend the formula—I think the formula has got a lot to say for it—but to make a judgment about what is fair, you have to know what the relative needs of the countries are. There is a presumption, to some extent derived from common observation and from what was done in the 1970s, that the needs of Scotland, Wales and Northern Ireland are higher than the needs of England. There have been some private updates by the Treasury in the intervening period but none of them has actually got into the public domain. So there is the presumption that that is the case, though, in fact, as soon as one starts thinking about how you run a needs assessment, you start realising the potential difficulties of that. In the Lords' debate started by Lord Barnett on 7 November, there were interesting contributions by Lord Forsyth, who has been the Secretary of State for Scotland, and by Lord Sewel.

500. Thank you. That is extremely enlightening for our purpose. The aspect of the formula bypass is something to which I would like to return. You have explained what the formula is in an extremely clear way and started to tease out some of the implications. I am interested in where it comes from. Is the point about equity, the assumptions that Professor Heald has just mentioned, the justification for it as a formula?

(Professor Heald) One lives in a highly centralised state where revenue is almost entirely controlled by the Treasury. Scotland, Wales and Northern Ireland have had—over the last 20 years on a more formalised basis but to some extent before that as well—very substantial expenditure switching discretion at the level of the Secretary of State. If you go back pre-devolution, there are two aspects to the system. One is the formula which controls marginal changes to the block, and also then you have the expenditure switching discretion by the Secretary of

State. For example, the Conservative Secretary of State used to come to the Scottish Affairs Committee and really very, very strongly defend the system because they very much liked the expenditure switching discretion. The great advantage from the Secretary of State's position—and this followed through to devolution—is that one does not have the Treasury looking over your shoulder on every policy issue. One has a real crisis in British Government at the minute with the relationship between the central departments and the main Whitehall departments—which is Downing Street and the Treasury on the one hand and the main spending departments on the other. The great advantage for the territorial department was that basically you got the Treasury off your back. The formula determined an overall spending envelope for the territories, as it does for the devolved administrations, in a way which keeps the Treasury out of the detail. One should not underestimate the actual importance of that. That is, to some extent, I think, the reason why the Treasury actually have quite liked the system themselves. What tended to happen in the 1960s and the 1970s, before the formula, is that Secretaries of State for Scotland, particularly Willie Ross, were extremely good at arguing for Scotland's share and then actually going to argue for a bit more as well. One of the attractions of the formula from the Treasury's point of view, is that Scotland, Wales and Northern Ireland are not very important in overall spending terms. In terms of the big spending numbers, they are not that important. If they can strike deals with Whitehall spending Ministers, they then know the multiplier that applies to the devolved administrations. So the system has had benefits on both sides. It gives a spending envelope to, in the past, the Secretary of State and, now, devolved administrations, which is hugely beneficial for them in terms of tactical public expenditure management—and also it ought to be in policy development terms as well—and, in a sense, it protects the Treasury's interests because the Treasury know that there are certain formula consequences which flow from the decisions on the big numbers about health and education in England.

(Professor Bell) I would like to add one point about that. I think that maybe the Treasury are becoming aware of the fact that money is being allocated to Scotland unconditionally, whereas now the Treasury is trying to be much more conditional through public service agreements with the Whitehall spending ministries. I suspect there is a feeling in the Treasury that, for completeness, there ought to be some kind of all-encompassing public service agreements covering all these spending departments, which would include the Scotland Office here, and of course that has big implications for policy freedom as far as the devolved authorities are concerned. Professor Heald pointed this out in his paper in respect of what has happened via Wanless and the Health Review. I think that is an important point to bear in mind. It is also true, looking internationally, that you do find many central governments allocate funds to regional governments on both a conditional and an unconditional basis. Scotland has always enjoyed unconditional block grants, as Professor Heald has just explained, and I think that is an issue

Chairman *contd.*]

that is worthy of exploring because it will constrain the ability of the devolved authorities to pursue independent policy.

Earl of Mar and Kellie

501. In United Kingdom terms, we are talking about financing the periphery. I would like to explore a little further to what extent should government be taking services to those who choose to live really on the periphery, those people who want to live on Orkney, Shetland, the Western Isles or large tracts of north-west Scotland. If you choose to live there, do you have a right to the same level of services as if you live in the central belt of Scotland or, indeed, elsewhere in the United Kingdom?

(*Professor Bell*) Is that not largely a political issue? Economically, clearly it does not make sense: it costs a great deal more to deliver a letter in Shetland than it does to Queensgate or wherever. It is a question of what decision central government has made—and the phrase would be “spatial equity”—about what level of spatial equity it feels it can support. Clearly there are limits. You are not going to put a general hospital on the Isle of Eigg, for example. These limits are largely undefined but there does seem to be, implicitly at least, a set of key services which central government is prepared to acknowledge should be delivered on a spatially equitable basis.

(*Professor Heald*) I agree with that answer. The other point I would make is that costs can be high because of sparsity and because of urban density: one should not just assume that it is the rural areas that can be expensive to serve. Central London would be a classic example of somewhere that is very expensive to serve. The actual relation of cost to density is really quite complex. But it is a political judgment about whether you financially support people living in the Scottish islands.

502. What is the experience of other countries of tackling this problem of people who choose to live on the periphery or out in marginal areas?

(*Professor Heald*) I would have thought countries like Australia and Canada have highly developed systems that do maintain population in areas that you could, on strict economic criteria, question. States tend to be concerned about their territorial integrity and that is perhaps one of the reasons why they maintain their periphery.

(*Professor Bell*) I think too that most states will not be blind as to whether a person has decided to live in a particular area or has been brought up there.

Lord Morgan

503. I wonder if we could pursue what is basically the point of this Committee's existence; namely, the compatibility or adaptability of the system to devolution. What have you said confirms worries that I had—and if I am misunderstanding, no doubt you will correct me. It seems to me that the Barnett formula is basically not compatible with the idea of devolution. It worried me very much when you said that the Treasury was very happy with the situation! I think the Treasury is the most centralising of all departments. I would like to make three points, if I

may, and perhaps you would correct me or advise me otherwise. Firstly, it seems to me that the whole principle of territorial funding is determined by the Treasury and by the dominant force within the Treasury, which is that of England, inevitably so, and the nature, character, balance of the territorial funding of Wales and Scotland, as it were, flows from that. It is not intrinsic in the process; it is a by-product. Secondly, I am very worried about the definition which you produced, which I fear is tremendously accurate, about the assessment of needs. You rightly say that there has not been an assessment of needs and Professor Heald said that in his paper. Who should determine those needs? It seems to me they should be determined by the most sensitive and informed institutions, which are the territorial legislatures. I do not know much about Scotland, but for Wales, for example, I would have thought you would form a very different assessment of needs with regard to medical and health provisions, where Wales is under-provided, as opposed to educational institutions, where Wales has been well provided for, for historical reasons. That, it seems to me, should be determined under the terms of devolution, and I would have thought in equity, in any case, in those areas, as perhaps they should in the regions of England as well. The third problem, I think, arose particularly in Wales in regard to Objective 1 funding in Europe, but it might have a Scottish application as well. There was a Welsh need determined by the Welsh legislature and there was, in effect, a Treasury block on it for a considerable time which, indeed, caused the resignation of the Welsh First Minister. That did seem to be a case where we began with the domination of the Treasury as to whether it would provide a matching grant to the European funding and almost ended up with the needs as seen there; in other words, devolution was at the very end of the decision-making process and not at the very beginning.

(*Professor Heald*) When I said the Treasury were happy, I did not mean they were very happy! I was trying to explain why the system had survived. There was mutual advantage. The Treasury would probably like to have had public service agreements on the territories, but they saw the potential dangers in terms of how much work it would be and the fact that they might lose in bilateral negotiations. One of the points about the devolution settlement is that it is not good criticising it on the basis that one would not start there if one had a clean slate. Given the kind of centralised control over revenue in Scotland and the fact that I do not see that shifting in any serious way, I think the territorial block system, modulated by something like Barnett, is actually really quite sensible. One has this asymmetric issue that England is 84 per cent of the United Kingdom—the territories taken together are only 16 per cent. It is quite a beneficial system for them because otherwise they would be at significant disadvantages. So I do not accept the proposition, given where one is in terms of the structure of government, that this is a bad system. On the assessment of needs, one of the things that has been happening is very rapid growth in nominal public expenditure. I have been interested in public expenditure for 30 years and at no point in that 30 years has public expenditure deliberately grown by

16 May 2002]

PROFESSOR DAVID HEALD AND PROFESSOR DAVID BELL

[Continued]

Lord Morgan *contd.*]

the amounts it is now growing. One is talking about nominal expenditure growth which is actually unprecedented—deliberately. (It was very high in the 1970s but that was not deliberate.) The convergence property of the Barnett formula is actually driven by the nominal rate of growth of spending, not by the real growth of spending. If convergence starts happening quite quickly, as it might well do if the very high numbers that we are presently getting are sustained, there is going to be pressure for a needs assessment. There is going to be pressure for a needs assessment from two quite different positions. Probably Wales and Northern Ireland would argue that they do badly now or prospectively badly, in the sense that the convergence will drive their expenditure index below their needs index. Certain English regions, particularly the north, would argue that Scotland is doing too well—Scotland, in particular, is doing too well, but the territories generally are doing too well. So there is going to be pressure for a needs assessment and, in a sense, Barnett and a needs assessment are not inconsistent. Even if you have got a needs assessment, you still need some mechanism to take you from where you are to where you actually want to go. But the point I would make about needs assessment is that it is not going to be simple. Given the kind of person-related services that devolved administrations have, there are fundamental questions that have to be addressed before you even start a needs assessment. For example, is there a universal entitlement to use the NHS? You get significant differences in exit to the private sector in both health and education and there are quite strong regional patterns in that. You first of all have to ask: Do you get funded for the average level of use of the NHS and public education? Or do people have an automatic right to use it and so you get funded 100 per cent? Another example, one of the things that people have commented on recently, is that when the needs assessment was done in the late 1970s, the Welsh language, bilingualism in Wales, was treated almost as an optional extra in Wales that had to be funded without getting any compensation from the UK. Because of something called the Education (Scotland) Act 1918, there are separate Catholic secondary schools within the local authority school system. There is an obvious question that would arise in a needs assessment: Is that a Scottish policy choice or is that part of the Scottish topography?—a bit like the Cairngorms. So there really are fundamental policy questions. Nobody is going to trust the Treasury to do the numbers. That is the first point. You have to set up some sort of independent body to do the numbers, but you first of all have to give it a very clear statement about actually what they are supposed to do. You can certainly set up a specialist body to try to put the data together in a consistent way, but you cannot expect that body to have legitimacy, to take essentially political decisions. On the point of Objective 1 funding, I suspect that was much more to do with the way in which the United Kingdom has run a consistent scam on the whole issue of additionality. There is almost medieval scholasticism connected with what actually is additionality in UK public finances. The deal that Wales eventually got is sometimes portrayed as being a breach of Barnett,

but it was relatively modest in money terms: it got the above-Barnett increase for the actual European payment but had to find matching payments within the block. It is within the spirit of a formula system that some things might happen that do require bilateral treatment. One of the examples would obviously be if only Wales had had foot and mouth disease. Would that all have had to be funded within Welsh resources? Or would one have said, "This is a UK problem"? So you can have a formula which deals with most things but at the margin there are always going to be issues that have to be addressed separately.

504. There always will be emergencies of that kind. One of the phenomena of foot and mouth disease is less spending on higher education in Wales. My question on the first point was not whether Treasury policies are good or bad or inevitable or not inevitable, just whether they are or are not compatible with devolution. It would seem to me that the nub of your answer is: No they are not.

(Professor Heald) I would disagree with that. I think the crucial point is the unconditionality of the block. The Secretaries of State benefited from that for 20 years and I think that anything that erodes the unconditionality of the block is actually damaging to devolution. In principle, one has a public expenditure system where you get announcements every two years; in practice, we are developing a system whereby the Chancellor keeps announcing more money whenever he has a budget statement. The danger of this piecemeal announcement—some of which is genuinely new money, some of which is a switch from annually managed expenditure into departmental expenditure limits, some of which is the release of the Reserve—is that, whenever the story runs in Scotland, Wales and Northern Ireland that there is more money for the NHS, there becomes a kind of implicit hypothecation of the increases to health in the three devolved administrations. Scotland has a deplorable record in certain aspects of health but it is not evident to me that one should necessarily spend more money on health. The problems that cause the bad health record of west and central Scotland are not necessarily resolved by spending more money on a line called health. So a system by which you get implicit hypothecation of increases seems to me a serious erosion.

(Professor Bell) Could I say a little bit about needs assessment because we have not really focused on the reason for a needs assessment. What is the point of a needs assessment? It seems to me that there are conditions under which a needs assessment is an appropriate vehicle and there are conditions under which it is not an appropriate vehicle. Needs assessments are carried out within Scotland for local authorities and for the health service in Scotland, and the same applies in England. Needs assessments are carried out in lots of different countries. They are ways of spatially allocating expenditure. Typically the reason or rationale for a needs assessment is that, whatever the sub-regional authorities (whether they be health board trusts or whatever), they should be able to deliver a standard level of service. That asks a lot of questions. David has mentioned one or two. Who is to determine what the standard level of

16 May 2002]

PROFESSOR DAVID HEALD AND PROFESSOR DAVID BELL

[Continued]

Lord Morgan *contd.*]

service is? Clearly here, if a needs assessment is to take place, then the devolved authorities have to have quite a strong say in what that standard level of service might be. In Australia the states all have an input into the decisions that are being made by the Commonwealth Grants Commission which actually carries out the needs assessment across the states in Australia. I would say, however, that there might come a point where it would be impossible to define what a standard level of service might be. One might have a complete breakdown about views on health between different parts of the United Kingdom. One might have the Department of Health saying, "OK, health should be delivered unfunded by private insurance" whereas Scotland, Wales and Northern Ireland might continue to believe that it should be funded through central taxation. That is a very extreme example, and I do not imagine it is going to happen but I use it to give you an idea. Then, it seems to me, it becomes impossible to determine what is the standard level of service that could be delivered. There, the unity of the state can only be maintained, it seems to me, while also satisfying the needs of the local populous, by going further down the route of fiscal autonomy.

Baroness Gould of Potternewton

505. It does seem to me that there are so many questions. What you are actually posing each time is another question mark and another question mark. One of the things that does arise in my mind is this relationship between your needs assessment, between whatever it is that is determined should be the level of need, and the political decision-making, because, at the end of the day, that is fundamental and I do not know how that balance is achieved. If you foresee something like your specialist body, perceive its relationship with government and with the political decision-making situation—what you call in your paper, Professor Heald, the Regional Exchequer Board—if they have a view, what would be their status? What would be their right? Would they be able to determine the things that government should be doing? That is one area I still have this big question mark about. There is another area I have a question mark about. Lord Barnett himself (with whom I happen to share an office) is very clear that in fact it is time the whole thing was scrapped and started again. He has made public statements to the effect that it is now out of date, it has gone. I have not heard—and it may be that I have just not been in the right place at the right time—the alternatives. I have not heard what sort of alternative could be put in place, for instance, that would benefit the devolved areas. I just do not know what those alternatives are. One of the other points which has been put is that maybe it is not a question of Barnett absolutely disappearing but of substantial adjustments being made. I do not know whether that is feasible or not. The other point is, if Barnett was to go—as I say we are looking for alternatives—who would determine what the alternative should be? Would that be a matter for central government? Would that be a matter for involvement with the devolved areas? I

have this mass of questions going on with absolutely no answers.

(*Professor Bell*) On needs assessment—Who would go about doing that task?—we do have examples in other countries. I hesitate a little to go through those because I agree with David that we are where we are and it is not necessarily easy to helicopter in a solution from another country. The economists' rather extensive phrase for it is "path dependency". We have come down this path so far and we cannot assume that solutions from elsewhere could be applied successfully. Before I go on to explain what a body might constitute that could go on to do this work, let me say a couple of things why I think that at the moment the fiscal autonomy route is probably ruled out. Firstly, as Professor Heald mentioned, Secretaries of State for Scotland have had a long period of discretion over expenditure in Scotland and we have had the devolved structure for three years. These arrangements have not resulted in massively different choices being made by the Scottish political body. Also, if you look at differences in preferences as between Scotland, England and Wales over fiscal issues—and I do not know if Professor McCrone talked about this yesterday—the differences are not that huge. There is perhaps some greater attachment in Scotland, and perhaps Wales, to a more redistributive approach to government policy but the differences are not huge and therefore it may be possible to define a standard level of service without having great schisms between the territories. How do you do it? It seems to me that the Treasury is not the appropriate body to do it. There has to be a body with constitutional legitimacy that will be accepted by the devolved authorities. The devolved authorities have to have some input into that process. Once it gets going, of course, it is going to be much more expensive to operate this procedure. There are currently 10 civil servants who manage all of the territorial funding arrangements. If an independent body is set up, we are probably talking of at least a budget of £10 million to do all the work that is necessary. Then you will run into political costs because, as Professor Heald has indicated, this is not a clear-cut exercise: there are huge opportunities for consultancy firms to earn vast amounts of money! They do this in the English local authority settlements which are a mirror of what a needs assessment would be for Scotland. In any adjustment to Barnett to which you referred, maybe I would see the soft landing as coming from the process Professor Heald mentioned, where you have sufficient convergence until you get to the point at which a needs assessment would roughly have put you anyway. So the transition is dealt with as a result of the Barnett squeeze, but there are still going to be ongoing schisms and they are going to be at a much higher level if we move over from the Barnett situation to one where needs assessment is the rule that applies.

(*Professor Heald*) In terms of the Regional Exchequer Board, I always take the view that such a body should be advisory. It needs a very clear remit about what it is supposed to be doing, it goes away and assembles the best possible evidence and then does a report—which says that Scotland is over-funded, Wales is under-funded, for example. The

16 May 2002]

PROFESSOR DAVID HEALD AND PROFESSOR DAVID BELL

[Continued]

Baroness Gould of Potternewton *contd.*]

question of what is actually done with that has to be a matter of negotiation between the UK Government and the devolved administrations, but it puts into the public domain, on the basis of a pre-agreed set of rules, what the present position is. If a particular devolved administration was held to be over-funded, you could not suddenly cut its budget by £x million next year, so you need a Barnett-type adjustment mechanism to get from where you are to where you actually want to go, and that is the kind of thing that is actually going to have to be the subject of negotiations. Obviously, with things like the Monetary Policy Committee, there is a sense in which some big areas of public policy have now been delegated to centrally appointed bodies, and some people might take that as an argument that you could delegate this kind of thing to such a body. My judgment would be not.

(*Professor Bell*) The process that Professor Heald has described is pretty much the same as what the Commonwealth Grants Commission is doing. It is an advisory body. There is a meeting of the State Premiers each year at which the advice given by the Commonwealth Grants Commission is considered. There is effectively a five-year rolling average applied to the change, a transition effect which stops abrupt changes, but, nevertheless, the recent history in Australia is that the advice given by the Commonwealth Grants Committee is contentious, because the richer states will always complain and the poorer ones will try to defend the settlement that they have been awarded.

(*Professor Heald*) On the question of Lord Barnett's judgment on his own formula, there is almost a code language here. The reason why the Government keeps saying that it has no intention to review the Barnett formula is, I think, partly because reviewing the Barnett formula means giving less money to the devolved administrations. Essentially it is code for that. Lord Barnett himself noticed that in the Lords' debate it was essentially the Welsh and Scottish peers who all turned up and not anybody else.

Lord Morgan

506. And we all criticised it.

(*Professor Heald*) So, in a sense, "reviewing Barnett" quite often tends to mean "giving less"—though, I agree, a review of Barnett could give Wales more. I was in the gallery for that debate. One of the things that people now talk about is regional GDP per head as though it was an index of the need for spending on public services. Relative GDP per head is pretty unconnected with how much you need to spend on education and health. That depends upon demographic structure, it depends upon participation rates in terms of staying in education and participation rates in terms of using public sector versus private sector. A Conservative Chancellor of the Exchequer, Lord Goschen, produced the predecessor of the Barnett formula in 1888 and that was essentially about Scotland having higher participation rates in secondary education. Now Scotland has a much higher participation rate in

university education than England. So these kinds of issues have been around a long time.

Lord Holme of Cheltenham

507. I have always admired Lord Barnett but I am coming to the conclusion that he is really Einstein, because we have something here which one might call eternally converging but never convergent! Given that on the whole, although I am sure there are exceptions among my colleagues, we are not a group of accountants, we are a group assigned to consider constitutional issues, I suppose, reverting to Lord Morgan's question, that my interest is in how the eternal triangle of taxation and expenditure and representation connect with Scotland. How do they connect in a way that is meaningful? The point that Professor Heald has made more than once and makes in his paper is that, because of the discretion within the block grant, there is an area there to make democratic choices that are connected to the will of the people of Scotland, as opposed to the will of the Treasury in London. And yet, if the Barnett formula itself is based on the notion of parity of services and on some sort of notion of equal delivery of standards across the United Kingdom, the simple premise of the Barnett formula reconciled previous relationships between an undeveloped Scotland and Wales and Northern Ireland and the rest of the UK, but, the moment Scotland is devolved, you say that the very crux of devolution is that you can make these choices within the block grant and say, "No, no, we are going to spend more on education and not as much as Alan Milburn wants us to spend on health. We are going to make that decision because that is what Scottish people want." The moment you do that, the premise of the Barnett formula, which is that there is a way of delivering parity of services across the United Kingdom, falls. You, Professor Heald, suggested another criterion, in which I am very interested but which I am not sure I fully understand, this notion of fiscal accountability at the margins as a way of getting the sort of nexus connection between the elected representative and the voter and the expenditure. I would be interested to explore that a little more. We heard some evidence yesterday which suggested that devolution is a dynamic model. If we accept for the moment that it is just not practical politics that we move to fiscal autonomy, as Professor Bell has said, if you were to try to foreshadow the next step of an incremental increase of powers for the Scottish Parliament and Executive rather than the move to the sort of fiscal autonomy that would go with independence, is there a state of fiscal semi-autonomy? Is it possible to imagine that and how would that work?

(*Professor Bell*) We can think of devolution as being entirely unconditional, so that one almost has complete policy freedom. Now the only fiscal arrangement that is compatible with that is fiscal autonomy. You can think of devolution being conditional on a given level of resource—that is another way to think about it. In other words, let us suppose that a needs assessment was carried out and therefore the costs of delivering different kinds of services in different parts of the United Kingdom

Lord Holme of Cheltenham *contd.*]

were taken account of, then it seems to me that what devolution delivers is the ability to vary policy or allocate more resources to one area only at the cost of delivering less resources to another area. So you go for free personal care for the elderly but at the cost of less spending on roads. That is essentially, it seems to me, what a needs assessment would deliver. It would deliver the standard level of service across the UK but there would be the ability to vary expenditure patterns at the margin to show that at least devolution can make a difference on expenditure at the margin. That is different, of course, from it making a difference as far as taxation is concerned. I guess the problem with your triangle is that the representatives in Holyrood have currently quite a lot of latitude to vary how they spend the block grant, but then bodies like the OECD and IMF, looking at fiscal arrangements in other countries, would say that politicians ought to take responsibility and that means, as far as the taxation is concerned, they have to deliver some of the bad news as well as the good news. So there is a problem, I think, with the current situation, that Holyrood and the politicians in the other devolved authorities are to a certain extent free-riding on a large block grant that they receive and they do not have to take responsibility for raising national insurance by one per cent to pay for the increases in the health budget that we may see.

508. I do not want this to be interpreted as some kind of anti-Scottish point, but what percentage of the population in Scotland relative to, say, the south-east of England are in the tax system below the tax threshold? Would there be a different perception from a relatively disadvantaged part of the United Kingdom to the merits of people one way or another—companies paying on national insurance, people on the 40 per cent rate going up to 45 per cent for middle classes? Would there be a different perception in Scotland, because of the distribution of income, on the merits of income tax?

(*Professor Bell*) That is a very important point. I think Professor McCrone's research has shown up some of these differences in attitude, but they are not huge. They are not huge. The level of income in Scotland is somewhat below that in England, but not much; significantly below that in the south-east; somewhat above that in Wales. What actually is the case is that there are fewer top-end earners in Scotland.

509. I was more concerned with the bottom end: the people who are officially or effectively without the income tax system. But that is only a marginal difference?

(*Professor Bell*) I think it is only a marginal difference as far as that is concerned. One thing that I know Professor Heald can talk about is the ability to vary at the margin. There are two or three areas where that might be done, like influencing local government finance, influencing effectively what was the old business rates. But it may be that Holyrood can still... Well, at the moment it is hiding behind local politicians while effectively jacking up the council tax. It would be nice if there was a way through this revision to change in the political arrangements of making politicians in Holyrood

more responsible for the expenditures that they make.

(*Professor Heald*) If I could answer the question in two parts. In an ideal world I would want the devolved administrations to have substantially more tax raising powers than they have. That is actually much more constrained than one might think in practice because of, first of all, European Union obligations: you are not allowed to vary corporate income tax within a Member State; you are not allowed to vary VAT within a Member State. There are certain historical legacies where people have got away with it, but you are not going to be able to introduce them now. That was even clear in the mid-1970s. In terms of the big revenue sources, the kind of taxes that you could actually pass to the devolved administrations would be a share of the income tax base (which is essentially what the tartan tax is, albeit on a modest scale) and also property taxes. I would object to what David said about passing the blame to local politicians. In Scotland it is quite fashionable to complain that we get a bad deal compared with Catalonia. In practice, that is just not true. Scotland has one huge advantage over Catalonia: it has complete control over the local government legal structure and finances. You have the United Kingdom—and Scottish Parliament with complete legislative and financial control of local government. What Madrid does is to bypass the Catalan Executive by dealing directly with the municipalities. One should see the local government taxes as part of the means of financing the package of expenditure that is delivered in Scotland by the Scottish Parliament and the various bodies that are accountable in various ways to the Scottish people and to the Scottish Parliament. Roughly 14 per cent of the total budget is paid for by council tax and by non-domestic rates, so about £3 billion out of £20 billion is actually raised. The constraints are political. One of the legacies of the poll tax is that the proportion of expenditure funded by local authorities went down in two steps. It went down in the transition from domestic rates to poll tax and then the big extra substitution of grant and then the transition to council tax. Yes, it is true that council tax levels have been drifting up. I would not have any sense of what the optimum level is but, I think, provided you have a proper tax-benefit system in place, property is something which should be taxed. For example, John Muellbauer at Nuffield College, Oxford makes the point that one of the reasons for the instability of the British housing market is the relatively low levels of taxation of domestic property in the UK compared with other countries. So I think there is nothing wrong with the Scottish Parliament seeing one of the sources of getting expenditure discretion by using the council tax system and the non-domestic rates system. But the constraints are political, because people are very keen on spending money, but they are not terribly keen on raising the money—and it is not just legislators that are like that, it is actually electors.

510. You have talked about Australia and Canada and other European models but, of course, there is the United States' model where, I do not think any resident in California is in any doubt, they have a

16 May 2002]

PROFESSOR DAVID HEALD AND PROFESSOR DAVID BELL

[Continued]

Lord Holme of Cheltenham *contd.*]

state government that they chuck out if they do not like what they are spending the sales tax revenue on. Is there the possibility of a consumer sales tax or is that too limited by Euro VAT inhibitions?

(Professor Bell) Yes, it is VAT.

(Professor Heald) To come back to David's point about path dependency, countries like Australia, the United States, Canada have these devolved tax systems. They are actually under substantial pressure now because of, for example, buying things through the Internet, so the sales tax systems in these countries are often themselves under substantial pressures and you find lots of discussion in those countries about how the system is going to be maintained. The big issue for the UK that makes the UK different is that it is geographically very small, so it makes the question of shopping over boundaries a much more important issue than it is in those countries, and, specifically, European Union tax regulation. As I said a few minutes ago, if you want to raise more money, you have to raise it on the income tax base or the property tax base or by user charging, and all of those are actually more difficult to do than they are to say.

(Professor Bell) As far as the business sector is concerned, it does seem to me that varying non-domestic rates would raise howls of protest if it was used to give Holyrood greater latitude. Of course having a parliament that is concerned really with the distribution of block grant means that the issue of revenue raising, and therefore the performance of the economy, is not necessarily at the top of the agenda. I think that is a point that is not in favour of the devolved settlement as it currently stands.

Lord Jauncey of Tullichettle

511. Professor Bell, you have explained, to my mind extremely clearly, the question of Barnett squeeze. Could you give me a similarly simple definition of the Barnett formula? I think probably I am the only person here who has never had occasion to consider it before.

(Professor Bell) The formula works essentially, as Professor Heald has said, in a settlement being made between the Treasury and the spending departments in Whitehall. Then, if an increase is agreed, and, let us say, that increase is £100 million, Scotland would get its population share of that increase. Its population is 10.3 per cent of the population of England at the moment, so, if £100 million is allocated to the English spending departments, then 10.3 per cent automatically is allocated to the Scottish block grant. The Scottish Parliament has liberty to spend that as it will. That, in raw terms, is how it happens. Of course there have been issues about bypassing the formula and so on, which Professor Heald has explained. The one matter that perhaps has not been fully explained is: Why does Scotland apparently do relatively well and why does Northern Ireland do relatively well? This is all to do with what happened when the settlement was set up in the first place. This is real path dependency. Where you are now depends where you started in 1979. If there has been slow convergence, the relative benefit that you enjoyed at that time continues—or the

relative disbenefit now in the case of Wales. It is the initial conditions which pertained, which were won by Secretaries of State for Scotland, I suspect, which are still influencing the current outcomes as far as the formula is concerned.

512. You said £100 million and you get a figure of £10.3 million. Is that £10.3 million additional?

(Professor Bell) Yes, it is additional. It becomes part of UK public expenditure.

Lord Holme of Cheltenham

513. The Scottish percentage of the UK -----

(Professor Bell) Scotland and the UK is about 8.8 per cent of UK.

(Professor Heald) That is in relation to Scotland to England.¹

(Professor Bell) There are differences depending whether the comparable programme applies to England to England and Wales, so there are different population rules.

514. In the public spending review and so on, when the Chancellor announces an increase, I thought—and maybe I am wrong—that he only announces the UK increase because it is a higher top line figure.

(Professor Heald) There is a tendency in the Treasury documents to quote a UK figure which presumes the devolved administrations will spend their health formula consequences on health. If you notice, in the documents there is now an education line as well. When one asks where that line comes from, it is an assumption that the devolved administrations spend on that line, but then you find a little footnote that says, "That depends on individual budget decisions".

Lord Jauncey of Tullichettle

515. Professor Heald, do I understand, from what you said a moment ago, that, because of the Scottish Parliament's control over local authority taxation, they could in effect reduce their grant to the local authorities if they wished to use more money for other purposes, leaving it to the local authorities to increase business rates—which I gather you think would probably be suicidal, but in theory they could—and council tax.

(Professor Heald) Yes. They have the power. That is one of the great strengths of the system because, essentially, what it stops is the kind of bypassing of the devolved administration that is possible in several other countries.

Baroness Gould of Potternewton

516. Can you perceive, if and when we ever get regional government in England, that this would have any effect on the way that the current block grants are allocated? Or would it be that the regions are already getting allocations of money from the Treasury and that would continue in the way that it is? Or do you think that the system would actually

¹ Note added by witness: The Barnett formula proportions relate Scotland to England, not Scotland to the United Kingdom.

16 May 2002]

PROFESSOR DAVID HEALD AND PROFESSOR DAVID BELL

[Continued]

Baroness Gould of Potternewton *contd.*]

change and that might be the point at which in fact the Barnett formula changes?

(*Professor Heald*) I have not had chance to digest properly the recent White Paper on England but I think that the system of devolved administrations is built on a great deal of history. In terms of "if one gets a regional assembly in the north-east of England", you are starting to see the consolidation of some programmes at a regional level in a way that happened a long time ago in Scotland and rather more recently in Wales. The issue in England, for an English region, is the fact that so much of the major programmes, like health and education in England, are driven by English national formulae, so that there is the RAWP formula for health, there is the standard spending assessment formula for revenue support grant to local authorities. The UK public expenditure system operates largely with four separate systems: Scotland, Wales, Northern Ireland and then England, and within England one has a strongly functional system with very little regional presence. One of the major questions in England is: What is the relationship between any English regional body and these functional formulae for health and education which pass money through to local authorities and to health authorities? In a sense, what one might well be seeing is the beginning of a system in England of a much stronger regional presence.

517. You do not think in any way it would affect the current expenditures for the devolved areas.

(*Professor Heald*) I do not think it will have, in a sense, any immediate effect. One of the interesting things about Spain is that you can either argue that Spain is very asymmetric or you can argue that it is asymmetric in process but not necessarily in destination; in other words, people are going at different paces but they might end up at the same place. One could envisage a National Assembly for Wales acquiring legislative powers like Northern Ireland and Scotland; you probably would not envisage the north-east of England acquiring legislative powers separate from legislative powers for the rest of England. One can see that, even though things go at very different paces, they might be pulling in the same kind of direction. Going back to one of my first points, there are only decent data in the United Kingdom if there is a strong government policy interest in that area and I think you will now start finding that the very poor data on English regional public expenditure will start improving.

Lord Morgan

518. It is a matter of political will. Look at Northern Ireland. There is plenty of political will there.

(*Professor Bell*) Just to add one small point to that, it will be interesting to see if needs assessment does become part of this process across the four bodies. Essentially, you have a needs assessment process already in place in England for local authorities and that might, in the course of time, become applied to the regional government in England. And then, of course, what would be the nightmare scenario for Scotland and Wales would be to be brought within

some all-encompassing needs assessment for the United Kingdom as a whole, where they would be treated on the same basis as the English regional authorities.

Chairman

519. If there is a funding dispute in the United Kingdom, it has to be resolved by the Cabinet. Is that appropriate in the context of devolution?

(*Professor Bell*) It seems to me that we have managed through various crises—foot and mouth being, I think, the best example so far—largely because we have devolved authorities that are broadly sympathetic with central government. If we did not have that situation, there would be an almighty mess. It is not at all clear to me that this is the best process.

(*Professor Heald*) It depends on what decisions you are talking about. In terms of relative expenditure need, the operation of that is something that can be delegated, and then, in a sense, one has negotiation between the devolved administration and the UK Government. But one cannot get away from the asymmetry of the United Kingdom. The only way to abolish the asymmetry of the United Kingdom is to abolish the United Kingdom. While you have the United Kingdom, it is going to be asymmetric, and this is something one has to live with. The reason why one has not had disputes is because people have too much money. The assumption four or five years ago was that the devolved administrations were going to be desperately short of money. The great problem for the British Government in Whitehall and the devolved administrations is spending the money they have. The underspend has become a very, very serious problem. Also, that has taken the edge off the revenue raising things. It would be rather strange for the Scottish Executive to use the tartan tax when it actually cannot spend the money it has at the moment. One would expect the issues about revenue raising to become much more important when resources are tight rather than when resources are growing so fast in nominal terms that, for various reasons, people do not have the capacity actually to spend the money.

Lord Morgan

520. You say that people have an excess of money, and I understand that, but would it be perhaps more appropriate to say an excess of money plus Europe as a standby. Wales does not have an excess of money for the poverty in the South Wales valleys.

(*Professor Heald*) Obviously what I was saying was shorthand. The National Assembly for Wales, I think, from memory, is the best performer in the last financial year of the devolved administration, but there is still significant underspend.

521. Underspend after getting Objective 1 funding, but it needed Objective 1 funding to make that calculation.

(*Professor Heald*) I do not know quite how that is treated. But, in terms of spending against the DEL,

16 May 2002]

PROFESSOR DAVID HEALD AND PROFESSOR DAVID BELL

[Continued]

Lord Morgan *contd.*]

all the devolved administrations significantly underspent.

Chairman

522. Apart from that aspect, Professor Bell's point is important, which is that the existing mechanisms for dealing with disputes have not come under stress because you have this affinity between the administrations in Edinburgh and Cardiff and the Labour Government, and therefore the good will on which it rests has carried it through. One of the things we are looking at is how robust the procedures are should the political complexion change. I think your point, Professor Bell, is that if it does change then the mechanisms will come under tremendous stress. That is important in the context of funding.

(Professor Bell) The solutions elsewhere appear to be either legal or to have an external referee that needs to have some legitimacy—as in, for example, the Commonwealth Grants Commission. The idea of having a third party would be quite a shock to the British constitution but . . .

Earl of Mar and Kellie

523. The presumption with the tartan tax is that we would increase revenue. Do you think that it ever would be possible within the United Kingdom actually to use the other aspect of the tartan tax which is the reduction? I know we have the legislative right to do so, but is that feasible?

(Professor Heald) There are two sides to that. If one had a needs assessment and found that Scotland's needs assessment exactly matched its expenditure relative at that time, there is absolutely no democratic reason why a Conservative administration in Scotland should not actually decide that private expenditure is more important than public expenditure. If you were in a position whereby Scotland had an expenditure index bigger than its needs index, that might be provoking wrath in London because one would be sending a rather odd message. But, unless you are assuming that you have an issue that somewhere is over-funded by London, I see no reason for not using the power symmetrically. In fact, the Conservative group in the Scottish Parliament has made the point that you could have actually used the tartan tax negatively simply by the underspend. There are tactical political bargaining issues. If you think that the needs assessment would come out that Scotland was over-funded, you probably would not be very sensible sending the signal out by using the tartan tax in a downward direction, but, other than that, I think fiscal accountability at the margin does work both ways. I mean, the tartan tax power took a great deal getting through anyway, but in my view it ought to be wider. I would rather have a wider band than one has. But the great problem, when it was being talked about, was that people used two arguments against the tartan tax: either it was so small it was irrelevant, or, alternatively, it would destroy the Scottish economy. One always, on tax matters, has to try to strike a balance between what is desirable and what is politically credible to get through.

524. What effect would it have on the integrity of the United Kingdom?

(Professor Heald) I do not think it would have any effect on the integrity of the United Kingdom. You get differences. Lots of States in the United States do not have income taxes, some do. It is not just the Treasury's fault. They have a very centralist fiscal psychology and we have a very centralist fiscal psychology. There is absolutely no reason why income taxes could not be different. In an economic sense, people obviously have to make trade offs. I mean, if you used the tartan tax, one of the things that no doubt people would argue about is the effect on the Edinburgh financial community. That, to some extent, is why it does not apply to the higher rate: it is only on the basic rate band. So people have to make political decisions about how they are going to use the tax power, but it is only the United Kingdom that could think that you must have the same taxes across the whole country. If people want to make different decisions about people going to university, for example, or different decisions about public versus private health or the level of provision in health, there is no reason why the taxes should not be different, but one really has a long journey to go on that issue.

Lord Holme of Cheltenham

525. I think Professor Heald is right, theoretically, about this effect on the rest of the United Kingdom. The first time it happened that Scotland has just reduced income tax, as long as it would be portrayed—no doubt, in *The Daily Mail*—as the "overgenerous provision of our money to Scotland," it would be quite a *cause célèbre*.

(Professor Heald) Yes.

Lord Morgan

526. You say you are in favour of a wider band. Would you like to offer a suggestion?

(Professor Heald) No, I would not want to commit myself. But, within the constraints of the asymmetric nature of the United Kingdom and European Union membership, I think one is going to rely quite heavily on a block grant system, an unconditional block grant system. Nevertheless, with that, I would want it to be quite clear that the devolved administration could actually put taxes up or down.

(Professor Bell) The current provision is about equivalent to 4.7 per cent of the total DEL that is applied. Professor Heald has noted that we are geographically smaller. We are also relatively immobile. Although business would kick up a great fuss, the use of differential taxes would not lead to mass migration either into or out of Scotland, as has been, I think, the case as far as the personal care of the elderly is concerned.

Chairman: I think we are going to have to finish. We are well over our time, although we could have gone on for longer. That has been an extremely stimulating session. You have made the complex understandable in, if I may say so, a very effective manner, as I would expect from professors! We are most grateful to you for your time. Thank you.