



THURSDAY 16 MAY 2002

## In the Wallace room, Sheraton Hotel, Edinburgh

## Present:

Gould of Potternewton, B.  
Holme of Cheltenham, L.  
Howells of St Davids, B.  
Jauncey of Tullichettle, L.

Mar and Kellie, E.  
Morgan, L.  
Norton of Louth, L. (Chairman)

## Memorandum by Professor David Heald, Professor of Accountancy, University of Aberdeen

## INTRODUCTION

1. The Committee has posed four direct questions on devolution finance, and I will answer them in turn. Three of those questions are about the funding mechanisms, and the fourth is about dispute resolution procedures.

## FUNDING MECHANISMS

*How is funding allocated to the different parts of the United Kingdom; and what consequences arise?*

2. The establishment of the Devolved Administrations in 1999 was effected without changing the territorial funding arrangements, which had taken shape over the previous 20 years. Most expenditure falls within the Assigned Budget, the changes in which are governed by the application of the Barnett formula).

3. I have written elsewhere about the operation of the post-devolution funding system (Heald, 2002, Heald and McLeod, 2002). I would stress three features:

- (a) Increases to the Assigned Budgets are driven by changes in comparable English expenditure, but the Devolved Administrations have expenditure-switching discretion.
- (b) Because *per capita* expenditure in all three Devolved Administrations is higher than that in England, such a mechanism entails a convergence process towards England = 100 (ie uniform *per capita* expenditure index). The formula delivers equal *per capita* increases, which necessarily translate into smaller year-on-year percentage increases. This is characterised as the "Barnett squeeze", though I do not view this as necessarily a problem. The extent of convergence depends on the annual rate of nominal expenditure growth, which is currently very high. It seems probable that the predicted movement in the direction of convergence, which failed to appear in the past, will become visible in the medium term.
- (c) An important strength of the UK devolution funding arrangements is that the Devolved Administrations have full financial control over the local authority financial and taxation systems; Scotland and Northern Ireland also have legislative control. The present structure of Scottish funding (2001–02 original plans) is as follows: Central government transfers 76 per cent; Own taxes 15 per cent; EU funds 3 per cent; Borrowing 3 per cent; and Assigned revenues 3 per cent (Scotland Office, 2001, Annex 5, Treasury, 2001b).

*How satisfactory are these arrangements?*

4. There is currently a great deal of criticism of the Barnett formula, albeit for diametrically opposite reasons: it is too generous to the Devolved Administrations; or the "Barnett squeeze" is undermining them. There is a strong case for giving the system time to settle down, and monitoring the extent of convergence of "devolved" expenditure indexes with the present formula).<sup>1</sup>

5. The Devolved Administrations are set a spending envelope, whose size they can vary at the margin by adjusting their tax effort. By concentrating exclusively upon the tartan tax, the debate has underestimated the extent of budgetary flexibility deriving from control over local government taxation and charging and over central government charging. Unsurprisingly, the major constraints on using the existing flexibility are

<sup>1</sup> The concept of the half-life comes from nuclear physics, where the half-life indicates the number of years it takes for the activity of a radioactive particle to decay to half its original value. With an annual rate of nominal expenditure growth of 2 per cent it would take 35.0 years for half the differential (upwards or downwards) of the *per capita* expenditure index 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 8 per cent this half-life becomes 9.0 years.

16 May 2002]

[Continued]

political, notably that increases would be unpopular. I have always emphasised that the devolved funding system should secure "fiscal accountability at the margin". Within constraints, Devolved Administrations should be able to vary their total budget. They should be responsible for raising the taxation to finance "higher" levels of expenditure, and their taxpayers should benefit in lower taxes from "lower" levels of expenditure.

6. In my view, an expenditure-based (as opposed to a revenue-based) approach to devolution is inevitable in the United Kingdom (Heald, *et al.* 1998). There are two principal reasons for taking this view. First, the United Kingdom has a highly centralised tax system, and it is difficult to envisage this changing to any significant extent. Quite apart from the resistance of the Treasury and existing avoidance problems with certain taxes, there are EU rules which strictly limit variations in consumption taxes and corporate income taxes within a member State. Second, Devolved Administrations operating within a revenue-based system would encounter difficulties because of changes in "regional" yield resulting from UK tax measures.<sup>2</sup> When discussing a revenue-based system, it is essential that assumptions about control over tax bases and rates are made explicit, and that there is clarity about how fiscal equalisation interacts with the revenue basis.

7. Almost all commentators, including myself, expected the Devolved Administrations to be short of money in their early years (Heald and Geaughan, 1998). No-one expected the torrent of money gushing through the Barnett pipeline as a result of Spending Reviews 1998, 2000 and 2002. Public finance economists have long been aware of the "flypaper effect": elected bodies are more enthusiastic to spend taxes raised by other tiers of government than they are to raise tax revenues themselves. At a time of rapid expenditure growth, there will not be great enthusiasm for more devolved fiscal effort, and this will reduce the proportion of expenditure that is self-financed. Indeed, the present problem is one of unprecedented underspending.<sup>3</sup>

8. The great advantage of the funding arrangements is the capacity of the Devolved Administrations to switch resources between programmes according to "local" circumstances. In the pre-devolution period, the extent of such switching was limited by various contextual factors, including the three territorial Secretaries of State being members of the same UK Cabinet (Midwinter, *et al.* 1991). There are grounds to be concerned about the way in which the 2002 Budget (Treasury, 2002a), with its emphasis on NHS funding, may be introducing an implied element of hypothecation of increases—the Devolved Administrations "should spend" their health-generated formula consequences on the NHS. Quite apart from the issues of principle, tackling Scotland's health inequalities does not solely involve spending money on a line labelled "health". The Treasury argument, evident in the context of the Wanless Report (Wanless, 2002), that it has a standing because it is responsible for funding, should be resisted.<sup>4</sup> Even though the centralised nature of the UK tax system is probably beyond challenge, the Treasury should not be allowed to use its control of revenue to erode devolved expenditure responsibilities.

9. One unsatisfactory feature is the lack of transparency of the system. Before devolution, much of what was known about the funding system derived from academic research (Heald, 1994, Bell, *et al.* 1996). A direct consequence of devolution has been the publication of the "block rules", which originated in 1984. The first published edition was in March 1999 (Treasury, 1999), just before the first devolved elections, and the second edition in July 2000 (Treasury, 2000) came immediately after Spending Review 2000. It is expected that the third edition will be published this summer, after the publication of the results of Spending Review 2002. While an improvement, such periodic updating is not sufficient.

10. The present position is that the processes are now well understood by a small group of specialist commentators, though there is much error and misrepresentation in political debate and media portrayal. Crucially, the system is not transparent because key information is still not in the public domain. For example, it is generally not possible to replicate the formula consequences of changes in comparable English expenditure from data in the public domain. This can now be done in isolated cases: for example, the data published by the Scottish Affairs Committee in February 2002 (Scotland Office, 2002) allows the replication of the Barnett formula consequences for Scotland in Spending Review 2000. What are required are proper tables of comparable English expenditure together with the changes made to them principally, but not exclusively, in successive Spending Reviews. The tables will be different for Scotland, Wales and Northern Ireland because of differences in functional responsibilities.

<sup>2</sup> This point can be illustrated with reference to the tartan tax power. 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 variable rate of income tax to £230 million per percentage point. Accordingly, the tartan tax would now generate more revenue than was initially anticipated, but the lower starting point makes the power more politically difficult to use.

<sup>3</sup> In 2000–01, the first full financial year of devolution, the Northern Ireland Departments underspent by 3.87 per cent against the final Departmental Expenditure Limit 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, 2001a).

<sup>4</sup> The Wanless Report (Wanless, 2002) was described by the Treasury (Treasury, 2002b) as "the first ever evidence-based assessment of the long-term resource requirements for the health service in the UK". No doubt parallel assessments of the need to spend on defence, education, pensions, prisons or transport would also have canvassed large increases.

16 May 2002]

[Continued

*In particular, how, and in what circumstances, is funding allocated outside the Barnett formula?*

11. The funding policy document (Treasury, 2000) contains diagrams including channels of funding other than the Assigned Budget. These are predominantly "agency-type" functions, such as in connection with the Common Agricultural Policy and, solely in the case of Northern Ireland, social security benefit payments.

12. In terms of numbers, the last 20 years of the Barnett formula are poorly documented; the relevant figures have not been in the public domain. "Formula bypass" is a term used to describe expenditure channelled to, or withheld from, the Devolved Administrations (and their territorial office predecessors) other than through formula consequences.<sup>5</sup> My understanding is that formula bypass is less common now than it was in the 1980s. A classic example relates to the 1988 nurses' pay settlement, when the territorial offices could not have afforded the UK pay settlement on the basis of formula consequences, as they employed more nurses per head. Since the 1992 top-down reforms to public expenditure management, the formula appears to have been more strictly implemented. Bypass of the formula does not necessarily benefit the territories. On at least one occasion during the 1992-97 Major Government, the Treasury implemented an across-the-board percentage reduction in departmental baselines, before applying the formula. Whether by accident or design, this device allowed ministers to state that the Barnett formula had been implemented, even though it eroded the protection afforded by the formula to inherited expenditure.<sup>6</sup> This device was permitted by the then secret rules governing the operation of the formula; it now appears within the published rules (Treasury, 2000), though recourse to it is now more likely to attract attention.<sup>7</sup>

#### DISPUTE RESOLUTION

*In the light of the principles of devolution, how appropriate is it that finance disputes would ultimately be resolved in the United Kingdom Cabinet?*

13. Within the context of the devolution settlement, a final power of UK government determination of the spending envelope seems inevitable. Indeed, this is one factor behind my advocacy of fiscal accountability at the margin. What is not inevitable is that the Treasury should be allowed to dominate debates about territorial funding because of its superior control over information. First, available territorial public expenditure data are buffeted by changes in the Treasury's public expenditure control system, which have occurred frequently over the past 15 years (Heald, 1995). The Treasury generates public expenditure statistics in support of government policy requirements, not for academic research or for policy-making by external bodies, taken to include opposition political parties. For 18 years, devolution was off the governmental agenda, and this is one reason why the data for English regional public expenditure are currently so deficient (Heald and Short, 2002). It was only the existing structure of administrative devolution that allowed reasonable data to be assembled for Scotland, Wales and Northern Ireland.

14. In the longer term, there is likely to be a formal needs assessment,<sup>8</sup> either as a result of pressure from English regions or from those Devolved Administrations which believe that convergence has reduced their expenditure index below the level justified by differential needs. The technical complexity and political difficulty of a needs assessment should not be underestimated.<sup>9</sup> Responsibility for data collection and analysis should not be left in the hands of the Treasury. Whatever the technical competence of that work, it would not carry political credibility in the territories. There have been periodic updates of the 1979 needs assessment (Treasury, 1979), most notably in 1988 and 1994, though nothing has reached the public domain. In my view, new institutional machinery will be required, such as a Regional Exchequer Board (Heald, 1990). I envisage this as a statistical and advisory body, not as a determiner either of levels of public expenditure or of tax structure.

Aberdeen

24 April 2002

<sup>5</sup> There are problems with the concept of bypass. There have been structural features of the public expenditure system which have limited convergence. In the early years, public expenditure planning took place in volume terms (ie constant prices, allowing for public service-specific rates of inflation), and an automatic uplift was applied to the horizon year (ie the "new" year introduced in each annual survey). These were structural features of the public expenditure planning system at that time, and not means of circumventing the formula.

<sup>6</sup> 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.

<sup>7</sup> There has been no across-the-board reduction since devolution.

<sup>8</sup> 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 region has above-average needs.

<sup>9</sup> The practical and political difficulties were highlighted, in the House of Lords debate on 7 November 2001, by Lord Forsyth (2001), Secretary of State for Scotland from 1995-97, and by Lord Sewel (2001), Minister of State in the Lords at the Scottish Office from 1997-99 and responsible for the Lords' passage of the Scotland Act 1998.

16 May 2002]

[Continued]

## REFERENCES

- Bell, D, S Dow, D King and N Massie (1996) *Financing Devolution*, Hume Papers on Public Policy, Volume 4, No 2, Edinburgh, Edinburgh University Press.
- Forsyth, Lord (2001) *Speech in House of Lords Debate on the Barnett Formula*, 7 November 2001, cols 237-239, House of Lords Official Report, London, Stationery Office.
- Heald, D A (1990) *Financing a Scottish Parliament: Options for Debate*, Glasgow, Scottish Foundation for Economic Research.
- Heald, D A (1994) "Territorial public expenditure in the United Kingdom", *Public Administration*, Vol 72, pp 147-75.
- Heald, D A (1995) "Steering public expenditure with defective maps", *Public Administration*, Vol 73, pp 213-40.
- Heald, D A (2002) "Decentralization in some non-federal countries: the case of the United Kingdom", in Commission on Fiscal Imbalance, *Report: Supporting Document 3—Texts Submitted for the International Symposium on Fiscal Imbalance*, Montreal, Commission sur le déséquilibre fiscal, pp. 265-86.
- Heald, D A and N Geaughan (1998) "Fiscal implications", in P Norton (ed) *The Consequences of Devolution*, King-Hall Paper No 6, London, Hansard Society, pp 11-13.
- Heald, D A, N Geaughan and C Robb (1998) "Financial arrangements for UK devolution", *Regional & Federal Studies*, Vol 8, pp 23-52.
- Heald, D A and A McLeod (2002) "Beyond Barnett? Funding devolution", in J Adams and P Robinson (eds) *Devolution in Practice: Public Policy Differences within the UK*, London, IPPR, pp 147-75.
- Heald, D A and J Short (2002) "The regional dimension of public expenditure in England", *Regional Studies*, Vol 36, pp 743-55.
- Midwinter, A, M Keating and J Mitchell (1991) *Politics and Public Policy in Scotland*, Basingstoke, Macmillan.
- Scotland Office (2001) *The Government's Expenditure Plans 2001–02 to 2003–04: Departmental Report by the Scotland Office*, Cm 5120, Edinburgh, Stationery Office.
- Scotland Office (2002) "Supplementary Memorandum Submitted by the Scotland Office", in Scottish Affairs Committee, *Minutes of Evidence Taken before the Scottish Affairs Committee, Wednesday 7 November 2001*, HC 345 of Session 2001–02, London, Stationery Office, pp 19-23.
- Sewel, Lord (2001) *Speech in House of Lords Debate on the Barnett Formula*, 7 November 2001, cols 245-246, House of Lords Official Report, London, Stationery Office.
- Treasury (1979) *Needs Assessment Study: Report*, London, Treasury.
- Treasury (1999) *Funding the Scottish Parliament, National Assembly for Wales and Northern Ireland Assembly: A Statement of Funding Policy*, London, HM Treasury.
- Treasury (2000) *Funding the Scottish Parliament, National Assembly for Wales and Northern Ireland Assembly*, Second edition, London, HM Treasury.
- Treasury (2001a) *Public Expenditure 2000–01: Provisional Outturn*, London, Stationery Office.
- Treasury (2001b) *Public Expenditure: Statistical Analyses 2001–02*, Cm 5101, London, Stationery Office.
- Treasury (2002a) *Budget 2002—The Strength to Make Long-Term Decisions: Investing in an Enterprising, Fairer Britain—Economic and Fiscal Strategy Report and Financial Statement and Budget Report*, April 2002, HC 592 of Session 2001–02, London, Stationery Office.
- Treasury (2002b) *Review of Long-Term Health Trends*, Press Release 34/02, 17 April, London, HM Treasury.
- Wanless, D (2002) *Securing Our Future Health: Taking a Long-Term View—Final Report*, London, HM Treasury.