

# Scotland's Fiscal Relationships with England and the United Kingdom

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## Introduction

THIS VOLUME ACKNOWLEDGES THE UNION OF THE CROWNS ON THE DEATH OF ELIZABETH OF ENGLAND IN 1603, 104 years before the Union of the Parliaments. The intervening century was one in which much happened, including a period when Scotland was incorporated into a full union with England and Wales. However, in terms of fiscal relationships, the Union of the Parliaments was a much more significant event than the Union of the Crowns. Prior to that, leaving aside the period of the Commonwealth, there were two independent countries sharing a common monarch. After that, there was a single government. Even without the asymmetry that has been such a feature of this union, it is exceptionally difficult to run fully self-financing units within a single polity. Moreover, data on relative fiscal 'contributions' usually do not exist, whether through conscious political or administrative choice or because of poor data collection systems.

The distinction drawn by Rokkan and Urwin<sup>1</sup> between 'unitary states' and 'union states' has been frequently applied to Scotland.<sup>2</sup> Whether the imperfect integration of Scotland into the union is something to be celebrated or deplored depends upon the perspective adopted, but important consequences follow, as are discussed below.

<sup>1</sup> S. Rokkan and D. Urwin, 'Introduction: centres and peripheries in Western Europe', in S. Rokkan and D. Urwin (eds), *The Politics of Territorial Identity: Studies in European Regionalism* (London, 1982), pp. 1–17.

<sup>2</sup> See, for example, M. Keating, *Plurinational Democracy* (Oxford, 2001), pp. 20–1; and J. Mitchell, *Governing Scotland: The Invention of Administrative Devolution* (Basingstoke, 2003), pp. 2–3.

The magnetic pull of London and the South-East of England within the single economy is a most striking phenomenon. The relative demographic trends that are presently much discussed were established long ago, as evidenced since the 1801 Census by Scotland's declining proportion of UK population.<sup>3</sup> This context is bound to affect debates about parliamentary representation and about public money, with explicitly and implicitly conflicting views being held as to whether Scotland's counterpart is England or a region of England of comparable size. Intriguingly, there has been a considerable amount of historical accident in determining both representational and expenditure proportions.

### Longevity of Formulae

Both the Goschen formula and the Barnett formula have had lives far beyond that originally envisaged. The Goschen formula lasted for nearly three-quarters of a century, having been announced in 1888 as a means of allocating assigned revenues in connection with local government.<sup>4</sup> The Barnett formula, now twenty-five years old, was originally a temporary measure for the initial funding of the proposed (but never established) Scottish Assembly,<sup>5</sup> pending the introduction of a more permanent arrangement,<sup>6</sup> but has proved more durable. The fact of the matter is that, where a devolved level of government has some power over the allocation of resources amongst the different services for which it is responsible, there has to be some means of deciding the overall allocation, with the minimum of disturbance, within the timescale of the public expenditure system operated by the Treasury. This is true whether the devolution in question is merely adminis-

<sup>3</sup> See D. A. Heald, *Formula-Based Territorial Public Expenditure in the United Kingdom*, Aberdeen Papers in Accountancy, no. W7 (Aberdeen, 1992), p. 29.

<sup>4</sup> G. McCrone, 'Scotland's public finances from Goschen to Barnett', *Fraser of Allander Institute Quarterly Economic Commentary* 24:2 (1999), pp. 30–46.

<sup>5</sup> The Scottish Assembly was to be set up under the Scotland Act 1978; however, following the failure to achieve sufficient support in a referendum, it did not proceed. By that time, the still-to-be named Barnett formula had been used to determine the expenditure the Assembly would have had in its first year, and that amount became the relevant part of the budget of the Scottish Office in that year. The use of the formula was continued by the incoming Conservative government; see D. A. Heald and A. McLeod, 'Fiscal autonomy under devolution: introduction to Symposium', *Scottish Affairs* 41 (2002), pp. 5–25.

<sup>6</sup> McCrone, 'Scotland's public finances from Goschen to Barnett', pp. 35–6.



trative or whether it is political; both the Goschen and Barnett formulae were used in circumstances of administrative devolution.<sup>7</sup>

Provided they are not, or do not become, too controversial, formulae of this sort can be a convenient device to smooth the process. Both the Goschen formula and the Barnett formula became at various times something for the Scottish Office to defend as a means of protecting its policy space and the perceived expenditure advantage they protected.<sup>8</sup> Moreover, there is an advantage to the UK government in not having to devote disproportionate resources, at a time when it can least afford them, to protracted and difficult negotiations over a relatively small part of total UK public expenditure.<sup>9</sup>

### Attitudes to the Barnett Formula

Attitudes to formulae such as Goschen and Barnett are conditioned, partly at least, by the perceptions of the extent to which the arrangements are favourable. These perceptions are not always based on reality. At the moment there is the bizarre situation whereby everyone thinks they are losing from the Barnett formula: the Scots, Welsh, and Northern Irish because of convergence;<sup>10</sup> and the English, especially in the North-East and London, because

<sup>7</sup> While the formal ability of the then Scottish Office to allocate within an overall envelope was greatly increased in 1979, there was some discretion, particularly within individual services, prior to that; see D. A. Heald and A. McLeod, 'Public expenditure', in *The Laws of Scotland: Stair Memorial Encyclopaedia* (Edinburgh, 2002), ch. 10, paras 480–551, esp. para. 535.

<sup>8</sup> Mitchell, *Governing Scotland*, p. 150, shows how opportunistic were the arguments of both the Treasury and the Scottish Office, with regard to the application of the Goschen formula, supporting it or condemning it according to circumstance. In contrast, the protection of the Barnett formula has been a consistent theme of the Scottish Office and its successor Scottish Executive.

<sup>9</sup> See C. Thain and M. Wright, *The Treasury and Whitehall: The Planning and Control of Public Expenditure, 1976–1993* (Oxford, 1995), p. 326; A. Midwinter, 'The Barnett formula and Scotland's public expenditure needs', in Treasury Committee, HC Select Committee on the Barnett Formula 2nd Report (HC Paper (1997–98) no. 341), pp. 29–32; and D. A. Heald and A. McLeod, 'Beyond Barnett? Funding devolution', in P. Robinson and J. Adams (eds), *Devolution in Practice*, Institute for Public Policy Research (London, 2002), pp. 147–75.

<sup>10</sup> In Scotland, the difference between the actual formula consequences and the amount by which the Assigned Budget would have increased if Scotland received the same percentage increase as England has become known as the 'Barnett squeeze'. This has been quantified by N. Kay and by J. and M. Cuthbert: N. Kay, 'The Scottish Parliament and the Barnett Formula', *Fraser of Allander Institute Quarterly Economic Commentary* 24:1 (1998), pp. 32–48; J. Cuthbert and M. Cuthbert, 'The Barnett squeeze in Spending Review 2000', *Fraser of Allander Institute Quarterly Economic Commentary* 26:2 (2001), pp. 27–33. In the Scottish media, this lower percentage growth rate than in England has often been portrayed as unjust, as though equal percentage increases were an entitlement, irrespective of the base.

they see it as preserving an unfair advantage. McLean has denounced the Barnett formula as unjust,<sup>11</sup> a view to which Lord Barnett himself now subscribes.<sup>12</sup> It is, indeed, 'nobody's child'.<sup>13</sup>

To some extent, this confusion is understandable. Prior to devolution, the details were little understood beyond a small group of civil servants and academic commentators, mostly in Scotland. These were transactions within a single government and generally regarded as boring and abstruse. For years the Scottish media regularly reported that Scotland obtained 10/85ths of English expenditure (that is, absolute expenditure, not the annual increment) and continued to report the 10/85ths proportion long after it had been superseded in 1992. Since these were internal transactions, governments felt little need to explain the details, or even to make much effort to correct misapprehensions. With devolution in place since 1999, the mechanics are now much better understood: for example, no one now makes the mistake of thinking the Barnett formula applies on absolute expenditure. However, there are still gaps in available data, as explained below. Presumably, more information will become available over time, particularly when politically opposed devolved administrations demand more information of the UK government.

### How the Arrangements have Worked under Devolution

The transition to devolved government seemed to go smoothly. There was no obvious disruption of public services due to transitional funding problems. The Scottish Executive and Parliament have coped well with the business of allocations, though many in single interest pressure groups would disagree with that. No doubt the existence of a bureaucracy already versed in these matters was a major factor, as was the continuity in the arrangements for determining, and to a large extent providing, funding. Added to that, the transition was lubricated by the large increases since 1999 in Departmental

<sup>11</sup> I. McLean, 'Previous convictions', *Prospect* 19 (1997), p. 80; and I. McLean, 'Memorandum', in House of Lords Select Committee on the Constitution (HL Paper (2001–02) no. 147): *Devolution: Inter-Institutional Relations in the United Kingdom. Evidence Complete to 10 July 2002*, pp. 422–7.

<sup>12</sup> Lord Barnett, oral evidence, in Treasury Committee, HC Select Committee on the Barnett Formula 2nd Report (HC Paper (1997–98) no. 341); Lord Barnett, Speech in House of Lords Debate on the Barnett Formula, Hansard HL (series 5) vol. 628, cols 225–9 (7 November 2001); and Lord Barnett, Oral Parliamentary Question on the Barnett Formula, Hansard HL (series 5) vol. 643, col. 913 (27 January 2003).

<sup>13</sup> See D. Bell and A. Christie, 'Finance—the Barnett Formula: nobody's child?', in A. Trench (ed.), *The State of the Nations 2001: The Second Year of Devolution in the United Kingdom* (Thorverton, 2001), pp. 135–51.



Expenditure Limits (DEL), and the consequential (in the Barnett sense) increases in provision for the Scottish Parliament. Devolution was therefore implemented at a time of relative plenty, not in the conditions of relative famine that had been expected.<sup>14</sup>

The processes are now much better understood. Prior to devolution the operation of the Barnett formula was explained only in general terms, with the 'block rules' unpublished. The detailed operating rules are now in the public domain; the Treasury published them in its *Statement of Funding Policy*, originally issued just before the 1999 elections, and updated at each Spending Review.<sup>15</sup> There is also information in the public domain on what happens to DELs between Spending Reviews. It can be shown that the process is much more complex than simply applying the formula proportion, reflecting the way in which devolution finance is embedded within the Treasury's public expenditure control system.<sup>16</sup>

There are still gaps in the data: there is no publication of the precise operation of the formula, and no explanation of how the additions at each stage were arrived at; in some ways it is surprising that the Scottish Parliament has never demanded a full reconciliation of successive expenditure figures. It is also extremely difficult, if not impossible, to tie up the numbers published by the Scottish Executive with those published by the Treasury. No doubt timing differences have much to do with that, but these are capable of explanation. Crucially, there is no published information on comparable provision in England, beyond some unsatisfactory information in successive issues of the *Statement of Funding Policy*.<sup>17</sup> Such information is vital for the assessment of the vexed question of whether or not there has been convergence and, if so, how much, because otherwise the relevant expenditure aggregate cannot be analysed. The Westminster Scottish Affairs Committee has repeatedly

<sup>14</sup> See D. A. Heald, N. Geaughan, and C. Robb, 'Financial arrangements for UK devolution', *Regional and Federal Studies* 8:4 (1998), pp. 23–52.

<sup>15</sup> HM Treasury, *Funding the Scottish Parliament, National Assembly for Wales and Northern Ireland Assembly: A Statement of Funding Policy* (London, 1999, 2nd edn 2000, 3rd edn 2002, 4th edn 2004).

<sup>16</sup> Heald and McLeod have provided for Scotland, Wales, and Northern Ireland a reconciliation between the respective Assigned Budget DELs in Spending Reviews 2000, 2002 and 2004. They demonstrate why it is inappropriate to attempt to see the workings of the Barnett formula in successive public expenditure announcements, in the absence of data showing the size of changes arising from other sources (e.g. changes in measurement conventions, such as the switch in 2001–2 from cash to resource). D. A. Heald and A. McLeod, 'Embeddedness of UK devolution finance within the Public Expenditure System', *Regional Studies* 39 (2005), pp. 495–518.

<sup>17</sup> Appendix C of the Treasury's 2002 *Statement of Funding Policy* does give figures for provision for comparable sub-programmes for 2002–3. It is not clear, however, to what stage of the process these relate (original plans, plans supplemented by in-year adjustments, or estimated outturn); and they do not separate English and Welsh expenditure in England and Wales programmes. It is therefore not possible, even if the run were long enough, to construct a meaningful time series.

attempted to elicit this information, but the UK government has simply pretended not to understand the request.<sup>18</sup>

Of course, there has been controversy. In Scotland there have been arguments about convergence—the so-called ‘Barnett squeeze’; about the role of tax-varying powers in economic policy; and generally about fiscal autonomy. In England, particularly the North-East and London, there are continuing mutterings about Scotland occupying a privileged position. Much of this is ill-informed, partly, but not wholly, because of the lack of hard information on convergence. It is difficult to gauge the political importance of this controversy, though we do not accept McLean’s proposition (in Chapter 6 of this volume) that the extent of controversy is such that the Barnett formula is ‘broke’. Whatever the fiscal relationships within the United Kingdom, the various asymmetries guarantee that there will be controversies. Their salience probably depends on political context, in particular on the size of Westminster majorities, the state of the UK and regional economies, and the public expenditure climate. Thus far the controversies on Barnett have been sporadic and have operated on different time frames in different countries/regions.

Although the figures are not ideal for the purpose, some evidence of convergence can be detected in the identifiable public expenditure series in the annual publication *Public Expenditure: Statistical Analyses*, eliminating Social Security and Agriculture etc. spending. Using this method, Goudie calculated that expenditure per head in Scotland had reduced from 30 per cent above that in England in 1987–8 to 20 per cent above in 1999–2000, notwithstanding the offsetting effect of further falls in Scotland’s relative population.<sup>19</sup> Although there is no definitive evidence in regard to the relevant ‘comparable expenditure’,<sup>20</sup> it seems more than likely that there has been some convergence in recent years.

There are a number of reasons for this. Two features of the system that had a major role in limiting the amount of convergence have been eliminated. Originally the Barnett formula was operated in a volume-planning environment, and therefore only operated on the increment after inflation had been taken into account. Volume planning was replaced by cash-planning in the early 1980s, but echoes lived on until the public expenditure reforms of 1992.<sup>21</sup>

<sup>18</sup> HC Scottish Affairs Committee, Minutes of Evidence Taken before the Scottish Affairs Committee, 7 November 2001, HC 345-i (2001–02); HC Scottish Affairs Committee, Scotland Office Expenditure, 1st Special Report, HC 198 (2002–03); and HC Scottish Affairs Committee, Scotland Office Departmental Report: Minutes of Evidence, Tuesday 17 June 2003, HC 815-i (2002–03).

<sup>19</sup> A. Goudie, ‘GERS and fiscal autonomy’, *Scottish Affairs* 41 (2002), pp. 56–85.

<sup>20</sup> Because the functional coverage of devolved expenditures differs among Scotland, Wales, and Northern Ireland, three separate series for comparable expenditure in England are required.

<sup>21</sup> In the period from the end of volume planning to 1992, baselines, including that of the Scottish Office, for the ‘new’ year in each Public Expenditure Survey were set at the level of the



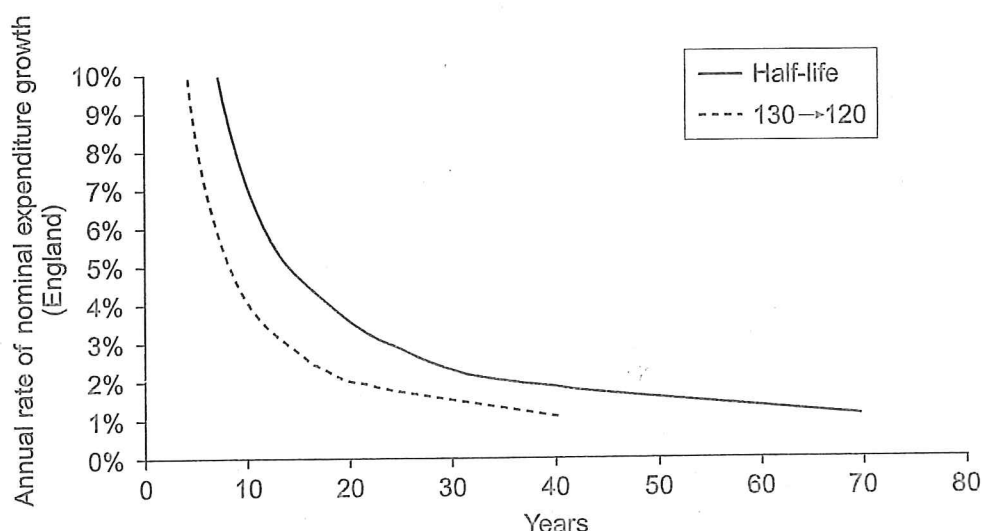


Figure 7.1. The convergence effect of the Barnett formula.

Added to that, the previous procedure, whereby in-year additions to provision were granted to departments responsible for funding public sector pay awards, such as for nurses and the police, was ended. Departments are now expected to cope with pay within the provision agreed in Surveys and Spending Reviews (with, arguably, more realistic provision being made in the first place). The point is that the in-year increases for Scotland were formerly determined on the basis of actual 'impacts', not by the Barnett formula (which would have produced a lower result). The primary reason for these reforms in public expenditure control was not to bring about faster convergence. That was merely an incidental consequence, though one that would have nonetheless been welcome to the Treasury, of actions taken for much wider reasons.

These factors will have made the rate of convergence through the 1990s higher than it would otherwise have been. However, given the low growth in nominal public expenditure, convergence would still not have been particularly great. One of the features of Barnett is that the rate of convergence increases with the rate of growth of nominal expenditure on comparable services in England. The relationship is not linear. Figure 7.1 shows how the rate of nominal growth affects the 'half-life'.<sup>22</sup> At a rate of growth of comparable nominal expenditure in England of 2 per cent, the half-life (shown by the solid line) is thirty-five years. Thus it would take thirty-five years for expenditure per head

previous year's provision plus an enhancement largely compensating for inflation; see Thain and Wright, *The Treasury and Whitehall*, p. 48. The abolition of this arrangement in 1992 was not publicly announced until December 1997; see 'Supplementary Memorandum Submitted by HM Treasury on Tuesday 16 December 1997', in Treasury Committee, HC Select Committee on the Barnett Formula 2nd Report (HC Paper (1997-98) no. 341), pp. 36-9.

<sup>22</sup> The 'half-life' is a concept borrowed from nuclear physics, where it is used in connection with the rate of decay of particles. It is the time taken for a quantity to reduce to half its original value.



20 per cent above that in England to reduce to 10 per cent above. In contrast, at a rate of growth of nominal expenditure of 8 per cent, the half-life is nine years. The dotted line in Figure 7.1 shows the years taken for an expenditure per head differential of 30 per cent to reduce to one of 20 per cent. In both cases, it will be seen that the rate of convergence is very sensitive to growth rates of nominal public expenditure in England.<sup>23</sup>

The public expenditure climate has changed and the significant increases in DEL since 1999 seem bound to have led to faster convergence. Paradoxically, this has not been noticed, particularly since the Scottish Executive, in common with departments in England, has had difficulty spending budgeted amounts. This context provided opportunities to adopt policies involving higher expenditure (such as on tuition fees, personal care, and concessionary fares), including those with no parallels in England to generate future formula consequences. Such commitments may cause future difficulties in a harsher expenditure climate.

### Possible Institutional Developments

Although there are few systems with sub-national governments where the sub-national units all have precisely the same powers and responsibilities, and where all are of a comparable size, the asymmetries in the United Kingdom are particularly marked. This must raise the possibility of some convergence in terms of powers. The Richard Commission,<sup>24</sup> set up by the National Assembly for Wales, has recommended that the Assembly should acquire primary legislative powers, and that a tax-varying power is desirable, but not essential, in the event of that happening. The Northern Ireland Economic Council commissioned a review of funding arrangements for the Northern Ireland Assembly,<sup>25</sup> one of the issues being greater alignment with Scotland. In England there have been developments with the establishment of the Greater London Authority and the publication of the White Paper on

<sup>23</sup> The calculations underlying this illustration assume that the formula is operated on the entire increment (as it now is) and there is no by-pass. They also assume, for simplicity, that the relative populations remain constant. The effect of relative population change on the operation of the formula has been modelled by Cuthbert. See J. Cuthbert, 'The effect of relative population growth on the Barnett squeeze', *Fraser of Allander Institute Quarterly Economic Commentary* 26:2 (2001), pp. 34–7. This does not affect the overall conclusion, though relative population decline reduces the speed of convergence for Scotland, as the index is calculated on a per capita basis.

<sup>24</sup> Lord Richard (chair), *Report of the Commission on the Powers and Electoral Arrangements of the National Assembly for Wales* (Cardiff, 2004), <http://www.richardcommission.gov.uk/content/finalreport/report-e.pdf>.

<sup>25</sup> D. A. Heald, *Funding the Northern Ireland Assembly: Assessing the Options*, Northern Ireland Economic Council Research Monograph 10 (Belfast, 2003).

English regional devolution.<sup>26</sup> It has to be said, however, that substantial devolution to the regions of powers over health and education, for example, would be far more radical than in the devolved countries, where there had already been long histories of administrative devolution and separate health and education departments. Expenditure-switching powers at the level of English regions would challenge the functional role of Whitehall departments, now predominantly responsible for England.

Perhaps it would be unwise to expect that changes, if they happen at all, will come quickly. The gestation period of devolution to Scotland and Wales was very long indeed, with protracted activity in the 1970s followed by an interlude of virtually an entire generation when the issue was, to all intents and purposes, off the UK agenda. Further movement, especially in England, would run counter to the clear centralist instincts and the impatience of the current government, parts of which may be inclined to view calls for more regional control with some scepticism. All of this, of course, is speculation: the future may well turn out differently. It remains unsettled whether the counterpart to the devolved countries is to be England or individual English regions.

### Funding: Options for the Future

There are two questions to consider: how expenditure is to be determined; and how it is to be funded. Obviously these two questions can be closely linked, but they would only be one and the same if there were to be a separate taxation system under the control of the Scottish Parliament and—crucially—if there were no needs equalisation. Where there is needs equalisation, it is the details of the equalisation system that determine the base amount of expenditure.<sup>27</sup> The base amount may be supplemented, positively or negatively, by tax-varying powers, but that does not alter the basic point.

#### Determining Expenditure Levels

The first option would be to continue with the present system. At some stage, this would result in provision in the devolved countries falling *below*

<sup>26</sup> Office of the Deputy Prime Minister, *Your Region, Your Choice: Revitalising the English Regions*, Cm. 5511 (London, 2002). The 2004 referendum in the North-East region removed the possibility of *elected* regional government in the foreseeable future.

<sup>27</sup> It is possible to devise equalisation schemes (equalisation of fiscal potential) that allow the lower-tier government to freely choose its level of expenditure; see D. N. King, *Fiscal Tiers: The Economics of Multi-Level Government* (London, 1984), pp. 168–70. This used to be a characteristic of revenue support grant systems for local authorities, but was suppressed because this involved (a) marginal incentives to higher expenditure and (b) either an open-ended budgetary commitment by central government or offsetting reductions in resource standard.



a needs-related index. Determining when that happens could only be done after a fresh UK-wide needs assessment (see below). While it never has been the intention that convergence should continue to that stage, it has to be noted that equalisation on the basis of equal expenditure, or revenue, per head is relatively common in other jurisdictions. That, for example, is broadly what happens in Canada and Germany.

On the other hand, if the view is taken that provision in the devolved countries should be broadly based on need, then the question arises as to what happens when convergence goes below that. This is likely to happen in Wales before it does in Scotland or Northern Ireland. There is, however, no means at present of determining when that is likely to happen. It is not just a case of lacking meaningful data on convergence, though that is a major factor. There is no up-to-date assessment of need; the last published material appeared in 1979,<sup>28</sup> and that was not universally agreed. While there is reason to believe that the Treasury has updated internally the 1979 assessment from time to time, nothing has been published. Nor has recent work co-ordinated in Northern Ireland by the Department of Finance and Personnel reached the public domain, though, paradoxically, a commentary on that work has been published.<sup>29</sup> A needs assessment produced in isolation by the Treasury would command no credibility in the devolved countries and some new 'independent' institutional machinery would need to be established.<sup>30</sup>

A needs assessment would not be a straightforward task: it requires subjective judgements on the extent to which particular indicators of need lead to different spending requirements; and there will have to be decisions as to the extent to which differential demand, for example because of different take-up rates of private provision, should be allowed for. Above all, it has to be understood that a needs assessment cannot come up with any absolute definition of need and the associated spending requirement. Need, in this context, is a political judgement. All that a needs assessment can hope to do is to arrive at some estimate of the extent to which providing the same level

<sup>28</sup> HM Treasury, *Needs Assessment Study: Report* (London, 1979).

<sup>29</sup> A. Midwinter, *Northern Ireland's Expenditure Needs: A Preliminary Assessment*, Northern Ireland Assembly Research Paper 81/02 (Belfast, 2002).

<sup>30</sup> Two arguments have regularly been used against such machinery. The first is that such a transfer of public functions into a new quango would be undemocratic and lacking in accountability. Provided that the role is advisory, as is the case with the Commonwealth Grants Commission in Australia, this objection now appears weak, especially since executive functions over monetary policy have been transferred by the Treasury to the Bank of England. The second is that of cost: any arrangement of this kind, both in terms of the operating costs of the body and costs imposed on governments and other bodies, would certainly be more expensive than either the present system or a needs assessment conducted entirely within governments. These additional costs would have to be justified on the basis of accountability benefits flowing from greater transparency and the possibility of the arrangements commanding a reasonable measure of consent.



of specified services in different areas will lead to different spending requirements.<sup>31</sup> The predominance of England in terms of relative size may lead to the English configuration of, for example, services and charging policies becoming the 'standard' that is costed.

A second option would be to replace population with some other proxy indicator of needs. Inverse GDP has been suggested,<sup>32</sup> as has social security.<sup>33</sup> The problem here is that there is no evidence that either of these indicators would serve as a satisfactory proxy for need to spend on devolved services and, in the absence of a needs assessment, there is not going to be such evidence. On the face of it, neither seems particularly plausible. The major expenditure responsibilities of the Scottish Parliament are health, education, and social work services—not obviously directly related to either of these suggestions.

If a needs assessment has to be carried out in order to validate proxy indicators, it would seem to make more sense to use the results more directly. The results of such an assessment could be used to amend the Barnett formula, substituting needs-weighted population for population. When the expenditure index is initially higher than the needs index, this modification would prevent 'overshooting'. Figure 7.2 shows that, instead of convergence being towards equal expenditure per head ( $E = 100$ ), it would be towards a needs index ( $N$ ); this is the line  $B^{nw}$ . Heald and McLeod also demonstrated the possibility of smoothing the transition, in order to ensure that the needs index is not reached in an abrupt fashion.<sup>34</sup> In that case, convergence switches, at a threshold value  $T$  above  $N$ , from being towards  $E = 100$  to being towards  $E = N$ . Accordingly, the convergence line  $B_z^{nw}$  is identical with the normal Barnett convergence line  $B$  until reaching the threshold at  $Z$ , and then converges on  $E = N$ .

A third option that has been suggested is the complete financial re-integration of the devolved countries into the United Kingdom, in particular imposing the same distribution systems for health and for local government UK-wide. Leaving aside the fact that the systems in England have come

<sup>31</sup> See Heald and McLeod, 'Beyond Barnett? Funding devolution', pp. 159–62. Whereas McLean is convinced that Scotland is currently over-funded relative to needs (McLean, 'Memorandum'), Midwinter disputes that conclusion: A. Midwinter, 'Devolution and public spending: arguments and evidence', *Fraser of Allander Institute Quarterly Economic Commentary* 25:4 (2000), pp. 38–48). These arguments are a prologue to the debates that would accompany a needs assessment.

<sup>32</sup> See I. McLean, 'Financing the union: Goschen, Barnett, and Beyond', Chapter 6 of this volume; and I. McLean and A. McMillan, 'The distribution of public expenditure across the UK regions', *Fiscal Studies* 24:1 (2003), pp. 45–71.

<sup>33</sup> See R. R. MacKay, 'Regional taxing and spending: the search for balance', *Regional Studies* 35 (2001), pp. 563–75.

<sup>34</sup> Heald and McLeod, 'Beyond Barnett? Funding devolution', p. 161.

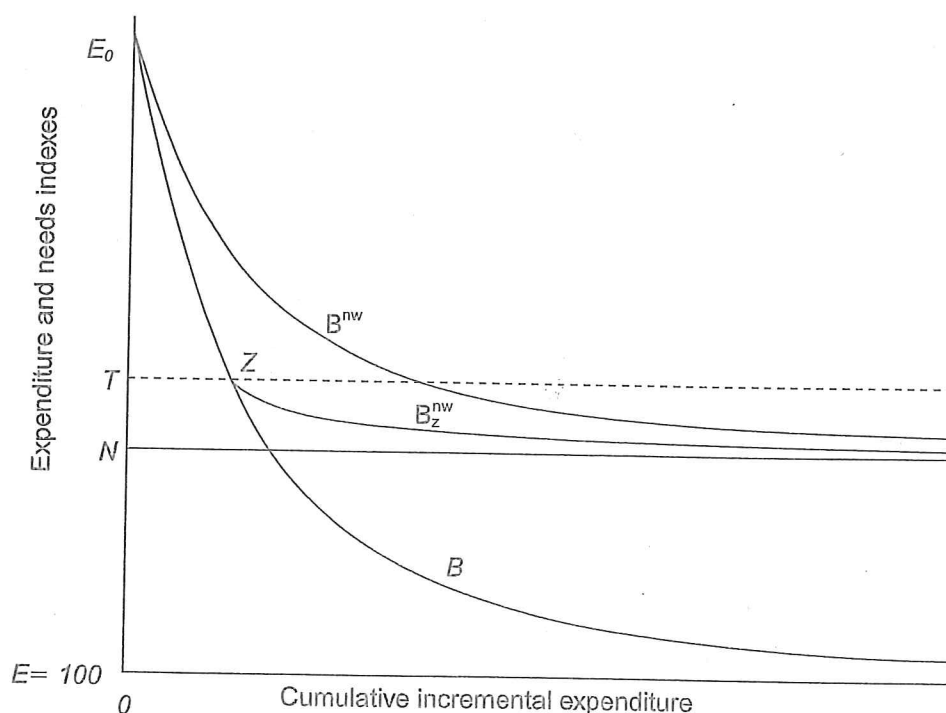


Figure 7.2. Convergence on a needs index.

under fierce criticism, this would be portrayed as the turning of the parliament and Assemblies into a sort of super local and health authority, in fundamental conflict with the notion of devolution. It seems more likely that, if this option ever really sees the light of day, it would be as a Treasury negotiating position rather than as a serious proposition.

A fourth option, which has in various guises received a lot of publicity, is that of greater fiscal powers for the Scottish Parliament.<sup>35</sup> At one level, the suggestion that the parliament should seek more fiscal powers when it has made little use of the powers it already has—and looks unlikely to use the ‘tartan tax’ power in the foreseeable future—seems surprising.

The markedly changed public expenditure climate, with rapid increases in both nominal and real devolved expenditure and a significant level of under-spending, has diverted attention away from the upward use of the tartan tax. However, there has been a considerable amount of political and media attention on the downward use of the tartan tax power.<sup>36</sup> It seems likely that ministers and civil servants in the Scottish Executive view this option with caution since they would expect the Treasury to react by initiating a needs assessment. In the absence of a recent needs assessment, such a downward

<sup>35</sup> See the symposium on fiscal autonomy in *Scottish Affairs* 41 (2002).

<sup>36</sup> See, for example, A. Bruce and T. Miers, *Scotland's Hidden Tax Cutting Powers*, Policy Institute Series: Economy no. 3 (Edinburgh, 2003).

use might be regarded as evidence that the expenditure index was higher than the needs index. From a public finance perspective, it is a matter of legitimate political choice for a high-needs political entity to trade off lower expenditure for lower taxes, without its needs-based entitlements being challenged. However, the political repercussions are unpredictable, especially given the fiscal centralism characteristic of the United Kingdom.

It is also not true that the Scottish Parliament is particularly out of line with the mainstream of sub-national assemblies in its fiscal powers, especially when compared to others in Europe. It has, for example, more powers than the German *Länder*, arising not only from its explicit tax-varying power but also from its legislative and financial control over local authority functions and taxation. Nevertheless, the idea of greater tax powers has acquired considerable momentum, drawing support from across the ideological and constitutional spectra.

On the face of it, many of the calls for 'fiscal autonomy' would mean a move from an expenditure-based system of allocation to one where the amount of revenue raised is the main determinant. This would only be true, however, if there were no equalisation. The effect of an equalisation system can be to change a nominally revenue-based system into one that is, in reality, expenditure-based,<sup>37</sup> as illustrated by the 1921–72 experience of the Stormont Parliament where that reality was obscured. Moreover, the existence, perhaps even the absence, of equalisation gives politicians an avenue to blame shortcomings not on their mismanagement but on the iniquities (or absence) of equalisation. Thus, while it is clearly true that the current funding system does not put as much responsibility as would be ideal on devolved politicians, the ability of a revenue-based system to change that can be overstated.

There are also practical constraints on tax variation *within* the United Kingdom,<sup>38</sup> particularly arising from the effects of globalisation and the existence of EU rules, that are often simply ignored in public debates. This is not to say that a move towards a revenue-based system of devolution finance would be impossible. But those putting forward such systems for serious consideration must address the questions of equalisation and practicality. Arguments, implicitly based on Laffer curves, that lower business taxes would, through increased growth, be self-financing ought to provoke scepticism, as they are too convenient. Moreover, it is never advisable to ignore the views of the UK Treasury. There are indications in one of the evaluation reports of the 'five euro tests' that the Treasury envisages that a more activist

<sup>37</sup> See Kilbrandon Royal Commission on the Constitution, *Royal Commission on the Constitution, 1969–1973: Report*, Cmnd. 5460, 5460–i (London, 1973).

<sup>38</sup> See Heald, Geaughan, and Robb, 'Financial arrangements for UK devolution', p. 30.



role for fiscal policy would be a consequence of the loss of discretion over interest rates inherent in euro membership.<sup>39</sup> This type of consideration would reinforce the Treasury's traditional centralist rein on the UK fiscal system; a lower business tax strategy within the United Kingdom is extremely unlikely to be tolerated by UK governments. It is a matter of judgement whether an independent Scotland could imitate the post-1988 economic development strategy of Ireland, though matters of timing suggest not.<sup>40</sup>

### Funding

Although it is not the case, as is sometimes suggested, that the Scottish Parliament receives all its funding from central government, it does receive by far the greatest element from this source.<sup>41</sup> Clearly there are other options.

One would be separate taxation, as discussed above. Another possibility is a system of assigned revenues, widely used in some federations. In such systems, all or part of the revenues from particular taxes are allocated to sub-national governments. Such a system could be used for any tax, though in some cases some proxy (such as population) for the actual revenues generated in particular areas would have to be used for practical reasons. It is important to understand that a system of assigned revenues confers no fiscal power on sub-national governments. It is not a form of fiscal autonomy, and in reality it does nothing to alter the vertical fiscal imbalance. (It may be supplemented by tax-varying powers, but that is a different point.) The judgement on whether or not it would be worth pursuing a system of assigned revenues turns on whether or not this would increase the perception of the responsibility of devolved politicians.

Charges are a source of potential funding, an option stressed by Bailey and Fingland.<sup>42</sup> However, the most probable trajectory—with some exceptions—is for the charge-financed percentage to fall through time and for political decision-makers in Scotland, Wales, and Northern Ireland to be less enthusiastic about charges than their counterparts (at present UK governments) for England.

<sup>39</sup> HM Treasury, *Fiscal Stabilisation and EMU: A Discussion Paper* (London, 2003).

<sup>40</sup> The US economist Paul Krugman expressed the view that the window used by Ireland is now closed; see S. Bain, 'Scots "too late" to copy Ireland', *The Herald*, 29 October 2003. For the view that Scotland's fiscal advantages would better take the form of lower taxes, especially business taxes, see J. Cuthbert and M. Cuthbert, 'Can fiscal autonomy improve a devolved Scotland's economic prospects?', *Scottish Affairs* 41 (2002), pp. 86–101.

<sup>41</sup> See Heald and McLeod, 'Fiscal autonomy under devolution', p. 11.

<sup>42</sup> S. J. Bailey and L. Fingland, 'The tartan tax versus other revenue-raising options: economic perspectives', *Fraser of Allander Institute Quarterly Economic Commentary* 28:3 (2003), pp. 30–7.

## Other Current Developments

There is much going on at present in England with implications for the funding of the devolved administrations. The possibility of extra revenue for services in England from congestion charging and from tuition fees in higher education would mean proportionately less coming through the Barnett formula.<sup>43</sup>

The 'Balance of Funding' review (of local government in England) is raising the possibility of the replacement of the council tax, a discussion that has its parallels in Scotland.<sup>44</sup> There are superficial attractions in replacing council tax with some sort of income-based tax, but property taxes have their advantages. Specifically, they are extremely difficult either to avoid or evade; have clear visibility; and could be made less regressive, for example, by introducing more bands and varying the multipliers that apply relative to the standard (band D) charge. They are suitable as a financing source for sub-national governments and form part of the portfolio of taxes that finance a modern welfare state. In addition, any sort of income tax would be subject to much tighter Treasury control than has been applied to property taxes, with the yield being sensitive to Treasury decisions on tax base and rate structure.

Taken together, these two points raise the question as to how much policy divergence from England there can be in practice, and how much the devolved administrations will, willingly or not, be forced to follow policy leads. Devolved administrations cannot be 'more generous' across the board than the UK government for England, unless there is a funding advantage and/or above-UK-average fiscal effort. Priorities might be different, but only within a budget envelope. Another relevant point is that the dynamics of the current system imply that the proportion of self-financed funding of the Scottish Parliament will fall over time, a circumstance hastened by the rapid increases in centrally funded public expenditure since 1999.

## Conclusion

The first thing that needs to be said is that fundamental changes cannot be undertaken overnight. In-depth consideration is needed, not just for Scotland, of the implications of proposed changes. This will involve consultation with

<sup>43</sup> Extra revenue generated by charging schemes will not attract the operation of the formula, and if the extra revenue is used in substitution for direct funding, with a consequent reduction of provision in England, there would be negative formula consequences.

<sup>44</sup> See M. Danson and G. Whittam, *Paying for Local Government Water and Sewerage Charges Fairly: The Case for a Scottish Service Tax and a Scottish Water Charge*, Department of Economics and Enterprise, University of Paisley (Paisley, 2003, mimeo).



interested parties, perhaps requiring a formal process such as an Inquiry or Commission of some kind. Transitional arrangements need to be worked out, again in consultation. The change cannot be so abrupt as to cause serious management and political problems. Apart from that, it does not seem right to implement fundamental changes now, only six years into a new system.

For these reasons, it seems more likely that any change in the short term will have to be incremental—building on rather than upsetting the current arrangements. This conclusion might, however, have to be revisited if there were some sort of constitutional crisis, for example if conflict between a UK government and one or more of the devolved administrations were to become particularly intense, or if Scotland seemed to be heading towards independence. Otherwise, what is likely to produce modifications to the current framework is that the tacit assumption behind the Barnett formula—that some convergence is desirable—will be rendered untenable by more rapid convergence than might have been foreseen, pushing one or more of the devolved administrations below what they perceive as their 'N' in Figure 7.2.

In any event, as convergence bites, one of the devolved administrations will at some stage feel that it has an unanswerable case that expenditure per head has converged towards that in England to such an extent that it is close to, or even below, that which would be justified on the basis of relative need. At that stage it might call for a new needs assessment. That would not be without its difficulties and would only have a chance of wide acceptance if it was supervised by an independent Commission. However, the reception of the recommendations of such a Commission can be expected to be highly politicised.

While some sort of tidiness is always attractive, it can be an illusion. There will always be difficulties at the edges, and the extent to which UK government seeks to influence, formally or informally, policy developments is always going to be contentious. Nor can it be assumed that there can ever be a solution that will be immune to criticism and controversy. There are always going to be deep disagreements about such fundamental matters as money and the operation of power. Of course, the particularly asymmetric structure of the United Kingdom, in terms of relative population and relative economic growth rates, compounds the problem. In these circumstances, the issue might be more about finding an acceptable level of self-financed expenditure, and finding ways of ensuring that self-financing as a proportion of the total does not diminish with time, than about major changes.

At the same time, we will need to keep alert to the effects of the evolution of the overall public expenditure system. Changes such as to the *details* of public expenditure control affected the operation of Barnett prior to devolution, and such things as resource accounting, the greater use of private



finance, and the extension of user charging will have had their effects since devolution. To some extent the recent effects will not be noticeable now because of the amount of money currently going through the system. The devolved administrations need to ensure that they have well-equipped and resourced finance departments, as well as active parliamentary scrutiny: one is not a substitute for the other. An unknown factor that has now been removed is the implications of elected regional bodies in (some) English regions taking on expenditure responsibilities.

The Barnett formula may be under some stress, but it is not 'broke'. It must be delivering some convergence—probably at as fast a rate as could be managed without creating severe difficulty, both in terms of budgetary pressure and macroeconomic impact.<sup>45</sup> Indeed, the Treasury may be getting more than it expected. Radical changes to the system would require transitional arrangements to minimise such problems, and the effect of these could well be very similar to that of the current situation. Indeed, the Barnett formula itself started life as a transitional arrangement.

Tension about financial arrangements, whatever they are, is an inevitable consequence of the asymmetrical structure of the United Kingdom. The only way to remove this would be full integration (implausible, and likely to generate pressure for constitutional change) or independence (a political choice). Otherwise, there is a choice between mechanisms that are simple in principle, like Goschen and Barnett, or Australian-type formalised mechanisms that might provide the basis for much more detailed central intervention in policy and expenditure priorities. Achieving political devolution, whilst keeping the expenditure-switching discretion evolved by successive Secretaries of State for Scotland, was a highly significant feature of the devolution funding settlement.

In such a setting, it is easy but unproductive to write Armageddon scenarios. There might be intense political conflict between Edinburgh and London over the constitutional status of Scotland. Or there might open up a wide ideological gulf between the devolved administrations and the UK government as to the proper range of public functions. In the latter context, it would be remarkably easy for a hostile UK government to undermine the finances of the devolved administrations in the following way. Taxpayers in England could be allowed to offset 60 per cent of the costs they incur on private hospital treatment against their income tax liabilities, with the resulting cost being deducted from National Health Service spending in England. If

<sup>45</sup> On the potential macroeconomic impact on the Scottish economy of lower-than-England growth rates of public expenditure, see L. Ferguson, D. Learmonth, P. G. McGregor et al., *The Impact of the Barnett Formula on the Scottish Economy: Endogenous Population and the Darling Amendment*, Department of Economics, University of Strathclyde (Glasgow, 2003, mimeo).

there were substantial take-up of this option, there would be large negative formula consequences for the devolved administrations that would seriously disrupt their planning and discharge of devolved functions.

The above example illustrates the obvious point that a UK government that wished to make the union unworkable could do so. However, that union has demonstrated a remarkable resilience and its future is properly a political choice. If there is the political will to make devolution work, funding mechanisms can be found that, however imperfect and exposed to more public glare, can be evolved to meet changing circumstances. Although, at some future time, the name of Barnett may disappear, some similar kind of mechanism might well be in place.