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Fair Shares?

Barnett and the politics of public expenditure

By Iain McLean, Guy Lodge and Katie Schmuecker

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'The Future of the Union'

This paper forms part of a series of commissioned research papers for ippr north and ippr's 'Future of the Union' project. To mark the 300th anniversary of the Acts of Union, ippr is exploring the state of the Union today, the challenges it faces and its future. We are looking at the economic, constitutional, social and cultural aspects of the Union, as well as changing public attitudes towards it.

Executive summary

The Barnett formula – the Treasury mechanism used to fund the devolved administrations (DAs) in Scotland, Wales and Northern Ireland – is now the subject of widespread political debate across the four nations of the UK.

In particular, there are growing concerns that the current disparities in funding across the UK are not fair and that this is creating a tension between the four nations, especially between England and Scotland, which could serve to undermine the Union unless addressed.

To help inform these debates this paper evaluates the way the Barnett formula works and asks:

- Does Barnett deliver an equitable and fair distribution of spending?
- Does Barnett provide for efficient and accountable spending?
- Do the public think the distribution of public spending across the UK is fair? Is Barnett procedurally fair?

About the Barnett Formula

The Barnett formula plays a central role in how the devolved administrations are funded. It is not the sole source of public spending in the devolved territories, as the UK government also spends public money on reserved functions in each territory, but it does account for the majority of public money spent in each devolved territory.

The Barnett formula pre-dates devolution, having been in operation since the 1970s. Since devolution it has allocated an unconditional block grant to each of the devolved administrations (DAs), giving them a great deal of flexibility over how they fund devolved functions. But while the devolved administrations have wide discretion over spending, they have limited scope to raise their own revenue: all have powers over business rates and council tax (domestic rates in Northern Ireland), and Scotland also has the thus-far unused 'tartan tax' – the power to vary the standard rate of income tax by 3p in the pound.

Barnett is not based on needs, but on historic spending patterns and population. It is used to calculate the increase (or decrease) to a baseline block grant which is historically too generous to Scotland and Northern Ireland, and too mean to Wales. In effect, for every pound of *extra* spending in England on a service that is devolved, Scotland Wales and Northern Ireland will get an increase in their block grant proportionate to their relative populations.

Ultimately the Barnett formula was designed to bring about equal spending per head in the four territories of the UK, slowly reducing the differentials in spending between the four nations. This is known as the 'Barnett squeeze'.

The formula has some positives, like the spending flexibility the unconditional block grant gives to the DAs. But it also has serious deficiencies. Importantly, the process by which the Treasury determines whether spending is subject to the Barnett formula or not is unclear. Decisions sometimes appear arbitrary and cause tension, for example, there is currently disagreement between the DAs and the Treasury regarding whether the regeneration funding for the Olympics should be subject to the Barnett formula.

A further problem is that the DAs have little influence over the size of their block grant as the Barnett formula is based on decisions taken by the UK government for England. This could create a real problem if a devolved administration wanted to increase spending at a time when a UK government was cutting spending in England. In such a scenario the DAs would be constrained in their ability to shape their own policy agenda, which not only has the potential to bring them into conflict with the UK government, but which might also serve to undermine devolution. This problem is compounded by the limited number of options available to the DAs to raise revenue themselves, meaning they do not have many alternative sources through which to top up their block grant should they wish to do so.

These drawbacks were more manageable when Labour was in power across the UK, but become increasingly problematic when different parties are in power, not least Nationalist parties, as they provide a platform for intergovernmental conflict.

Comparing the distribution of public spending across the nations and regions of the UK

The UK government does not publish data showing what each devolved administration receives through the Barnett formula. To calculate this we manipulate HM Treasury's Public Expenditure Statistical Analysis (PESA) data on identifiable public spending, which allows us to provide the most accurate picture possible of monies flowing through the Barnett formula.

The data shows wide disparities in public spending between the nations of the UK for 2007/08:

- Northern Ireland received £5,684 per head: 21 per cent above the UK average spend per head and £1,161 more per head than that spent in England
- Scotland received £5,676 per head: 21 per cent above the UK average and £1,153 more per head than that spent in England
- Wales received £5,050 per head: 8 per cent above the UK average and £527 more per head than that spent in England
- England received £4,523 per head: 3 per cent below the UK average.

We find evidence of the 'Barnett Squeeze' operating in Wales and Northern Ireland between 2002-3 and 2007-08 but not in Scotland:

- In Wales spending per head fell from 13 per cent to 8 per cent above the UK average in this period
- In Northern spending per head fell from 38 per cent to 21 per cent above the UK average
- In Scotland there is little evidence of a spending squeeze. Spending in Scotland declined between 2002-03 and 2004-05 (from 21 per cent above the UK average to 15 per cent above), but it then increased again sharply from 2004-05 onwards (back to 21 per cent above).

This disparity in public spending, combined with the lack of any clear spending squeeze (in Scotland at least) would suggest that public disquiet over territorial finance is unlikely to disappear.

PESA data also allows us to compare public spending per head for each of the four nations of the UK with the nine regions of England. The Barnett formula does not govern the distribution of spending within England, but including the English regions in the analysis provides a wider comparison of how public spending is distributed across the UK.

Identifiable public spending per head (minus social protection and agriculture), and deviation from the UK average, across the nations and regions of the UK 2007-08

Nation / Region	£ per head	per cent deviation from UK average
London	5,985	+28
Northern Ireland	5,684	+21
Scotland	5,676	+21
Wales	5,050	+8
North East	4,960	+6
North West	4,927	+5
UK	4,679	0
England	4,523	-3
Yorkshire and the Humber	4,477	-4
West Midlands	4,430	-5
East Midlands	4,086	-13
South West	3,947	-16
East of England	3,820	-18
South East	3,874	-17

Does Barnett deliver an equitable and fair distribution of spending?

A progressive funding system should place a particular emphasis on equity or fairness. Our original analysis, comparing the distribution of spending to two measures of need: levels of economic performance (GVA per head) and levels of poverty (households below 60 per cent median income levels), finds the current distribution of spending is neither equitable nor fair. There is no clear relationship between spending and our chosen measures of need. In particular Scotland was found to be receiving more than its needs would suggest on both measures, while England received less. Within England London receives more than its need would suggest, while the East Midlands is the region that does least well.

Does Barnett provide for efficient and accountable spending?

The Barnett formula is not sufficiently efficient or accountable. While the DAs are accountable for how they spend money, they have only limited revenue-raising powers. This mismatch severs the link between revenue and spending and reduces the incentives for efficiency and raises concerns about the accountability of the DAs.

Do the public think the distribution of public spending across the UK is fair? Is Barnett procedurally fair?

The Barnett formula is increasingly not seen to be fair by the public. In England there is evidence that an increasing number of people think that Scotland receives 'more than its fair share' of public spending, rising from one fifth in 2003 to one third in 2007. Moreover, political parties, commentators and the media are increasingly drawing attention to the issue, which may further increase public awareness. This has potential to become a major source of tension between the constituent nations of the UK.

There is also overwhelming support within England (75 per cent) for the idea that now Scotland has its own devolved institutions, services in Scotland should be paid for out of taxes collected in Scotland. Interestingly this view is supported by 57 per cent of Scots too.

Barnett is unsustainable: options for reform

The Barnett formula is neither fair, nor sufficiently efficient. It is no longer appropriate for devolution as it does not give the DAs sufficient control over the size of their block grant, and creates potential for intergovernmental conflict between the DAs and the Treasury, especially now different parties are in power.

For these reasons the Barnett formula has very few remaining friends. Even Lord Barnett, after whom the formula was named, wants it scrapped on the grounds that it is too unfair. Political parties across the political divide and across the UK are voicing their concerns about the way it works. The Welsh are committed to reviewing the distribution of spending and there is pressure to do likewise in Northern Ireland. In Scotland, the Scottish Government's White Paper on constitutional reform is consulting on whether Scotland should be granted greater fiscal powers, while the pro-Union parties have established the Calman Commission to review the way Scotland is funded and the financial powers of the Scottish Parliament. Importantly, this review is backed by the UK government which suggests that the UK government is for the first time – albeit indirectly – backing a review of devolved finance.

The Scottish and Welsh reviews of finance are welcome, but ultimately the UK needs to find a sustainable funding settlement that covers the whole of the UK – including England – and not just one country solutions. It is doubtful anyway that a one country solution is possible. For example, if Scotland is granted more revenue-raising powers, the size of the block grant will have to be reduced, which in turn will require a review of the Barnett formula.

Three options for reform

i) A needs-based equalisation system – like the Barnett formula this would provide a block grant to DAs, but based on an assessment of need. This would better meet our equity principle, and if not too overly complex would increase public fairness. But it would not enhance efficiency and accountability, as DAs would still not be responsible for raising revenue.

ii) Full fiscal autonomy – under such a system raising revenue would be devolved to the DAs. This would improve efficiency and accountability, linking public spending with the responsibility for raising revenue. It would also mean the DAs are not wholly dependent on a block grant from the UK government, and may help to ease some of the political tensions around the Barnett formula. But there are concerns with regard to equity, as disparities in tax capacity across the UK mean not all areas would be able to provide an equivalent level of public services.

Greater fiscal autonomy must therefore be accompanied by needs-based equalisation in a hybrid model, which is what we recommend.

iii) Hybrid model – this combines the efficiency gains of greater fiscal autonomy with the equity of a needs-based grant, and is, we believe, the best option for reforming Barnett. Under such a system a combination of devolved and assigned taxes would ensure the DAs were responsible for raising more of their own revenue, while a needs-based top-up block grant would ensure greater equity. A hybrid model would also assist procedural fairness as there would be a more clearly defined relationship between need and spending, while also responding to public support for the devolved administrations being responsible for raising more of the revenue they spend. The needs element would also help to preserve intra-UK solidarity.

Such reform would give some meaningful fiscal autonomy to the devolved governments, in a framework that also seeks to balance UK-wide interests of equity with devolved autonomy. For this reason combining fiscal responsibility and a needs-based system is the best way to reform territorial finance in the UK.

However, because of the asymmetry of the UK devolution settlement, whereby the Scottish Parliament has full legislative powers but the National Assembly for Wales does not, reform will have to be staggered.

We recommend:

For Scotland: Scotland's full legislative powers should be matched by stronger revenue-raising powers. There is already some devolution of income tax in the shape of the (unused) tartan tax and we recommend building on this by strengthening the fiscal powers of the Scottish Parliament. This could involve extending its powers over income tax, and could also be accompanied by assigning tax revenue, for instance a proportion of VAT. This would be topped up with a grant based on a needs assessment. This would be in line with Scottish public opinion which supports stronger tax raising powers for Scotland.

For Northern Ireland: Northern Ireland could move towards the same model as Scotland, although the new assembly may need time to bed down before financial powers are devolved.

For Wales: In the absence of full-legislative powers we suggest that the National Assembly for Wales could be funded from a full needs-based block grant, with the possibility of assigning some tax revenues. If the National Assembly gains primary legislative powers in the future, then it should be given greater revenue-raising powers in line with what we recommend for Scotland.

Introduction

The death knell may finally be sounding for the infamous – although much misunderstood – Barnett formula. This obscure Treasury instrument which has been used to govern the distribution of funding to Scotland, Wales and Northern Ireland since the 1970s is coming under increased scrutiny, with many predicting that it is only a matter of time before it is consigned to the history books.

Concerns about territorial finance are becoming a source of tension within and between the constituent nations of the UK, and have provoked a growing and impassioned debate about how public spending is distributed, with politicians, commentators and the public increasingly asking: who gets what and is public money distributed fairly?

The Barnett formula is regularly vilified as the device that over-rewards Scotland, Wales and Northern Ireland at the expense of England. This is beginning to irritate the public in England, with recent data from the British Social Attitudes Survey suggesting that the proportion of people in England that think Scotland receives 'more than its fair share' of public spending rose from one in five in 2003 to one in three in 2007 (Curtice 2008b). This is compounded by a perception that additional funding enables the Scots and Welsh to enjoy popular policies such as free personal care for the elderly and the abolition of prescription charges, which are not available to the English.

Although the Barnett formula does not govern the distribution of spending within England, spending comparisons across the UK are nonetheless prompting the northern English regions to complain that objectively their needs are greater than those of Scotland, yet they receive less spending per head, while the Greater South East complains that it subsidises everyone else.

It is not just the English that have a problem with Barnett. In Wales an independent commission is being established to review the funding and finance of the country's Assembly. And in Northern Ireland too there are concerns about whether the level of spending is keeping pace with need, and the Finance Committee of the Northern Ireland Assembly is currently urging the Executive to examine the implications of the Barnett formula and scenarios for reform (Committee for Finance and Personnel 2007).

In Scotland a different but related debate is emerging over the fiscal powers of the Scottish Parliament. The Scottish Government's White Paper on constitutional options is consulting on whether Scotland should be granted more fiscal powers (Scottish Government 2007). This position seems to chime with public opinion in Scotland, where a majority now support giving the Scottish Parliament greater powers over finance.

In recognition of this development and reflecting their concern about the lack of financial accountability in Scotland, the pro-Union parties (Labour, Conservatives and Liberal Democrats) have established the Calman Commission to review the way Scotland is funded and the financial powers of the Scottish Parliament. Importantly, this review is backed by the UK government, which suggests – albeit implicitly – that the UK government is for the first time backing a review of devolved finance. And as Wendy Alexander, the former leader of the Labour Party in the Scottish Parliament, conceded, a move towards fiscal autonomy in Scotland would also have the advantage of helping to defuse growing concerns within England about the extra spending Scotland receives (Alexander 2008). This sentiment is supported by the British Social Attitudes survey of English opinion, which found that three-quarters of those surveyed agreed with the statement that 'now Scotland has its own parliament, it should pay for its services out of taxes collected in Scotland' – a view that 57 per cent of Scots agree with too (Curtice 2008b).

While the Union currently enjoys popular support across the UK (Curtice 2008a) it seems clear that concerns about the distribution of public spending have the potential to create tension between the four nations. Failure to act now and address the issue of devolved funding could have implications for the future of the Union.

2. Principles for distributing public spending in a Union-state

Before we look at how the Barnett formula works and how public spending is currently distributed, it is helpful to be clear about the key principles that should underpin a progressive distribution of spending. Below we suggest that the mechanism used to distribute funding across a decentralised political system such as the United Kingdom should adhere to the following principles: equity, efficiency and accountability, and procedural fairness.

Equity

Public expenditure should be allocated across the UK on an equitable and fair basis. By equity we mean sharing risk across a state, so that each area can provide the same standard of public services regardless of the wealth of the area or if delivery of those services costs more in some areas (for example, due to higher wages or sparsity of population). Essentially this is a principle of redistribution. A crude way to ask whether the distribution of public spending is equitable is to check whether, in general, transfers flow from rich people and areas to poor people and areas. A more sophisticated way is to ask whether public expenditures secure an equivalent level of public services to citizens all over the UK, irrespective of the region they inhabit. Thus if region A gets more public spending per head than region B, the reason could be because people are poorer in A than in B, and/or that it costs more in A than in B to deliver a standard level of public services (on this, see especially Blanchflower and Oswald 2005).

This version of equity – or fiscal equalisation – is important, as without it poorer areas would be likely to provide poorer public services (as they have a lower tax base to draw upon), and it would be the poorest people in those areas that would suffer most as a result. In a multi-national or union-state like the UK, fiscal equalisation can also play an important role in maintaining the unity and cohesiveness of the state.

When it comes to assessing how equitable – or fair – the current distribution of public expenditure is we compare the actual distribution with the distribution that would occur if public expenditure were designed to meet relative needs.

Efficiency and accountability

The funding system must also ensure that the way spending is distributed provides sufficient incentives for prudent and responsible spending and more generally for economic growth. An efficient system will encourage money to be spent effectively and to grow the economy and tax base of the area. This is good not only for that area but also for the economy of the country as a whole. In decentralised political systems the debate about economic efficiency concerns the balance between the spending and revenue powers of sub-national governments – and, therefore, the degree to which they are dependent on grants from central government to fulfil expenditure responsibilities.

A strong theme that emerges from the academic literature is that a degree of fiscal autonomy – the extent to which devolved administrations are responsible for raising at least some of the revenue they spend – has an important role to play in encouraging efficient spending. Conversely, it is argued that where there is a lack of fiscal autonomy – where the link between revenue and spending is severed and where the sub-national government is entirely dependent on transfers from central government – perverse incentives can arise which might encourage inefficient and profligate spending (see Scott and Jeffrey 2007 for a discussion).

Debates on efficiency extend beyond important but narrow economic concerns and also relate to the degree to which financial arrangements ensure political and parliamentary accountability. It could be argued that the most effective form of political accountability is realised when the level of government that is responsible for spending public money is also responsible for raising that money. In such circumstance the electorate can make a judgement on the revenue raising and spending decisions made by the Government. However, it would be wrong to assume that there is no accountability in a situation where the devolved body is responsible for spending the money but not raising it (where it would be provided through a central government grant). This is because the devolved body is still accountable to the electorate for the way in which it chooses to spend the money. Moreover, the desire for political accountability needs to be balanced against the principle of equity: poorer areas, with lower tax bases, will require transfers from richer areas to carry out the responsibilities devolved to them.

Procedural fairness

Morgan (2001) adds an important criterion when he argues that the distribution of public spending should be transparent. In other words not only should the distribution of public spending be fair, but in order to carry legitimacy and be sustainable in the long run, it must be seen to be fair. We call this the principle of procedural fairness and will later go on to consider how fair the current system for distributing public spending in the UK is perceived to be.

Before going on to assess the Barnett formula against these principles, which we do in section 4, section 3 will outline how public money is distributed to the devolved administrations in Scotland, Wales and Northern Ireland through the Barnett formula.

3. How public spending is distributed to the devolved administrations

Reflecting on the notoriously complex Schleswig-Holstein question, Lord Palmerston is believed to have said that of the only three men in Europe who had ever understood it, one was dead, one was mad, and the third, Palmerston himself, had forgotten what it meant. Much the same could be said of the widely misunderstood Barnett formula. This section will explain how the formula works, what it is and what it is not, before outlining some key concerns with the Barnett formula as a mechanism for financing devolution.

The Barnett formula plays a central role in how the devolved administrations are financed. It is not the sole source of public spending in the devolved territories as the UK government also spends public money on reserved functions in or for each territory. The monies flowing through the Barnett formula constitute the majority of the public money spent in each devolved territory, and the vast majority of the funds available to the devolved administrations. However, the formula is not statutory, and could be revoked unilaterally by the UK government.

The Barnett formula actually pre-dates devolution by many years, having been in operation since at least 1978 (for a brief history of the Barnett formula see Box 3.1). Prior to devolution the formula allocated funds to the territorial offices of state (Scottish, Welsh and Northern Irish Offices). Since devolution it has allocated a block grant to each of the devolved administrations (DAs). The block grant is their most important source of public expenditure, as it is unconditional, giving them a great deal of flexibility over how they fund devolved functions. But while the devolved administrations have wide discretion over spending, they have limited scope to raise their own revenue: all have powers over business rates and council tax (domestic rates in Northern Ireland), and Scotland also has the thus-far unused 'tartan tax' – the power to vary the standard rate of income tax by 3p in the pound.

The formula is used to distribute monies from the UK government to the devolved administrations based on planned spending[1] in England. However, while based on spending in England, it does *not* govern the allocation of spending within England, either to regional bodies or local government (see Box 6.1 and McLean 2005). The Barnett formula also does *not* determine the absolute level of the DAs' block grant; rather it determines the increase (or decrease) to a baseline block grant with each spending review or comprehensive spending review. The baseline is the result of historic patterns of public expenditure, which in the 1970s (when the Barnett formula was established) were too generous to Scotland and Northern Ireland, and not generous enough to Wales (see Box 3.1).

The formula calculates the increase or decrease to the block grant by considering three elements:

- The changes in spending for England (or England and Wales in some cases) by UK departments
- The 'comparability percentage', which essentially refers to the extent to which a programme or service is devolved[2]
- The size of the population compared with England.

1. Public spending in the UK is divided into planned spending known as Departmental Expenditure Limits (DEL) and Annually Managed Expenditure (AME). DELs are three-year spending limits assigned to government departments in the regular spending and comprehensive spending reviews. AME cannot be planned in this way as it is based on entitlement. Social Security is the biggest element of AME spending.
2. The Barnett formula operates on DEL spending.
For programmes and areas where there is devolution, when spending is increased in England, monies will go to the devolved administration to fund a 'comparable' programme (although in reality, due to the unconditional nature of the block grant, it could be used to fund something different instead).

So, following every spending review the following calculation is made:

Change to UK Department's Programme	*X*	*Relevant comparability percentage*	*X*	*Relevant population proportion*

The result is known as a 'Barnett consequential'. The calculation is made for each UK government department and the sum is the net change to the DAs budget.

To put it another way, this effectively means that for every one pound of *extra* spending in England each year on a service which is devolved, Scotland, Wales and Northern Ireland will get an increase in their block grant proportionate to their relative populations. Originally the proportions were set arbitrarily at 85:10:5 for England, Scotland, and Wales. So, for every 85p of extra spending in England, Scotland would get 10p added to its block grant, and Wales 5p. These population proportions were too generous to Scotland (and too mean to Wales) until altered by Michael Portillo, as Chief Secretary to the Treasury, in 1992, to the correct population proportions. Now they are rebased for the following two or three years after every spending review.

It is clear from this that the Barnett formula is *not* about needs. It is not based on any assessment of either relative needs or of costs of services. Rather it is based on historical spending levels and relative population. In this respect it is unlikely to meet the equity principle outlined above.

Furthermore, the Barnett formula was not designed as a long-term solution for how to distribute spending in the UK. Rather it was a temporary expedient designed to reduce the spending disparities across the nations of the UK over time (see Box 3.1).

It was designed to ultimately bring about equal spending per head in the four territories of the UK, slowly reducing the differential in spending levels per head between Scotland, Wales, Northern Ireland and England. This is known as the 'Barnett squeeze', a process that should occur when public spending within England increases. The idea was that in the long run, the original baseline, under which each country got more per head than England, would become swamped by the successive increments added every year. When spending had converged sufficiently to be aligned with needs, Barnett was to have been replaced by a needs-based system (Mitchell 2003, McLean 2005).

The long run, however, has been longer than anyone anticipated in 1978, and the Barnett formula remains in place. And, as we will explore in section 4, there does not appear to be conclusive evidence of the Barnett squeeze operating in Scotland (although it is true that spending has squeezed in Wales and Northern Ireland). In part this is because the Conservative Party, as the pre-eminently unionist party at the time, so feared a nationalist threat to the continuation of the United Kingdom that whenever Barnett threatened to produce embarrassing results they found ways to bypass it throughout the 1980s and most of the 1990s.

Drawbacks of the formula

This points to one of the major drawbacks of the Barnett formula as a means of funding the devolved administrations: its lack of procedural transparency. While the Barnett formula itself is reasonably straightforward, as set out in the mathematical formula above, what seems more arbitrary is the process by which the Treasury determines whether spending is subject to Barnett or not. In a small number of cases spending is deemed to be exceptional, and of benefit to the UK as a whole, and therefore outside the Barnett formula, such as the Channel Tunnel or the 2012 Olympic Games.

However, the process through which such a classification is made is unclear, and is not underpinned by any published criteria, and can therefore lead to tensions between the UK government and the DAs. For example, there is currently disagreement between the DAs and the Treasury regarding the Olympics being classified as of benefit to the whole of the UK, as the DAs are arguing that the regeneration elements of spending on the Olympics should have Barnett consequentials.

A further example of the tension that can be caused is that of the £1.2 billion increase in spending on prisons in England and Wales in response to the Carter Review and pressure on prison places. This extra spending was taken from the UK reserve, outside of the Comprehensive Spending Review, meaning there was no Barnett consequential for Scotland. This decision has provoked a strong response from the Scottish Government who claim that Scotland is being financially penalised.

There have also been instances of the Barnett formula being 'bypassed', a process by which the UK government gives the DAs money without using the formula. For example, the Treasury's decision to provide match funding to enable Wales to draw down Objective 1 funding from the European Union was taken outside of the Barnett formula.

While this flexibility has some benefits, it is the uncertainty and sometimes seemingly arbitrary nature of when spending has Barnett consequentials and when it does not that lacks transparency and creates tension between the nations – especially when there are different parties in power.

A further drawback to the Barnett formula as a means of financing the devolved administrations is that they have little control over the size of the block grant that is available to them, as it is based on decisions taken by the UK government (or more specifically HM Treasury) for England. This would be a particular problem if, for example, the Scottish government wanted to increase spending at a time when the UK government (acting for England) was cutting spending, as should the UK government decide to cut spending on, say, the health service in England (an area where there is a very high degree of devolution or 'comparability') the result would be less spending for the devolved administrations through the Barnett formula. In such a scenario the DAs would be constrained in their ability to shape their own policy agendas, which not only has the potential to bring them into conflict with the UK government, but which might also serve to undermine devolution.

This problem is compounded by the limited number of options available to the DAs to raise revenue themselves, meaning they do not have many alternative sources through which to top up their block grant should they wish to.

These drawbacks were more manageable when Labour was in power across the UK, but become increasingly problematic when different parties are in power, not least Nationalist parties, as they provide a platform for intergovernmental conflict. As King notes, with the DAs dependent on a grant they cannot determine the size of, they will blame the UK government not only when they believe their funding from central government is insufficient, but whenever they have 'any political reason to wish to *assert* that their revenues are insufficient' (King 2007: 198). King rightly suggests that the political problem with Barnett is that it 'institutionalises infinite blame potential' (ibid).

Box 3.1. A brief history of the Barnett formula

The Barnett formula was established in 1978 and succeeded another allocation formula, known as the Goschen Proportion, which dated back to 1888. Under these formulae Scotland has enjoyed higher public spending per head than England since about 1900.

A number of reasons are often given to explain this disparity, including: Scotland's weak economic position relative to other parts of the UK and the additional costs incurred in delivering public services across such a sparsely populated country. However, the biggest reason might be political. With the rise of Scottish nationalism, some have suggested that the UK government has tried to placate separatism and keep Scotland in the union by giving it extra public money. This was a policy pursued (vainly in the end) by the UK government in its attempt to keep Ireland in the union, and was known as *killing Home Rule by kindness* (McLean 2005).

The Goschen Proportion assigned £11 to Scotland for every £80 assigned to England and Wales on particular programmes, to be spent by the Secretary (of State) for Scotland who oversaw Scottish public administration. The proportion was based on share of the population, but by 1901 Scotland had dropped below 11/80 of the population of England and Wales, and has continued to drop further below. By the time the ghost of Goschen finally vanished in the 1970s, public spending per head in Scotland was about 20 per cent above that in England (and substantially higher than in Wales, which was as poor as Scotland and also has a sparse population). But the Secretary of State

cont. next page

could protect the Goschen Proportion because he had a credible threat at his back. He could tell the Cabinet that unless they protected Scotland's spending share the Nationalists would start winning elections, and where would the United Kingdom be then?[3]

The prospect of an SNP triumph began to look more plausible in the 1970s, leading Prime Minister Harold Wilson to announce plans for devolution in summer 1974.[4] As it was, the 1979 referendum in Wales led to a crashing No vote. In Scotland there was a faint Yes, but far below the 40 per cent threshold that had been set following an English backlash.[5] But in the run up to the referendums plans were laid for life after devolution. The Treasury conducted a needs assessment, to inform the design of a needs-based funding formula for devolution. This assessment, not published until 1979, gave the following numbers for the relative needs and the actual spending in the four countries of the UK, for the services that the Scotland and Wales Acts would have devolved (Table 3.1). This suggests that Scotland and Northern Ireland were receiving more than their need would suggest, while Wales was receiving less.

Table 3.1. HM Treasury 'Needs Assessment', 1979 (data for 1976-7)

	England	Scotland	Wales	Northern Ireland
Relative needs assessment	100	116	109	131
Actual spending levels 1976-7	100	122	106	135

Note: The Treasury used a range of 'objective factors' in its needs-assessment, including: age, road lengths, crime levels and housing.
Source: HM Treasury Needs Assessment – Report (1979), esp. para 6.5.

Treasury papers released to us under a Freedom of Information (FoI) request in May 2005 include the service-by-service assessments that led to these summary numbers. Hints in the published document already suggested that there was a fight between the Treasury and the territorial departments. The FoI release confirms this. The Scots fought for a health formula that would record Scotland's 'needs' as being higher than the Treasury was prepared to concede. The matter was fought to a draw, when Mrs Thatcher drew stumps by winning the 1979 General Election, which along with the collapse of the devolution campaigns meant that neither devolution nor the planned needs-based system was ever implemented.

However, the Treasury's other preparative step has lasted. This was the Barnett formula, named after Joel Barnett, then Chief Secretary to the Treasury. Officials at the Treasury had designed the formula as a temporary expedient to reduce Scotland's relative spending advantage until a needs-based formula could be introduced. Lord Barnett, as he now is, told a Commons Select Committee in 1997 that he expected the formula would not last more than 'a year or even twenty minutes' (House of Commons Treasury Committee 1998). It has not only lasted, but it is still used today.

3. All Secretaries of State have done this, but the supreme practitioners have been Tom Johnston (Lab., in the Churchill wartime coalition 1941-5), Willie Ross (Lab., 1964-70 and 1974-6), Ian Lang (Cons., 1990-5) and Michael Forsyth (Cons., 1995-7). A recent Freedom of Information release proves that George Younger (Cons.) and his officials successfully fought off a Treasury attempt to subject Scotland to a needs assessment in 1984. Younger's main argument was the 'credible threat' argument.
4. In fact, the electoral system did for them more effectively than Wilson. In October 1974, the SNP got 30 per cent of the vote in Scotland to the Conservatives' 24 per cent, but only 11 seats to the Conservatives' 16. Labour retained the majority of Scottish seats on a minority vote. With 35 per cent of the vote, the SNP would have swept the board, won more than half the seats in Scotland, and started to negotiate independence.
5. An English backlash caused a Government defeat which killed the original flagship bill in 1977. Separate bills for Scotland and Wales were then enacted, but rebels added sections requiring a referendum on the plans, with a 'Yes' vote not to be confirmed unless at least 40 per of the electorate voted Yes.

4. Where public money is spent across the nations and regions of the United Kingdom

In this section we show where public money is actually being distributed across the nations and regions of the UK. In the absence of comparable data on monies distributed by the Barnett formula we use we use data from HM Treasury's *Public Expenditure: Statistical Analyses* (PESA). PESA is published annually and gives figures for 'identifiable' public spending per head across the nations and regions of the UK. The nations and regions are: the three devolved administrations in Scotland, Wales, and Northern Ireland; and the nine standard regions of England (North East; North West; Yorkshire and the Humber; East Midlands; West Midlands; East of England; London; South East; and South West).

Identifiable public spending is that which can be identified as benefiting the population of a particular region. Allocating some spending requires a sophisticated approach: for instance, the headquarters expenditure of Whitehall departments is neither treated as unidentifiable, nor is it lumped on to London or wherever the HQ office is. Rather, it is apportioned out among the regions in the same proportion as each department's programme expenditure. Expenditure on things which are in one region but also benefit people in other regions is apportioned out as best as possible – for instance, spending on national museums is apportioned by the mix of their visitors; expenditure on rail support by the pattern of where journeys are made, and so on.

Over the years the Treasury has increased the percentage of public expenditure that is deemed identifiable so that in the latest PESA, 83 per cent of public spending is currently identified as benefiting a particular region (HM Treasury 2008). The remaining 'non-identifiable expenditure' covers spending which is intended to provide public goods equally to each citizen of the UK irrespective of residence. This includes defence (by far the largest item); intelligence agencies; foreign affairs; overseas aid; and the running of national systems of taxation – so that the cost of running the Treasury, HM Revenue and Customs, and the Office for National Statistics themselves are treated as non-identifiable.

Analysis of identifiable public expenditure therefore enables us to compare the distribution of public expenditure across the nations and regions of the UK.[6] For Scotland, Wales and Northern Ireland identifiable public spending figures include all spending through the Barnett formula *plus* other central government spending in those territories (but minus non-identifiable expenditure). By far the largest item of central government spending in the territories is social security spending, which makes up over 80 per cent (see HM Treasury 2008, table 9.17). Social security, along with items such as farm support, is an entitlement rather than planned spending, and is therefore not subject to the Barnett formula. To get a more accurate account, therefore, of what the devolved administrations receive through Barnett we need to remove expenditure under the headings 'social protection' (benefits and pensions) and 'agriculture' (farm payments)[7] from the identifiable public expenditure figures.

This manipulation of the PESA data gives us the most accurate set of figures for money that flows to the devolved administrations via the Barnett formula.[8]

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6. Following the McLean Review (2003) the PESA's country and regional analysis data has improved significantly, enabling reasonably direct comparisons of identifiable public spending per head across the countries and regions of the UK. Previously there was some very sloppy practice. For example some Departments simply divided their reported expenditure in England according to the relative populations of the nine regions. This resulted, for instance, in London reportedly having the second-largest flow of farm support of any of the nine regions – just because it is the second most populous.
7. The most recent changes to PESA, described above, have brought more agricultural spending into DEL. But to present a consistent time series, we have excluded agricultural spending from our tables.
8. Further reinforcement of this method can be found in a further PESA table which breaks down identifiable spending in Scotland, Wales and Northern Ireland into that which is spent by the devolved administration, local authorities, territorial Whitehall departments (Scotland Office, Wales Office etc) and other UK departments. Analysing these figures confirms that over 80 per cent of spending by UK government departments in Scotland, Wales and Northern Ireland is on social protection.

Figure 4.1: Index of identifiable public expenditure per head in the Nations of the UK, not including social protection and agriculture. UK=100

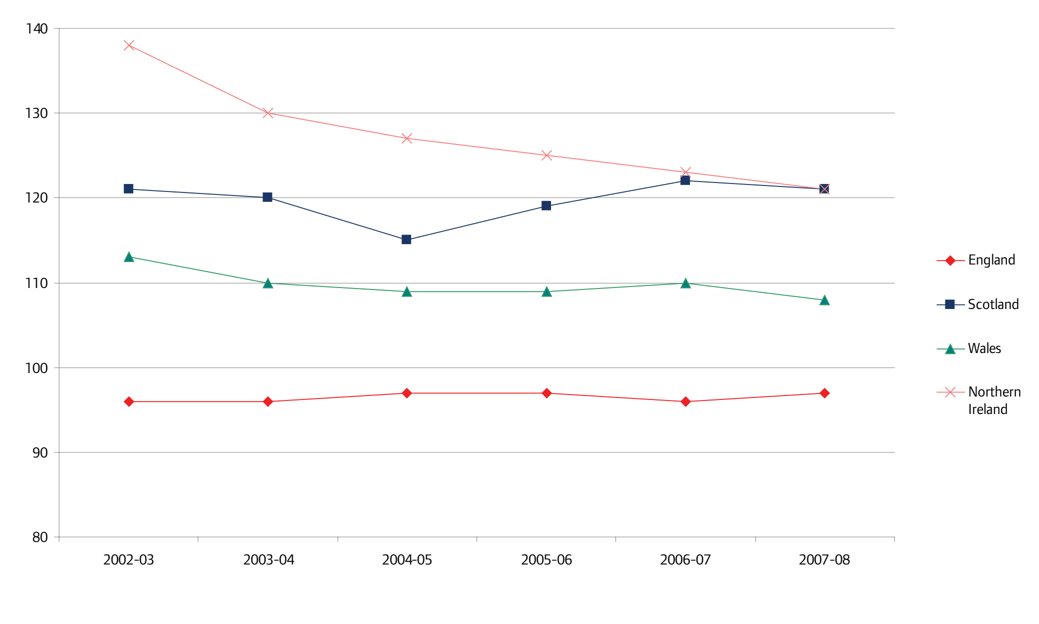


Figure 4.1 gives data for 'identifiable' public expenditure in England, Scotland, Wales and Northern Ireland, minus entitlements, for the last five years. The data are presented as an index, where the UK average is 100.

The graph shows that of the four nations of the UK, Scotland and Northern Ireland receive the highest public expenditure per head while England receives the lowest. In 2007-08 spending per head in Northern Ireland and Scotland was 21 per cent above the UK average, in Wales it was 8 per cent above, while in England it was 3 per cent below the UK average. To put it another way, this means that spending per head in Northern Ireland is £1,161 more than in England; £1,153 more per head in Scotland than in England; and £527 more per head in Wales than in England.

Figure 4.1 provides some evidence of the Barnett squeeze operating in Wales and Northern Ireland in particular, where the level of public spending has declined from 2002-03 to 2007-08: in Wales spending fell from 13 to 8 per cent above the UK average in this period, and from 38 to 21 per cent above the UK average in Northern Ireland. In the latter case some of this decline may be accounted for by reduced spending on security, policing and public safety as the peace process progresses. In Scotland, however, there is little evidence of a spending squeeze. Spending per head may have declined between 2002-03 and 2004-05 (from 21 per cent above the UK average to 15 per cent above), but it then increased again sharply from 2004-05 onwards. The evidence presented here, however, suggests that there is little chance of the Barnett formula delivering its goal of bringing each of the three devolved administrations to a position of equal per capita spending with England in the near future. Consequently, public disquiet over the disparities in spending between the nations of the UK, and between England and Scotland in particular, is unlikely to abate.

From our analysis we can make two further observations. Firstly, some have suggested that the lack of a spending squeeze in Scotland is best explained by additional spending it receives from funding that operates outside the Barnett formula, of which social security is the largest (see for instance Bell and Christie 2005). However, while it is true that expenditure per head on social security in Scotland is higher than that in England our decision to remove social protection spending from our calculations shows that Scotland is still receiving significantly more public money than England once the social security spend has been accounted for. In other words it is not correct to suggest that increased per capita spending in Scotland is simply the result of spending outside Barnett.

Secondly, we would note that Barnett has failed to squeeze in Scotland during a period in which we have witnessed an almost unprecedented growth in spending on public services within England by the UK Labour government. This is significant because it is precisely when spending in England increases that Barnett is supposed to squeeze in the devolved territories (see above). Given that public spending within England is set to grow at a lower rate than in recent years, there will be less for Barnett to bite on in future years, which is further proof that the debate on Barnett is only likely to become more – not less – salient.

Improvements to PESA following the McLean Review (2003) also enable us to make reasonably direct comparisons between public spending per head for each of the four countries of the UK, and for each of the nine regions of England. While the Barnett formula does not allocate spending to England or the English regions, including the regions in the analysis paints a richer picture of how public spending is distributed around the UK. The latest set of figures, published in May 2008, has reliable numbers going back to 2002-03. There are no comparable numbers for the years before 2001-02 (which were published along with PESA 2007); the numbers previously published for earlier years and used by various analysts (including ourselves) are not reliable enough to make any fair deductions (McLean 2003).

Figure 4.2 shows the identifiable public spending per head across the nations and regions of the UK (minus social protection and agriculture) for the last five financial years. Again, expenditure per head for each region is expressed in relation to the UK average, which is set to 100. Therefore a region with above average expenditure per head is above the 100 line, while those receiving less than average expenditure per head appear below the line. The data is also provided in Table 4.1.

Figure 4.2 Index of identifiable public expenditure per head across the nations and regions, minus social protection and agriculture (UK=100)

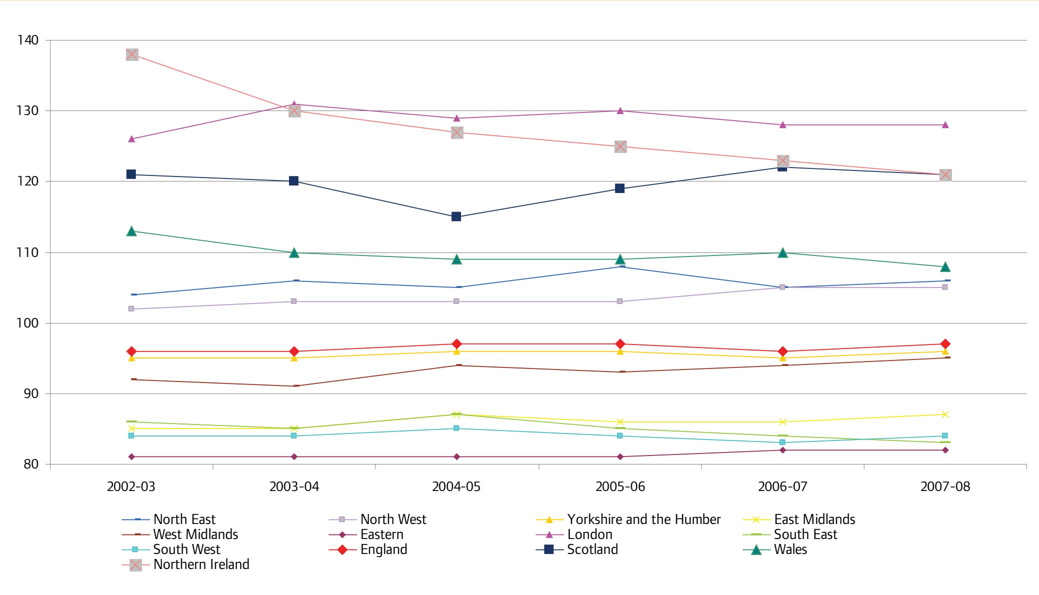


Table 4.1: Identifiable public spending per head, minus social protection and agriculture, and deviation from the UK average, across the nations and regions of the UK 2007-08

Nation / region	£ per head	% deviation from UK average
London	5,985	+28
Northern Ireland	5,684	+21
Scotland	5,676	+21
Wales	5,050	+8
North East	4,960	+6
North West	4,927	+5
UK	4,679	0
England	4,523	-3
Yorkshire and the Humber	4,477	-4
West Midlands	4,430	-5
East Midlands	4,086	-13
South West	3,947	-16
South East	3,874	-17
East of England	3,820	-18

As Figure 4.2 and Table 4.1 demonstrate there is considerable variation in spending per head between the different parts of the UK. They also show that the pattern of spending has been fairly stable throughout the 2002-03/2007-08 period (with the exception of Northern Ireland). From 2003-04 onwards London received the highest public expenditure per head, a mantle held by Northern Ireland for many years. In 2007-08 spending per head in London was 28 per cent above the UK average. In Northern Ireland and Scotland it was 21 per cent above. Wales, the North East and North West of England were the only other regions in receipt of spending above the UK average, but received considerably less than that received by Scotland, Northern Ireland and London. To take the North East, for example, in 2007-08 London received £1,025 per head more than the North East, Northern Ireland £724 per head more and Scotland £716 per head more.

England as a whole and all the English regions other than the North East, North West and London received public spending per head below the UK average, ranging from Yorkshire and the Humber which received 4 per cent less than the UK average, to the East of England, which received 18 per cent less than the UK average. The spending gap between the top (London) and the bottom (East of England) is £2,165 per head.

With such sizeable variation in the level of public spending per head across the nations and regions of the UK it is perhaps not surprising that a debate on the distribution of public spending is rising up the political agenda. Three regions consistently stand out as being in receipt of large amounts of public spending per head: London, Northern Ireland and Scotland.

5. Does the current distribution of spending match our key principles?

Having established how public money is distributed in the UK, this section seeks to assess it against the three principles we outlined in section 2: equity, efficiency and accountability, and procedural fairness. As a progressive distribution of spending should place a particular emphasis on equity, the first sub-section below considers this at some length, and includes original analysis which explores the degree to which spending and need coincide across the nations and regions of the UK. We then go on to consider more briefly each of the other principles.

It is important to note that when it comes to comparing the funding system against these principles we focus on territorial funding allocated through the Barnett formula to the devolved administrations. It is outside the scope of this paper to fully assess the strengths and weaknesses of various mechanisms used to distribute funding within England itself (for a detailed discussion of this see McLean 2005; see Box 6.1 also). Nevertheless, when it comes to considering the fairness of the current distribution of spending our analysis extends to include all English regions as well as the nations of the UK.

Is the distribution of public spending equitable and fair?

Equity – or fairness – is essential not only for a progressive approach to distributing public spending, but also for maintaining public legitimacy of the state.

As we established in section 2 the most basic – although admittedly crude – way to assess whether spending is fair or equitable is to see if, in general, poorer people and areas receive more money than richer people and areas. For our purposes the way to think about this is to ask whether the rank-order of public spending set out in Figure 4.2 above is fair. To answer this we ask whether the current distribution of spending is the one we might expect to see if the nations and regions were ranked according to relative need.

To try to address this the following analysis attempts to explore the correlation between public spending and need. To do this we use two proxies of need: economic performance and poverty. To measure economic performance we use Gross Value Added (GVA) per head, and to measure poverty we use relative household income. However, it is important to note that while both these indicators are important, and ones that an equitable distribution of public spending should be concerned with, they inevitably give an incomplete account of the correlation between spending and need. A full needs assessment would have to include a range of other measures, including for instance, demographics, mortality rates and sparsity of population, weighted by their importance. Clearly what indicators are chosen for a needs analysis and the weighting that is accorded to them is not a perfect science, and there will be political decisions involved in what is and is not deemed important. However, such a complex calculation is beyond the scope of this paper, so we confine our analysis to these two measures.

We use economic performance as a measure, as the often heard argument from those that object to the UK's distribution of public spending is that greater spending should go to economically poorer regions. We use GVA per head as it is a measure of economic output and a good general measure of economic performance. However, we recognise that GVA is an imperfect measure of need as it does not give an indication whether people in a given territory share the benefits of strong economic performance. This is a particular problem for a region like London where there is a wide wealth disparity. We also, therefore, provide a second analysis, comparing spending to poverty, as a more widely accepted indicator of need, and one that is concerned with the relative distribution of income.

For each measure, we first present the rank order of how the regions perform on that indicator. We then provide a more sophisticated picture of how spending and need correspond by combining the datasets and conducting a thought experiment: we ask what the distribution of spending would look like if all identifiable expenditure was designed to assuage need. In that case, it would be perfectly inverse to GVA and the prevalence of poverty. The richer a region, or the less impoverished a region, the less public expenditure per head it would receive. The more impoverished a region, the more public expenditure per head it would receive. The formula we use to calculate the correlation can be found in Appendix 1.

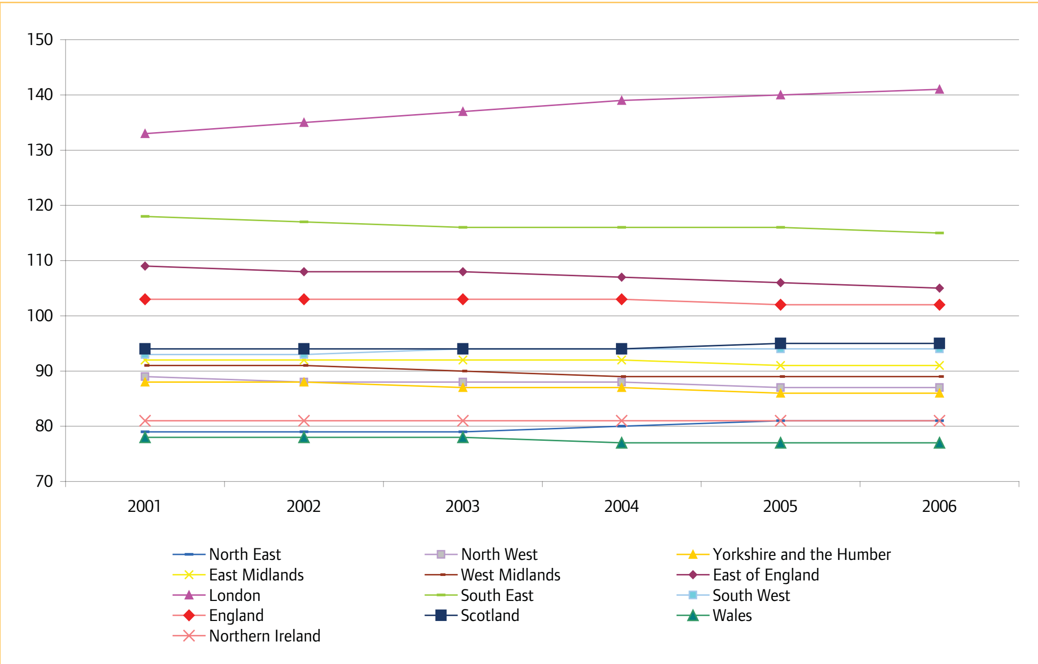
Comparing the distribution of public spending to economic performance

To assess the correlation between the distribution of public spending and economic performance we have used the Office for National Statistics (ONS) income statistics for the UK's 12 standard regions, under the heading of Gross Value Added (GVA) per head. GVA is a standard output measure used by the Government to analyse economic performance over time and across regions and industries. The reliability and comparability at the regional level are of particular importance for this analysis. But as a measure it does have its limitations in that it includes only goods and services sold in the market sector of the economy, or those not sold on the market but whose value is imputed by ONS (for example public services like health and state education). It therefore misses out household production, and includes no measure for many things that people value in life, such as the environment and relationships with friends and family.

As with PESA, we need to know something about how the figures are compiled before we can safely use them. Whereas the PESA figures relate to expenditure over a financial year, the GVA per head figures are collected annually to relate to a single point in the year (December). Because of the interdependent nature of the nations and regions there has to be some uncertainty about the GVA figures. As far as possible, the value added by people (labour income) has been assigned to the place they live rather than the place they work. Getting this right is most important for the three south-eastern regions, since millions of people commute from the South-East and the East of England region to London (and a non-trivial number commute the other way). The value added by capital is more difficult to calculate, as one needs to know not only where firms' HQs are located, but where their plants are located, and which plants are adding value within the firm. Therefore, through no fault of ONS, it is necessary to treat the GVA per head figures with more caution than the public expenditure figures in PESA.

One more qualification is important, especially for Scotland. The ONS classifies some GVA as 'Extra regio', which refers to value added outside the territory of the UK. The main category is the processing of oil in the North Sea. The Scottish Nationalists would, of course, prefer it to be assigned to Scotland, and the tax proceeds from it retained in Scotland. If it is assigned thus, it makes Scotland appear a relatively wealthier part of the UK than it does in Figure 5.1. However, this cuts both ways. If Scotland is (even) wealthier than shown in Figure 5.1, then its high public spending per head (Figure 4.2) is (even) more anomalous.[9]

Figure 5.1. Index of GVA per head (UK less Extra-Regio = 100)



9. The issue is discussed further in the annual GERS (*Government Expenditure and Revenue in Scotland*, a Scottish Government National Statistics publication), which enables the analyst to calculate the balance of revenue and spending in Scotland in the event that various proportions (up to 100 per cent) of oil tax revenue were to be assigned to Scotland.

Figure 5.1 provides an index of GVA per head for the nations and regions of the UK, where 100 is the average GVA per head for the UK. Therefore regions that lie above the 100 line are those adding more value per head than average for the UK, and the remaining regions add less.

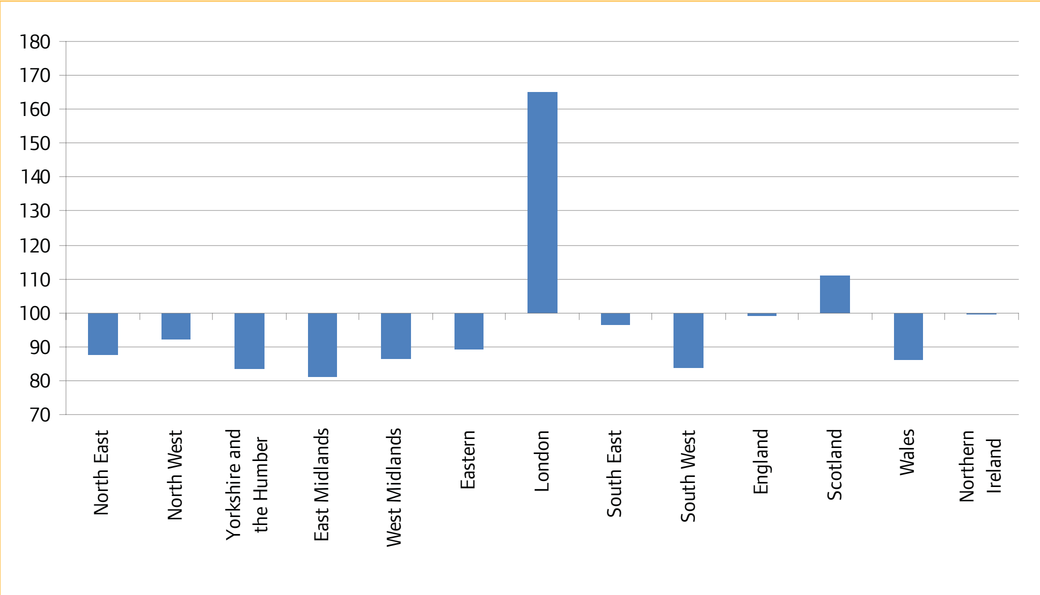
The richest region (alternatively, the region adding the most value) by far is London (41 per cent above the UK average), and its relative advantage is increasing. The two other southern regions, South East and East of England, come second and third, respectively 15 and 5 per cent above the UK average. England is the richest of the four nations at 2 per cent above the UK average. Scotland comes next at just 5 per cent below the UK average, and is followed by the South West and the two Midlands regions. The trailing regions are those that have trailed for decades: the North West (13 per cent below the UK average), Yorkshire and Humber (14 per cent below), Northern Ireland and the North East (both at 19 per cent below) and Wales, which at 23 per cent below the UK average is the region that adds the least value per head.

Of interest here is the relative prosperity of Scotland compared to a number of English regions, particularly those in the north, and Wales. One of the historic arguments used to justify extra spending per head in Scotland was her relative poor economic performance. But these data show that Scotland actually performs better than several regions of the UK, something supported by wider analysis which shows that Scotland's economic situation relative to the rest of the UK has improved considerably since the 1970s when the baseline blocks for grant allocation were put in place (Scott and Jeffrey 2007). And yet, as we have seen in Figure 4.2, Scotland still receives more public money per head than all regions of the UK outside of London (it gets the same as Northern Ireland). So although Scotland has a much higher GVA per head than Wales, for instance, it actually receives a higher level of public expenditure through the Barnett formula than Wales does (in 2007/08, for instance, Scotland received £626 more per head than that allocated to Wales).

Now we compare this ranking of GVA per head with the distribution of public spending for the year 2006-07 (the most recent year for which GVA per head figures are available), to see whether spending and need correlate. To do this we first align the economic performance figures into the financial year in which they belong. Thus GVA for December 2006 is assigned to financial year 2006-07, the December 2005 figure to financial year 2005-06, and so on. Then we apply our formula (see Appendix 1).

The results are presented in Figure 5.2. Here, the 100 line represents the point at which spending and need correspond, those above the 100 line are receiving more than their need would suggest, and those below the line, less.

Figure 5.2: Identifiable public spending per head compared to GVA per head (100=public spending in line with 'need') 2006-07

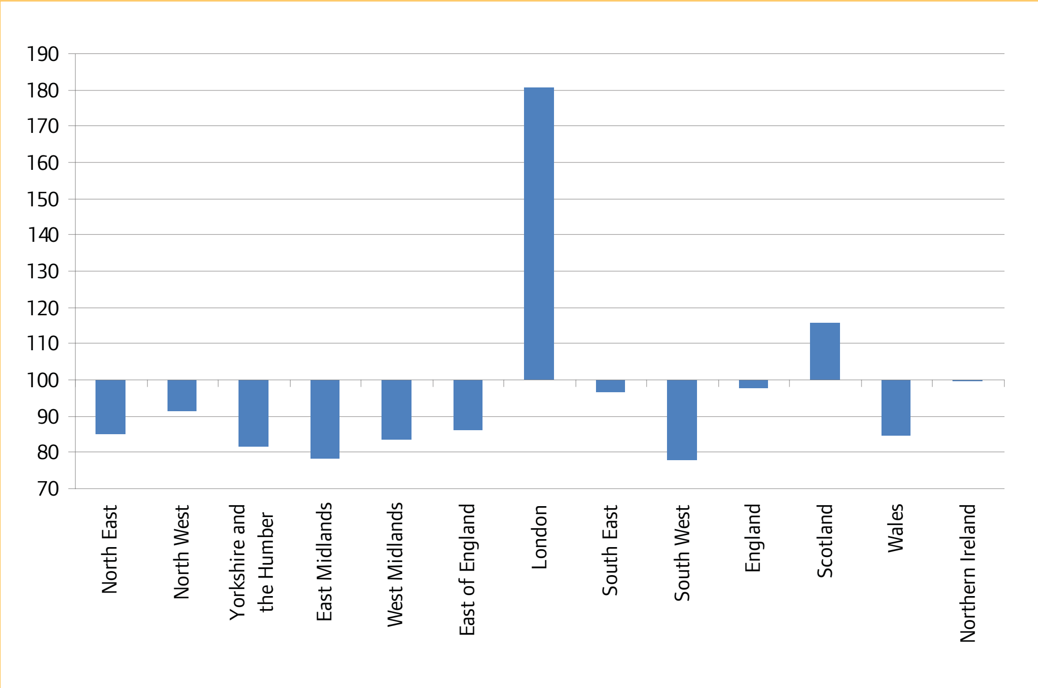


The two regions above the line in Figure 5.2 (London and Scotland) are therefore those that are receiving more than they would get if all public spending were allocated on the basis of GVA per head. On this basis London receives 65 per cent more, and Scotland 11 per cent more than they would do if all public spending was based on GVA per head.

Northern Ireland, England as a whole, Wales and all the English regions other than London are receiving less. The region doing 'least well' on this measure is the East Midlands, which receives 19 per cent less than it would if spending was based on GVA per head. It is closely followed by Yorkshire and Humber (17 per cent less), the South West (16 per cent less) and Wales and the West Midlands (both receiving 14 per cent less).

Next, we refine the figures somewhat. As discussed above we remove social protection and agriculture from the spending figures, in order to get an idea of the correlation without entitlements in case this is skewing our findings. The result is shown in Figure 5.3.

Figure 5.3: Public expenditure compared to GVA, excluding social protection and agriculture (100=public spending in line with need) 2006-07



The effect of this change is to sharpen the distinction between London and all other regions. On this basis, in 2006-07 London received 80 per cent more spending per head than would be predicted if planned public expenditure were assigned on the basis of GVA per head. Scotland is also still ahead (by 16 per cent). As with Figure 5.2, all other regions are below the index level where public spending and need are in line. The regions that do the 'worst' are the East Midlands and South West, both receiving 22 per cent less spending per head that would be predicted if expenditure were assigned on the basis of GVA per head. They are closely followed by Yorkshire and the Humber (18 per cent less) and the West Midlands (16 per cent less).

It would be premature to jump to the conclusion from this analysis that London receives far too much public spending (or conversely that the East Midlands receives too little), as this is based on just one measure of need. This is particularly the case for London, where there are wide disparities between inner and outer London, for instance, and where the City of London exists cheek by jowl with some of the country's poorest communities. Using regional GVA per head data conceals these internal disparities. Moreover, we need to recognise the special status of London as a capital city, which will account for some of the extra spending it received. To strengthen this analysis we now compare spending to the prevalence of poverty.

Comparing the distribution of public spending to poverty

In order to compare the distribution of public spending to poverty we use the Department for Work and Pensions' annual Households Below Average Income (HBAI) series. This dataset provides income data at a household level based on the Family Resources Survey (FRS). HBAI data, despite its name, covers all income at a household level, not just households with low income. However, the key figures that are of interest for our purposes are those on poverty, understood as households with an income below 60 per cent of median income, either before or after housing costs.

The large sample size of the FRS (over 28,000 households were interviewed across the UK in 2005/06) provides a robust dataset that can be analysed at the national and regional level. However, the regional averages are presented as three-year averages to smooth out year-on-year variation as the single-year regional estimates are considered too volatile. The UK data is presented as a single-year average. HBAI provides data on poverty among the general population and among children at the national and regional level. As a general measure of need we use the data for poverty among the general population for our calculations below.

Figure 5.4 provides an index for those not at risk of poverty across the nations and regions in 2005-6, both before and after housing costs. The inclusion of before housing costs (BHC) and after housing costs (AHC) is important, as while the former gives an overall picture of income levels, the latter allows some indication of the cost of living as housing is generally the most sizeable item of expenditure (and there are not currently robust data on overall cost of living). As above, the UK average risk of poverty is set at 100. Regions that lie above the 100 line are those where there is *less* risk of poverty, while those below the line have a *higher than average* risk of poverty.

Figure 5.4: Index of those not at risk of poverty 2005-6 (100=UK average)

Note: Where bars cannot be seen they = 100

This provides a different picture to that in Figure 5.1. On this measure the regions least in need are the:

- South East (7 per cent less likely to be at risk of poverty than the UK average before housing costs and 6 per cent less likely after housing costs)
- East of England (5 per cent for both BHC and AHC)
- South West (4 per cent both BHC and AHC).

In Scotland the risk of poverty is 3 per cent less than the UK average AHC, but is the same as the national average BHC. There are also interesting variations in Northern Ireland, the West Midlands and the East Midlands, where the risk of poverty is greater than the national average before housing costs, but lower than the national average after housing costs are considered.

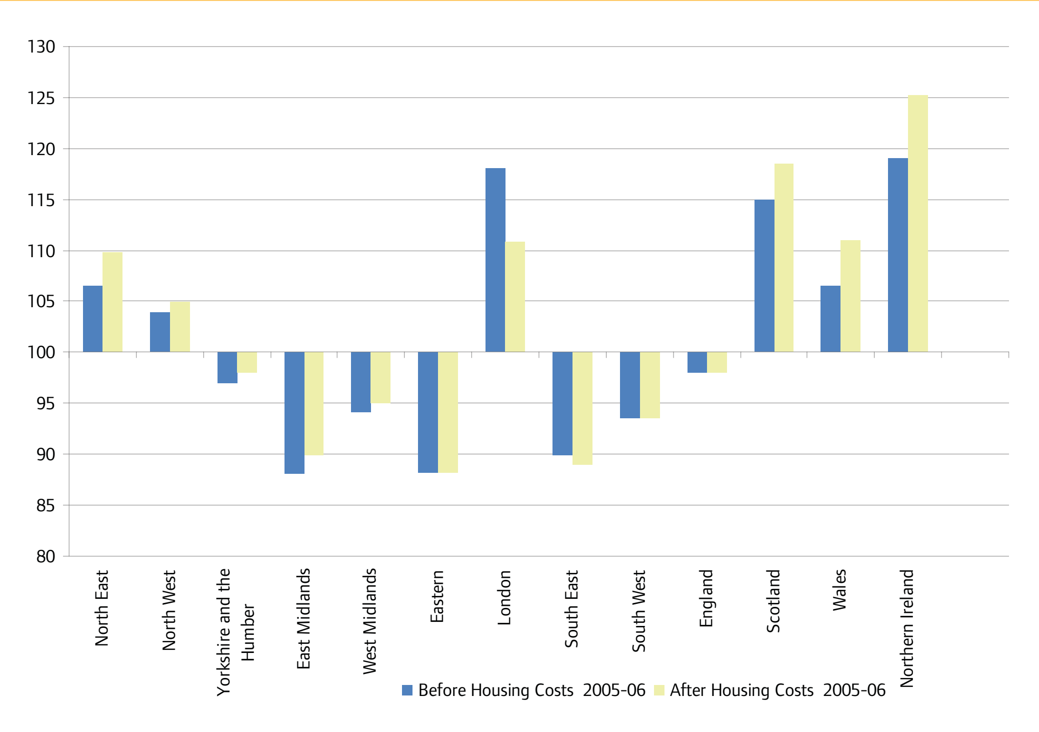
The regions where the risk of poverty is the greatest are the:

- North East (4 per cent greater than the UK average BHC and 1 per cent AHC)
- Wales (4 per cent BHC, and at the UK average AHC)
- Northern Ireland (but only BHC when the risk is 4 per cent greater than the UK average).

Housing costs are a significant factor in London, where the risk of being in poverty is the same as the UK average BHC, but is 6 per cent greater than the national average AHC, which is greater than anywhere else in the UK.

The next step is again to compare spending to our measure of need, in this case the risk of poverty in the general population. And again, if all spending were designed to assuage poverty then we would expect spending to be higher where the risk of poverty is higher. To test whether this is the case we use the same formula as before, comparing HBAI data for 2005-6 to 2005-6 spending data. For the purposes of this calculation we leave in entitlements with the spending figures as social protection payments are fundamentally important to tackling poverty. If public spending were correlated to poverty rates, we would expect all the nations and regions to converge on the 100 line in Figure 5.5.

Figure 5.5. Public spending compared to poverty, before and after housing costs (100 = public spending in line with need) 2005-6



On this measure, the nations and regions receiving 'more' than their need would suggest if spending were based on poverty are:

- Northern Ireland (10 per cent more BHC, 25 per cent more AHC)
- Scotland (15 per cent more BHC and 19 per cent more AHC)
- London (18 per cent BHC and 11 per cent AHC).

It is notable that London emerges from our analysis as still receiving more than its poverty need would suggest after housing costs, as it has the highest level of poverty AHC in the UK by quite a margin. This serves to underline the very high level of public spending in the capital.

In contrast to the results from the GVA analysis, when using poverty as an indicator, Wales, the North East and the North West all receive more than their need would suggest.

The regions furthest below the line, and receiving less public spending than their 'need' would suggest, are:

- East Midlands (12 per cent less BHC and 10 per cent less AHC)
- East of England (12 per cent less both BHC and AHC)
- South East (10 per cent BHC and 11 per cent AHC)

However, again, it is important to put these results in a wider context. To again take London as an example, inner London has higher levels of poverty than any of the nations and regions, both before and after housing costs, while outer London has average levels of poverty (HBAI data, Department for Work and Pensions 2006). Our analysis takes inner and outer London together because the spending data is only available for London as a whole. If they were analysed separately, the picture would be different across London.

The current distribution of public spending is neither fair nor equitable

Our analysis above shows that the current distribution of spending is neither fair nor equitable when compared to allocations of spending based upon either an inverse GVA per head or where it is inversely related to the prevalence of poverty. Naturally such an analysis has its limitations. Most obviously we have only used two indicators, whereas a full needs-based analysis would have to consider a range of other variables. An important consideration in this would almost certainly be the higher costs of delivering services in places like London, where for example the costs of agency staff are higher. Similarly, we would want to consider sparsity of population, which may explain some of the higher spending in Scotland, since sparsity increases the costs of delivering services outside of the urban areas. And as we have made clear, analysis of regional spend does not pay sufficient attention to the disparities within regions, most obviously in London, although this would apply to other regions too (for a wider discussion of intra-regional disparities in England see Johnson 2007a and b).

However, accepting these caveats as we do, it is nonetheless clear that public spending across the nations and the regions of the UK does not correlate with either of our measures of need. Of most interest is where the results from the two indicators concur. Both suggest that Scotland and London receive high levels of public spending even once our chosen measures of relative need are taken into account. Both suggest that it is the East Midlands region, rather than the Northern regions, that fares least well on both measures. When it comes to comparing public spending between Scotland and England (as a whole) it is also clear that Scotland is getting more than its need on both indicators, whereas England receives less.

In summary, this analysis suggests that there is not a clear relationship between levels of public spending across the nations and regions of the UK and levels of need, implying that the current distribution of public money is neither fair nor equitable.

Achieving a fair distribution of spending is, however, only one of our three principles. We now go on to consider how the current spending arrangements perform against the principles of efficiency and procedural fairness.

Does the Barnett formula provide for efficient and accountable spending?

As a block grant Barnett also presents challenges for efficiency since, in theory at least, it gives little incentive to the devolved administrations (DAs) to seek economic (or more narrowly, tax) efficiency. All three DAs manage substantial amounts of public expenditure, but none of them manages public revenue except in a small way. This severs the link between revenue and expenditure and thereby reduces the scope for budget constraint for the DAs. The tartan tax power might be a good fiscal discipline for the Scottish Parliament, but Scotland is so generously funded at present that politicians have no need to use the tax power. Unsurprisingly, they do not use it.

Concerns about efficiency have recently been expressed by senior political figures, including the Prime Minister, Gordon Brown MP, who, commenting on the situation in Scotland said: 'There is an issue about financial responsibility of an executive … that has £30 billion to spend but doesn't have responsibility for raising [that]. In any other devolved administration in the world, there is usually a financial responsibility that requires not only the spending of money by the administration but also its responsibility to take seriously how it raises it' (BBC 2008). These comments echoed those made by Wendy Alexander MSP, the then leader of the Labour Party in the Scottish Parliament, who has written: 'the financing of the Parliament almost wholly through grant funding does not provide the proper incentive to make the right decisions' (Alexander 2007).

A rational politician would rather spend more than less (because a marginal pound of public spending, financed out of somebody else's taxes, should always improve his or her chances of re-election). The absence of hard budget constraint makes spending on low return activities more likely, as there is greater incentive to spend rather than ensure a return on spending, when compared to a system with a harder budget constraint. This is the case up to the point where the marginal effect of extra taxation *in that territory* outweighs the marginal benefit from the spending.

Such a mismatch between revenue and expenditure creates perverse incentives, for example the DAs have less incentive to broaden their tax bases because they do not see the proceeds. These arguments also apply to local authorities in England, where again a lack of fiscal powers puts the emphasis on expenditure rather than revenue. A further perverse incentive for the DAs is to switch their block grants from capital spending (which brings benefits after the next election) to current spending (which brings benefits before the next election). Such decisions could have consequences for the UK's macroeconomic management, as it could interfere with the UK government's fiscal rules (currently labelled the Golden Rule and the Sustainable Investment Rule, which are likely to be followed by a UK government of any political complexion).

This is not to say, however, that all spending by the devolved institutions is inevitably inefficient or profligate. We note that although the devolved administrations are not responsible – or accountable – for raising much public money, which is mostly done by the UK government through UK-wide taxation, they do still have to face the electorate and account for the spending of public money at election time. This might not provide as much impetus for efficiency as that gained through being directly responsible for raising revenue but it is not an insufficient incentive for the devolved administrations to ensure that their spending policies are effectively managed. Moreover, as Scott and Jeffrey acknowledge, arguments about the impact of Barnett on efficiency would be aided by more empirical testing (2007).

Is public spending procedurally fair?

If intergovernmental finance arrangements are to secure legitimacy then they need to attract public support. Devolution has put the Barnett formula under the spotlight – and the extra spending per head it provides for the devolved institutions compared to that which England receives – with many suggesting that it would provoke an English backlash against the funding disparities. So what is the public's view of the Barnett formula?

In the last few years a number of opinion polls have been published which suggest widespread dissatisfaction with the current spending disparities across the UK. These polls have particularly highlighted growing concern within England about the higher spend per head going to Scotland. According to such polls large proportions of the English believe Scotland's share of public spending to be unfair: in November 2006 an ICM poll in England found that 60 per cent of respondents thought that the extra spend per head in Scotland was 'unjustified' (ICM/Telegraph 2006). Meanwhile a YouGov poll in April 2007 found that 68 per cent of people across Great Britain as whole thought that it was unfair that 'Government spending per head in Scotland is currently about 20 per cent higher than in England' (Sunday Times/YouGov 2007).

But as John Curtice points out most of these polls felt it necessary to tell respondents that public spending in Scotland is higher than in England, which suggests that the English only object to spending disparities between the two nations when those disparities are pointed out to them. In other words they do not tell us much about how aware English public opinion is of the spending disparities and how salient an issue this is for people (Curtice 2008a).

More useful in this respect is new data published by the British Social Attitudes (BSA) survey, which suggests that awareness within England is growing. Using more neutrally worded and unprompted surveys which simply ask respondents whether they think that Scotland's share of government spending is fair, the BSA has found that between 2003 and 2007 the number of English respondents who believe that Scotland gets more than its fair share of spending has risen from one in five to one in three (Curtice 2008b).

The more public awareness grows, the more likely that this issue will become a major source of tension between the constituent nations of the UK. And given the increasing number of critics of Barnett within the political parties and the media it seems perfectly reasonable to suggest that public awareness will continue to grow.

Moreover, while the English public may not be entirely familiar with the specific details of the Barnett formula they do see and notice the increasing degree of policy variation taking place across the UK since devolution. They look at policies like the abolition of prescription charges, and the introduction of free personal care for the elderly, and assume firstly that these policies are funded by the extra spending the devolved institutions receive, and that they, the English tax-payers, are paying for 'the better deal' in Scotland and Wales. The media who regularly suggest that policies pursued by the devolved institutions are being funded by an English subsidy is helping fuel this perception. When the Scottish Government, for instance, declared that it would freeze council tax in 2008-09, the *Daily Telegraph* responded with the headline: 'Scotland freezes council tax – with English subsidy' (15 November 2007).

This might explain the overwhelming support within England for the idea that now Scotland has its own devolved institutions, services in Scotland should be paid for out of taxes collected in Scotland (Curtice 2008b). The 2007 BSA survey found that 75 per cent of respondents in England supported this view. Interestingly this view appears popular within Scotland too: 57 per cent of Scots support the view that 'now Scotland has its own parliament, it should pay for its serves out of taxes collected in Scotland' (ibid). This suggests a lack of support within Scotland for the status quo, although it is arguable that the Scots are more interested in wanting further powers for their parliament than they are concerned about the fairness of the spending distribution. That said, there is even some evidence to suggest that the Scots themselves are uncomfortable with the share of public money they received. The number of Scots who think that Scotland's share of public money is 'more than fair' rose from 10 per cent in 2001 to 16 per cent in 2007 (ibid).

Equivalent data on public attitudes in Wales and Northern Ireland are much more limited than those available for England and Scotland and so we need to look at other indicators. In Wales, Plaid Cymru and others have repeatedly expressed concerns about the fairness of the Barnett formula since devolution, and now the Welsh Assembly Government has decided to set up an independent commission to review whether the funding formula is denying them their fair share of the public spending cake and whether it should be replaced. In Northern Ireland too there are concerns about whether the level of spending is keeping pace with need, and the Finance Committee of the Northern Ireland Assembly is currently urging the Executive to examine the implications of the Barnett formula and scenarios for reform (Committee for Finance and Personnel 2007).

6. Barnett is unsustainable: options for reform

The evidence presented in this paper suggests the time has come to reform the Barnett formula. It fails when tested against our key principles. It is neither fair, nor sufficiently efficient, and increasingly it is not *seen to be fair* by a sizable proportion of the population across the United Kingdom, especially within England.

For these reasons the Barnett formula has very few supporters left: political parties across the political divide and across the UK are voicing their concerns about the way it works. The Conservative Party leader David Cameron has strongly hinted that any future Conservative government would scrap Barnett (The Herald, 23 May 2008), while the Liberal Democrats have advocated replacing it with a system of greater fiscal decentralisation as set out in the Steel Commission (2006). In Wales the Labour-Plaid Cymru coalition is committed to reviewing the impact of Barnett on Welsh public expenditure, and in Scotland the SNP-led Scottish Government has launched a *National Conversation* on Scotland's future within the Union, which includes options for overhauling the way Scotland is financed (though of course in the latter cases the decision for reform rests with the UK government).

Perhaps the most interesting developments on this front, however, are those taking place within the Labour Party. Labour in government (in Westminster) has consistently ruled out reforming Barnett; indeed it has even refused to review the way devolved finance operates.[10] However, in the last year this position has begun to shift. This is being driven by events north of the border, with the then leader of the Scottish Parliamentary Labour Party, Wendy Alexander, coming out in favour of reforming the way the Scottish Parliament is funded. Working with the other unionist parties in Scotland (Scottish Conservatives and the Scottish Liberal Democrats), Alexander established the Calman Commission to review the way Scotland is funded and the financial powers of the Scottish Parliament. An Independent Expert Group on finance, reporting to it, will look at the current funding arrangements across the UK in the hope of developing a coherent account of Scottish funding. Significantly, the UK Labour government is also backing the work of the commission, and since the commission will need to review the way Barnett operates as part of its investigation, this amounts to a UK-backed review of devolved finance for the first time, albeit an indirect one. And as noted above, the Prime Minister, Gordon Brown, has himself raised the prospect of giving greater fiscal powers to the Scottish Parliament, which if adopted would by definition entail reforming Barnett.

In other words all major political parties now accept the need to review the current financial arrangements – which itself reflects how the issue of territorial finance has moved up the political agenda.

These developments, particularly the Calman Commission in Scotland and the promised review in Wales, are to be welcomed: the UK is long overdue a review of the way funding is distributed across the nations and regions. Of course, the Scottish and Welsh initiatives will not provide the comprehensive UK-wide review that is needed, but they will, inevitably, have to look beyond their respective borders in appraising the status quo and in exploring any reform options. For example, a consideration of greater fiscal responsibility is an explicit part of the remit for the central government backed Calman Commission. But it is inconceivable that the Scottish Parliament could be granted greater revenue-raising powers without the size of its block grant being reduced as a result, so any such recommendation is likely to have implications for the fiscal system beyond just Scotland.

Ultimately the UK will need to find a sustainable and workable financial settlement that addresses funding across the UK as a whole, covering funding for the English regions too. As our analysis suggests there are clear grounds for overhauling the way spending is distributed within England, since it has been shown that the current distribution is far from equitable (see Box 6.1 on England).

10. As late as July 2007 the Chief Secretary to the Treasury, then Andy Burnham MP, repeated the Government's position that it has 'no plans to review the Barnett formula'. HC Debate 18 July 2007, c443w.

Box 6.1: Spending and England

There are questions about whether the distribution of spending within England is equitable, and these debates have become entangled with the debate about how devolution is financed (despite the fact that Barnett does not govern spending within England).

Stakeholders and MPs in the Northern English regions have been particularly vocal in their opposition to the Barnett formula, arguing that their needs are objectively greater than those of Scotland, yet they receive less spending per head. In the greater South East too there is dissatisfaction, with some arguing that their tax take is subsidising the North of England as well as the devolved administrations, and that the latter are using their higher public spending per head to fund policies such as free personal care for older people and universal free prescriptions which are not available in England. So within England too there are questions about how public spending is distributed bubbling not far beneath the surface.

In section 4 we analysed the distribution of public spending per head across the nations and regions of the UK. This analysis uses data at the standard region level in England, as this is the territorial scale at which the data are available. Our findings confirm there is substantial variation in the level of spending per head across the English regions, and lend support to those that question the equity of the distribution of spending within England, as we find no obvious relationship between spending and our chosen measures of need. Our analysis finds London consistently receives higher spending than would be predicted if spending was distributed on the basis of either economic performance or poverty. Meanwhile the region that loses out is the East Midlands – not the Northern regions as some might expect.

But while it is arguably right not to treat England as a single block, given the clear differences in levels of need between the regions of England, there are problems with taking the regional level as the unit of analysis. Most notably this is because public spending is not distributed at the regional level. There are two key formulae used to distribute spending to areas of England: one distributes funds to local government, the other to primary care trusts (PCTs), neither of which operate at the regional level. Both formulae are to some extent needs-based, although in reality are cross-cut by other considerations such as cost of delivery and (in the case of local government) the tax base.

This results in a practical difficulty, as while the argument can be made that the regional distribution of public spending is not equitable and should be reformed alongside the Barnett formula, it is not clear how this can be done. Without elected regional assemblies in England funding cannot be distributed via block grant to the regions, as there is no legitimate and democratically accountable body operating at this level. And following the No vote in the North East referendum, elected regional assemblies for the rest of England appear to be off the political agenda for the foreseeable future at least. The exception here, of course, is London.

However, there are ongoing debates about strengthening the role of local authorities in England, in terms of the powers and functions that are devolved to them, including fiscal powers. As these debates progress there will be value in carefully considering how changes to English local government dovetails with the wider debates around devolution and intergovernmental finance.

Finally, while making reform work in England may be difficult, it is essential that any reform of UK intergovernmental finance fully takes England into account. Given its diversity, a funding formula that treats England as a single block is unlikely to address the concerns expressed by different parts of England, and addressing only the four nations of the UK would give an incomplete picture.

Principles to guide reform

As previously stated we believe there are some clear principles that should guide any reform of the funding system. We believe any new system must be:

- **Equitable** – a progressive system of funding should ensure that the distribution of public money is fair and equitable. This is important for ensuring that all citizens can access the same standard of public services irrespective of wealth. It is also important for ensuring the cohesiveness of the state. While the UK retains popular support, it is right that this sharing of risk should take place at the UK level. This essentially means there should be transfers from rich to poor people and areas, and account must be taken of the different level of resources required to deliver a similar level of service in different areas.
- **Efficient and accountable** – a new funding system must also ensure that the way spending is distributed provides sufficient incentives for prudent and responsible spending and more generally for economic growth. In other words it must encourage fiscal responsibility. Financial arrangements should also seek to ensure effective political and parliamentary accountability.
- **Procedurally fair** – it is not possible to design a system that everyone will agree on. But if a new system is transparent and a robust case can be made for why it is fair, it will have greater legitimacy than the Barnett formula.

Beyond these principles we also argue that any reform will need to address a number of other considerations specific to the current UK debate. Since current spending disparities are a source of increasing friction between the constituent nations of the UK any replacement for Barnett should aim to reduce this tension and strengthen relations across the UK. We take the view that while the UK continues to attract public support, reform measures should seek to strengthen the integrity of the union. We also recognise that any reform will need to achieve cross-party consensus if it is to bed down successfully. Finally, reforms need to appreciate the asymmetry of the devolution settlement, which implies that different options will need to be considered for different parts of the UK.

Three options for reform

In the three options for reform we outline below, we concentrate our efforts on assessing the pros and cons of each; we are not able to provide detailed financial modelling for how spending would change under each system. Nor do we consider the transition arrangements that would be necessary for phasing in a new system, given that some areas would likely undergo a change to the level of funding currently received. Such matters will need to be addressed by the Calman Commission and others in their more substantive and detailed reviews.

i) A needs-based equalisation system

A needs-based – or equalisation – system would be similar to the Barnett formula, in that it would be used to calculate a block grant, but instead of being based on population, it would be based on a calculation of the needs of different areas. A needs assessment would entail 'determining how much it would cost to provide a standardised level of service across a wide range of public services in different parts of the UK' (Bell and Christie 2005: 169). Needs-based systems are used in several federal states, notably in Canada and Australia, where there is a strong commitment to ensure that each state or province is provided with sufficient public expenditure to secure an equivalent level of public service provision for all citizens, irrespective of the region in which they live.

Undoubtedly there are challenges associated with measuring needs objectively and calculating a full needs-assessment, but these are surmountable as shown by successful operation of the models in Australia, Canada and elsewhere. A needs- assessment for the UK would need to consider factors such as wealth, demographic characteristics, levels of poverty, health of the population, and the sparsity of each territory's population. However, too fine-grained a needs assessment can be opaque, a criticism that is often heard in relation to the system of local authority grants in England, which is based on detailed measures of relative deprivation. This can obscure procedural fairness, so a coarser but more transparent needs assessment may be preferable. To carry credibility we believe that such a task should be carried out by an independent body and not be left to the Treasury. One potential model for the UK is the Australian Commonwealth Grants Commission (see Box 6.2).

Clearly a needs-based system meets our principle of equity, as spending would be directly related to the relative need of an area. So long as the needs calculation is not overly complex, it would also improve procedural fairness, as there would be a clear and demonstrable relationship between relative need and spending. Under a needs-based system spending disparities would of course still exist but they would be based on the assumption that poorer and more needy areas would receive additional money which is much more defensible than the arbitrary distribution delivered by Barnett. It seems likely that a needs-based system would reduce public expenditure in Scotland, which may also have the advantage of defusing anxieties within England about the current disparities.

However, a needs-based grant system would suffer from the same efficiency problems as the Barnett formula currently does: the devolved institutions would still not be responsible for raising the money they spend. A further concern would be that the DAs might be perversely incentivised to keep their 'needs' artificially high in order to ensure they received higher levels of expenditure, which would further undermine efficiency.

Box 6.2: An Australian-style Grants Commission for the UK?

The Australian Grants Commission was established in 1933 to assess claims made by the Australian states for financial support from central government. It advises on the per capita 'relativities' which are then used to determine equalisation between the states. Per capita relativities involves assessing both states' capacity to raise revenue and their expenditure needs – in other words their relative need. Its definition of equity is that 'each State should be given the capacity to provide the average standard of State-type public services assuming it does so at an average level of operational efficiency and makes an average effort to raise revenue from its own sources'.

A version of the Australian Grants Commission model could be used as the basis for a needs-based system in the UK. The UK Government would, as now, decide how much to spend on each of the functions of government. For non-devolved functions such as defence and foreign affairs, nothing would change. For devolved functions such as health and education, the UK government would decide, through the current Spending Review, Pre-Budget and Budget process, how much to spend, in the territory for which it is responsible, on each service. But to ensure that spending reflected need, a UK Grants Commission would use a relativity formula to determine how much each of the four countries would get for that service.

It would, of course, be up to each devolved government to decide how to spend its block. A devolved government could, in the technical term, 'vire' between headings – that is, transfer block grant from one function of government to another, if (say) it wished to spend relatively more on health and relatively less on education than the UK government had assigned.

As in Australia it would be important that the body tasked with doing this worked at arms' length from politicians to ensure it was free from partisan interference. Such a commission could be a non-departmental public body that reported to the four Parliaments of the UK (the UK Parliament, or a committee of it, would act for England). A joint committee of the four Parliaments would appoint the Commissioners, but they would not be delegates either from any of the Parliaments or from any political party. They should be chosen for their professional expertise subject to the current rules for making public appointments. They would be chosen for fixed terms, renewable once.

The Grants Commission's professional staff (geographers, statisticians, economists, social and health policy specialists, who could be secondees from government departments under any of the four sponsoring Parliaments) would be charged each year with producing a Red Book of Relativities, like the Australians' 'Report on Revenue Sharing Relativities'. The main driver for the formula should be relative population, with a weighting for needs, which would most likely consider factors such as the age structure of the population, the impact of sparse population (or, at the other extreme, congestion) on the cost of delivering public services, and the health of the population. But as discussed above, too fine-grained an analysis of needs can obscure procedural fairness.

The Commissioners would discuss and could modify the relativities produced, but once agreed they would determine the allocation of block grants to each of the four countries for the next time period.

ii) Full fiscal autonomy

Fiscal autonomy would entail the devolved administrations having responsibility for raising their own revenue, which, consequently, would mean that they would receive less support from the UK government. Proponents of fiscal autonomy tend to highlight the efficiency gains of such a model, as it would create a strong link between revenue raising and spending decisions. At its most extreme this would mean the DAs being responsible for raising all taxes in their area, and using the revenue to fund all services provided by them. A transfer would also have to be made to the UK Exchequer for functions such as defence, international aid and the welfare state. This would amount to a model of full fiscal autonomy. However, such a system does not exist anywhere in the world, with the closest being the Basque region of Spain, which has full fiscal autonomy in principle, but in practice it is committed to following the broad structure of Spanish taxation policy (Scott and Jeffery 2007).

In the UK context there are significant arguments against such a system. The first concerns equity. If each territory were to be made entirely responsible for its own public spending and taxation decisions and there were no fiscal transfers between areas, then this would mean that the areas with lower tax capacities (for instance where a larger proportion of the population is retired, in ill health or out of work) would not be able to provide an equivalent level of public service provision to those in areas with higher tax capacities. Under this model it would be the poorest areas that would suffer most and this would be unacceptable. In a union-state like the UK this lack of fiscal equalisation would undermine the unity and cohesiveness of the state.

Indeed it is highly questionable whether full fiscal autonomy would be compatible with the continuation of the union, as a territory with full fiscal autonomy would essentially be independent. It would amount to a form of fiscal separation. For these reasons we reject such a model.

iii) A hybrid model: fiscal decentralisation and needs-based funding

If a model of full fiscal autonomy is not feasible there is the third option of moving to a system of partial fiscal autonomy, in which the DAs would be responsible for raising some of their own revenue. But given disparities in tax capacity and wealth across the nations of the UK, any system of greater fiscal decentralisation would need to be supported by a UK grant, capable of securing the fiscal equalisation needed to ensure UK-wide equity. The size of the equalisation grant from the UK government would be determined by a relative needs-assessment.

Such a hybrid model aims to combine the efficiency gains of greater fiscal autonomy with the equity of a needs-based grant. There are two broad options for increasing the fiscal powers of the DAs: through devolved or assigned taxes.

Devolving taxes: This is where an administration has the power to vary certain taxes. Currently the DAs have only limited tax powers – all have powers over council tax (domestic rates in Northern Ireland) and business rates, and Scotland has the thus far unused ‘tartan tax’, which gives it the power to vary the basic rate of income tax by 3p in the pound. A model of devolving taxes would build on these powers and extend them into other areas either by making administrations fully responsible for certain taxes, or giving them the power to vary taxes within prescribed boundaries, as is currently the case with the ‘tartan tax’.

The challenge, of course, is getting the right taxes. One tax that can be ruled out is VAT, as it cannot be devolved due to EU rules. Similarly there are some doubts over whether corporation tax could be devolved without breaching EU state aid and competition laws (see Scott and Jeffery 2007 for a discussion). The mobile nature of capital also means devolving corporation tax is frequently ruled out by the fiscal autonomy literature, as it risks inter-regional tax competition (Hallwood and MacDonald 2004). There is also a question mark over whether it would be fair to devolve taxes on natural resources, as natural resources are not evenly spread across a country, and territories can do nothing to enhance their endowment.

It would, however, be possible to allow the DAs to have greater control over income tax. The current tartan tax only allows Scotland to vary the basic rate of tax by 3p in the pound. Under a revised model the DAs might be given wider powers to vary the rate of personal income tax. Any move in this direction would, of course, need to consider provisions for regulating inter-regional tax competition.

There are also some other options that could be explored. For example, the DAs already control some property taxes, but could also be given control over stamp duty. Other candidates for consideration would include gambling taxes, tourist taxes, green taxes and taxes on alcohol and tobacco.

Assigning taxes: this is where the proceeds of certain taxes, or a proportion of them, are attributed to the area where they were raised. Germany uses a system of tax assignment. In theory it ought to be possible to assign any tax, although in practice some are very difficult to apportion (Heald and McLeod 2002). For example, this would apply to corporation tax when firms have more than one office in the UK. The most obvious candidate for tax assignment in the UK is VAT, where it would be possible to assign a proportion of the revenue raised from it to the DAs. Assigning taxes may have benefits for fiscal responsibility, creating a link between revenue and spending, although not as clear a link as that established by devolving taxes. Furthermore, on their own assigned taxes do not afford greater fiscal autonomy, as responsibility for setting the base and rate of taxes remains with central government.

More serious thought needs to go into whether to devolve or assign, and which taxes should be considered, along with modelling the possible implications of different scenarios. We welcome the fact that the Calman Commission will be able to investigate this issue in much more detail. The Commission will also be able to consider the wider economic impact that fiscal autonomy would have on the UK: in particular it should look at the impact that fiscal decentralisation will have on inter-regional tax competition and it will also need to look at what borrowing powers would be granted to the DAs under a system of greater fiscal autonomy and the implications of this on UK-wide macro-economic policy.

From our perspective it seems clear that a hybrid model brings with it a number of important benefits. Most obviously it would be equitable as there would be an explicit attempt to deliver fiscal equalisation, developing a clearly defined relationship between need and spending, moving away from allocating spending according to the arbitrary base-lines of Barnett. The needs element would also help preserve intra-UK cohesion. And while the UK maintains public support as a state, it is right that in a progressive system there are transfers from richer to poorer people and places. A needs-based equalisation system is an important expression of solidarity between the nations and citizens of the UK.

It would also improve the financial accountability of the DAs as it would link public spending with the responsibility for raising revenue. This would encourage greater efficiency and reduce the perverse incentives associated with Barnett. By giving the DAs greater control over tax policy it would also give them an instrument of economic policy to boost the performance of their economies (Webb 2007). And it would remove the DAs' dependency on a UK government grant. As Lord Steel noted: 'no self-respecting parliament could exist permanently on a grant from another parliament' (Steel Commission 2006).

Greater fiscal autonomy would not only improve the financial accountability of the DAs, with the positive impact on efficiency, but it would also help diminish the scope for intergovernmental conflict by reducing the DAs' dependency on a grant from the UK government (see Section 3). There would be less scope for the 'infinite blame potential' King associates with the Barnett formula, which pits the DAs against central government (King 2007).

Furthermore, such a model would enhance the ability of the DAs to pursue their own policy agendas. Currently the DAs have little control over the size of the block grant that is available to them, as it is based on decisions taken by the UK government for England. In certain scenarios this has the potential to both undermine the policy autonomy of the DAs and bring them into conflict with the UK government. For instance, if the Scottish government wanted to increase spending at a time when the UK government (acting for England) was cutting spending, the result would be less spending for the devolved administrations through the Barnett formula. By making the DAs more responsible for raising their own revenue such conflict would be mitigated, as they would be less reliant on the block grant to finance their policy agendas.

A hybrid model would also be seen to be fairer, and hence improve procedural fairness. Public opinion supports the principle that the devolved institutions should be responsible for raising some of the revenue they spend on devolved services. We have already noted that there is widespread support within both England and Scotland for the Scottish Government to fund devolved services out of taxes collected in Scotland. In this sense greater fiscal autonomy would also help address growing concerns within England about the current spending disparities between the two nations. Indeed, Wendy Alexander has made this point, when she argued that:

> 'A beneficial by-product of strengthening the [financial] accountability of the [Scottish] Parliament through greater autonomy would be to address some of the concerns elsewhere in the UK around relative spending levels. Inevitably a larger assigned or devolved element means the grant element would be smaller and so potentially less contentious.' (Alexander 2008)

A hybrid model is the best option for reforming devolved finance

We believe that a hybrid model, which combines the efficiency gains of greater fiscal autonomy with the equity of a needs-based grant, represents the best option for reforming Barnett. We recommend that the Calman Commission, and any further reviews of finance in the UK, look seriously at this reform option.

Such a system would ensure that the DAs were responsible for raising some of their own revenue – either through control over the rate and base of defined taxes or through assignment of specific tax revenues, or a combination of both – which would then be supplemented by an equalisation grant from the UK government, the size of which would be determined by a relative needs-assessment.

Hybrid models have been shown to work in places such as Belgium (with its mixture of devolved taxes and fiscal equalisation) and Germany (with its mixture of assigned taxes and fiscal equalisation). The same can be said for the Canadian and Australian examples: in Canada the provinces collect around 50 per cent of their own revenue and in Australia the states collect over 30 per cent, with the rest made up of grants from the federal governments based on needs assessments (Bell and Christie 2005).

However, any move to a hybrid model will need to work within the parameters laid down by the UK's asymmetrical model of devolution. While the Scottish Parliament has full legislative powers, the Welsh Assembly does not. The implications of such asymmetry is that a package of greater fiscal powers might be appropriate for the Scottish Parliament but would not – yet – be appropriate for the Welsh Assembly.

In other words, one consequence of the UK's asymmetrical devolution settlement is the need for a corresponding asymmetrical approach to fiscal reform.

For the Scottish Parliament this would mean granting it greater fiscal powers – matching fiscal responsibility to its primary legislative powers – with a needs-based top-up grant. There is already some devolution of income tax in the shape of the unused 'tartan tax', and we would recommend building on this by strengthening the fiscal powers of the Scottish Parliament. This could involve extending its powers over income tax, and could also be accompanied by assigning tax revenue, for example a proportion of VAT. Importantly, such an approach would also be in line with public opinion in Scotland, which favours greater tax-raising powers for the Scottish Parliament (Curtice 2008).

In time the same system may be appropriate for Northern Ireland, but given the disruption to devolution there in recent years, the new Assembly should be given time to bed down before further financial powers are devolved.

Such a settlement would not be appropriate for Wales given the absence of primary legislative powers. There we recommend a full needs-based grant, possibly with some assigned taxes, as a more appropriate model. As with the Barnett formula block grant, the Welsh Assembly Government would have discretion over how it distributes the grant. If a referendum is won on devolving primary legislative powers to the Assembly, plans to move into line with the Scottish fiscal settlement could also be made.

Conclusion

The Barnett formula has few remaining friends. For different reasons, in all parts of the UK there are growing concerns about the way public spending is distributed, and the level of fiscal autonomy available to the devolved administrations. All of the major political parties, including the UK Labour Party through its support for the Calman Commission, now back a review. Even Lord Barnett, after whom the formula is named, wants to see it reformed.

As this paper shows, the way devolution is currently financed is neither equitable, nor sufficiently efficient and accountable. Its lack of transparency also undermines procedural fairness. This is becoming a source of tension in the Union, and if not dealt with now, such tension could grow and weaken support for the Union. This demonstrates the importance of territorial finance. A system is needed that provides for UK-wide cohesion, and which promotes public legitimacy and enhances solidarity.

Territorial finance also underpins the devolution settlement, shaping the ability of the devolved administrations to pursue their own policy agendas. The current financial arrangements give the DAs very little influence over the size of their block grants. They are at the mercy of funding decisions made for England, and have limited ability to raise their own revenue. Furthermore, given the lack of transparency over what does and does not have Barnett consequentials, the current system has endless opportunities for inter-governmental conflict. Sustained conflict of this nature could also have implications for the future cohesion of the Union.

It was said by Ron Davies that devolution is 'a process, not an event'. Yet where funding arrangements for Scotland, Wales and Northern Ireland are concerned there has been no change – Barnett, which has been in operation since before devolution, remains in place. This is no longer tenable. It is time that the UK's system of territorial finance was overhauled, creating arrangements that are not only more suitable for devolution, but that meets our principles of equity, efficiency and accountability, and procedural fairness. Importantly, reform must be UK-wide.

A new financial settlement is needed that combines greater revenue-raising powers for the devolved administrations, with a block grant from the UK government based on an assessment of need. Such a system would be more equitable and encourage efficiency. It would also give the devolved administrations more control over the amount of funding available to them. But, because of the asymmetry of the UK devolution settlement, whereby the Scottish Parliament has full legislative powers but the National Assembly for Wales does not, reform will have to be staggered. For Scotland such reform will respond not only to public demand in Scotland – and England – for greater fiscal powers, but will also address concerns over the fairness of the current distribution.

This reform would give some meaningful fiscal autonomy to the devolved governments, in a framework that also seeks to balance UK-wide interests of equity with devolved autonomy. For this reason combining fiscal responsibility and a needs-based system is the best option for reforming territorial finance in the UK.

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Appendix 1: Formula to calculate how spending and need correlate

For our two chosen measures of need, poverty (below 60 per cent median income) and economic performance (GVA per head), we first present the rank order of how the regions perform on that indicator (Figures 4.1 and 5.4; Tables A3 and A6 in Appendix 2). We then provide a more sophisticated picture of how spending and need correspond by combining the index with the index of public spending per head, using the formula below. The formula is designed to reveal what the distribution of spending would look like if identifiable expenditure was designed to assuage need, taking this to mean it would be inverse to GVA or the prevalence of poverty. The richer a region, or the less impoverished a region, the less public expenditure per head it would receive. The poorer or more impoverished a region, the more public expenditure per head it would receive. The formula we use to calculate Figures 5.2, 5.4 and 5.5 is below. The data for these figures is found in tables A4, A6 and A7 in Appendix 2.

Formula to calculate how spending and need correlate:

$$R_{ij} = \frac{P_{ij} G_{ij}}{100}$$

where:

R_{ij} = Public expenditure relative to need of territory *i* in year *j*;

P_{ij} = Identifiable public expenditure per head in territory *i* in year *j* (UK = 100) (from Figure 4.1);

G_{ij} = Gross Value Added per head in territory *i* in year *j* (UK less Extra Regio = 100) (from Figure 4.2).

Because the product $P_{ij} G_{ij}$ is divided by 100, Figures 5.2, 5.4 and 5.5 are again in index units where 100 denote the correspondence of spending and need.

Appendix 2: Data for charts

A1. Data for Figure 4.1: Index of identifiable public expenditure per head in the Nations of the UK, minus social protection and agriculture (UK = 100)

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
England	96	96	97	97	96	97
Scotland	121	120	115	119	122	121
Wales	113	110	109	109	110	108
Northern Ireland	138	130	127	125	123	121
UK identifiable expenditure	100	100	100	100	100	100

A2. Data for Figure 4.2: Index of identifiable public expenditure per head in the nations and regions, minus social protection and agriculture (UK = 100)

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
North East	104	106	105	108	105	106
North West	102	103	103	103	105	105
Yorkshire and Humber	95	95	96	96	95	96
East Midlands	85	85	87	86	86	87
West Midlands	92	91	94	93	94	95
Eastern	81	81	81	81	82	82
London	126	131	129	130	128	128
South East	86	85	87	85	84	83
South West	84	84	85	84	83	84
England	96	96	97	97	96	97
Scotland	121	120	115	119	122	121
Wales	113	110	109	109	110	108
Northern Ireland	138	130	127	125	123	121
UK	100	100	100	100	100	100

A3 Data for Figure 5.1: Index of GVA per head across the UK nations and regions (UK = 100)

	2001	2002	2003	2004	2005	2006
United Kingdom	100	100	100	100	100	100
North East	79	79	79	80	81	81
North West	89	88	88	88	87	87
Yorkshire and Humber	88	88	87	87	86	86
East Midlands	92	92	92	92	91	91
West Midlands	91	91	90	89	89	89
East of England	109	108	108	107	106	105
London	133	135	137	139	140	141
South East	118	117	116	116	116	115
South West	93	93	94	94	94	94
England	103	103	103	103	102	102
Scotland	94	94	94	94	95	95
Wales	78	78	78	77	77	77
Northern Ireland	81	81	81	81	81	81

Figure 5.2 compares the index of total identifiable expenditure per head (available from HM Treasury 2008, table 9.2) to the index of GVA per head, using the formula in Appendix 1. Figure 5.2 shows only the data from 2006-07.

A4 Data for Figure 5.2: Total identifiable public spending per head compared to GVA per head (100 = public spending in line with 'need') 2006-07

	2002-03	2003-04	2004-05	2005-06	2006-07
North East	87	87	88	90	87
North West	93	92	93	91	92
Yorkshire and Humber	87	85	85	84	83
East Midlands	82	81	82	81	81
West Midlands	86	86	85	85	86
Eastern	90	91	90	89	89
London	155	162	163	165	165
South East	98	97	100	97	97
South West	83	85	86	85	84
England	99	100	100	99	99
Scotland	110	109	106	109	111
Wales	89	87	85	85	86
Northern Ireland	105	102	101	100	100
UK	100	100	100	100	100

Figure 5.3 compares the index of identifiable expenditure per head minus entitlements (social protection and agriculture) to the index of GVA per head, using the formula in Appendix 1. Figure 5.3 shows only the data from 2006-07.

A5 Data for Figure 5.3: Public expenditure minus social protection and agriculture, compared to GVA (100 = public spending in line with need) 2006-07

	2002-03	2003-04	2004-05	2005-06	2006-07
North East	82	84	84	87	85
North West	90	91	91	90	91
Yorkshire and Humber	84	83	84	83	82
East Midlands	78	78	80	78	78
West Midlands	84	82	84	83	84
East of England	87	87	87	86	86
London	170	179	179	182	180
South East	101	99	101	99	97
South West	78	79	80	79	78
England	99	99	100	99	98
Scotland	114	113	108	113	116
Wales	88	86	84	84	85
Northern Ireland	112	105	103	101	100

A6 Data for Figure 5.4: Index of those not at risk of poverty 2005-6 (100=UK average)

	Before Housing Costs	After Housing Costs
North East	96	99
North West	99	100
Yorkshire and the Humber	99	100
East Midlands	99	101
West Midlands	98	99
Eastern	105	105
London	100	94
South East	107	106
South West	104	104
England	101	101
Scotland	100	103
Wales	96	100
Northern Ireland	96	101
UK	100	100

Figure 5.5 compares the index of identifiable expenditure per head minus entitlements (social protection and agriculture) to the poverty index, using the formula in Appendix 1.

A7 Data for Figure 5.5: Public spending compared to poverty before and after housing costs (100 = public spending in line with need) 2005-6

	Before Housing Costs	After Housing Costs
North East	107	110
North West	104	105
Yorkshire and the Humber	97	98
East Midlands	88	90
West Midlands	94	95
Eastern	88	88
London	118	111
South East	90	89
South West	94	94
England	98	98
Scotland	115	118
Wales	107	111
Northern Ireland	119	125