



National Assembly for Wales
Cynulliad Cenedlaethol Cymru

The Barnett Formula: funding the devolved administrations

This paper provides an overview of the Barnett formula, how it operates and its effects on public expenditure in the UK. It also covers the criticisms that have been aimed at the Barnett formula, current reviews and some of the suggestions which have been put forward for alternative funding mechanisms.

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The Barnett Formula: funding the devolved administrations

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Executive Summary

This paper is intended to provide some background information on the Barnett formula and how funding is allocated to the devolved administrations within the UK.

Section 1 deals with the framework of public expenditure within the UK, and how funding is allocated to the devolved administrations within this framework. It also covers some of the terminology associated with public expenditure and the 'block grant' for the devolved administrations.

Section 2 explains the purpose of the Barnett formula, and how it determines incremental changes to expenditure within the assigned budgets of the devolved administrations.

Section 3 covers the history and origins of the Barnett formula.

Section 4 explains how the formula works in calculating changes to the assigned budgets of the devolved administrations, based on changes in planned spending in UK Government departments, comparability and population.

Section 5 explores the effect of the Barnett formula on public expenditure and considers the issue of convergence or 'Barnett squeeze'. It also provides some potential explanations as to why convergence may not be occurring.

Section 6 considers some of the criticisms that have been made of the Barnett formula, including the issues of accounting for need and the perception of fairness.

Section 7 deals with reviews which are currently being undertaken in Scotland (the Calman Commission), Wales (the Holtham Commission) and the House of Lords.

Finally, section 8 considers some of the alternative mechanisms of funding sub-national government which have been put forward, including tax assignment and fiscal autonomy or federalism.

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1 Funding the devolved administrations

The responsibility for fiscal policy, macroeconomic policy and public expenditure allocation across the UK lies with HM Treasury. As a result, the budgets for the devolved administrations continue to be set within the framework of public expenditure control within the UK. Once the overall public expenditure budgets have been decided, the devolved administrations have the freedom to allocate spending within these limits, however they must ensure that their plans comply with the UK Government's fiscal policy.

The Statement of Funding Policy¹ published by HM Treasury states that:

The devolved administrations, while assuming responsibility for many of the functions of the departments which they inherited, are not themselves departments of the United Kingdom Government. Their funding arrangements are the subject of detailed scrutiny by the elected Members and those whom they represent. It is important, therefore, that the way in which the budget of each of the devolved administrations is determined should be clear, unambiguous and capable of examination and analysis by the devolved Parliament and Assemblies and the United Kingdom Parliament.

Funding for the devolved administrations is determined alongside that for the UK Government departments as part of spending reviews. The UK Parliament votes the necessary provision to the Secretary of State; payments are then made to the devolved administrations in accordance with each devolution Act.²

The devolved administrations budget is not exclusively funded by grant from the UK Parliament. Further resources are raised through local taxation (including non-domestic rates and council tax) and through borrowing by local authorities and other public bodies to finance their capital spending. As with UK Government departments, European Structural Fund expenditure falls within the devolved administrations allocation.

The total budget for the devolved administrations is comprised of the following two separate categories of expenditure.

- **Departmental Expenditure Limits (DEL)** – normally set over three years as part of the UK Government's Spending Review process. Most of the DEL is unhyphenated and allows the devolved administration full discretion over its spending priorities (known as 'assigned budget' items). Changes in the provision for these items are determined through the Barnett formula. Some elements of DEL, however are ring-fenced ('non-assigned budget') and can only be used for specified purposes.
- **Annually Managed Expenditure (AME)** – covers items whose provision cannot be reasonably subject to firm multi-year limits (such as Common Agricultural Policy) and thus is reviewed and set annually. Further AME can be drawn down from HM Treasury if it is required, while any unspent portion will be reclaimed by HM Treasury.

¹ [HM Treasury. Funding the Scottish Parliament, National Assembly for Wales and Northern Ireland Assembly: Statement of Funding Policy \(October 2007\)](#). [on 12 February 2009]

² [Part 5 of the Government of Wales Act 2006](#) established the Welsh Consolidated Fund (WCF) into which the block grant from the Secretary of State is paid. [on 12 February 2009]



The 'assigned' element of DEL is commonly known as the 'block grant'. This is the portion of the total budget over which the devolved administrations have complete discretion regarding its allocation across departments and programmes.³ Changes to these budgets are generally determined by the Barnett formula, thereby removing the need to negotiate the allocation with HM Treasury.

The UK Government applies certain principles in allocating public expenditure between the countries of the UK. These are based on the Statement of Principles to govern changes to the devolved administrations' budgets set out in the Chief Secretary of HM Treasury's reply to a Parliamentary Question on 9 Dec 1997.⁴ Although this does not refer to Northern Ireland, being prior to the Good Friday Agreement, the principles apply equally to Northern Ireland. These principles are detailed in [Annex A](#).

³ The devolved administrations have **no** discretion over the total level of the assigned DEL.

⁴ [HC Deb 9 December 1997 c510-513W](#) [on 12 February 2009]

2 Barnett formula – what is it?

The non-statutory Barnett formula determines **changes** to expenditure within the assigned budgets of the devolved administrations, but does **not** determine the absolute level of the assigned DEL.

When the UK Government reviews its spending plans,⁵ changes in the allocation to the devolved administration are determined by changes in planned spending on comparable services in UK Government departments. The actual change is calculated using the population-based Barnett formula.

Thus, **the devolved administrations receive the amount allocated in the previous year, plus or minus a population based share of changes to comparable UK Government spending for England.** The Barnett formula operates an incremental system, in that the allocation in one year is based on that in the previous year.

This system was first used in the 1978 Public Expenditure Survey. The devolution White Papers stated the Government's commitment to retaining the existing formula and arrangements. '*Scotland's Parliament*' states:⁶

In practice these arrangements, based on the Block and Formula, have produced fair settlements for Scotland in annual public expenditure rounds and have allowed the Secretary of State for Scotland to determine his spending decisions in accordance with Scottish needs and priorities. They have largely removed the need for annual negotiation between the Scottish Office and the Treasury. The Government have therefore concluded that the financial framework for the Scottish Parliament should be based on these existing arrangements with, in future, the Scottish parliament determining spending priorities.

Similarly, '*A Voice for Wales*' states:⁷

Changes to the Welsh block will be calculated by the population-based Formula used at the moment. These arrangements based on the Block and the formula have worked in practice, producing fair settlements for Wales in annual public expenditure rounds.

⁵ In the main, through the UK Government's spending reviews though other spending announcements, such as those made by the Chancellor in his Spring and Autumn Budgets, also impact on allocations to the devolved administrations DEL.

⁶ [Scotland's Parliament White Paper 1997, Chapter 7](#). [on 12 February 2009]

⁷ *A Voice for Wales*: The Government's proposals for a Welsh Assembly. Cm 3718.

3 History of the Barnett formula

The use of a formula to allocate funds to the countries of the Union can be traced back to the 1880s by the then Chancellor, George Goschen. He decided in 1888 to use a formula to allocate probate duties. The Goschen formula allocated funds on the basis of 80% to England and Wales, 11% to Scotland and 9% to Northern Ireland; note that this was not based on population, but on the relative contribution of probate duties to the Exchequer. The Goschen formula continued to be used until 1959.

From 1959 to 1978 there was no formal mechanism in place to allocate resources to the territories. Public expenditure for Scotland, Wales and Northern Ireland during this time was settled collectively by negotiation, on the same basis as other public expenditure programmes. However, it is generally thought that these negotiations were likely to be based on Goschen as a minimum.

The Barnett formula was introduced at a time of uncertainty about the constitutional future of the UK, with devolution to Scotland and Wales then part of the Government's legislative agenda. At the same time, a needs assessment was undertaken in preparation for devolution.⁸ When plans for devolution fell, the Barnett formula was implemented, first being used in Scotland in 1978. The origins of the Barnett formula are not well documented; it is thought to have been originally intended as a temporary measure prior to Scottish devolution; however it has been in continuous use since. The Barnett formula was extended to Wales in 1980, and later to Northern Ireland.

Giving evidence to the Treasury Committee's inquiry into the Barnett formula in 1997,⁹ Lord Barnett himself stated:

...I am flattered that the Barnett Formula has lasted twenty years. I hope it will last much longer. At the time, I must confess, I did not think it would last a year or even twenty minutes. I was not sure. Can I also make clear, as you also refer to the question of devolution that the Barnett Formula, either then or now although I know somebody said it at the time, has nothing whatsoever to do with devolution.

Thus, the Barnett formula was a pre-devolution system of allocating resources. On the introduction of devolution in the late 1990s there was no change in the relationship between the devolved administrations and HM Treasury; despite significant constitutional changes.

⁸ HM Treasury, *Needs Assessment Study – Report*, 1979.

⁹ [Treasury Committee, *The Barnett Formula*, 22 December 1997, HC341 1997-97](#) [on 12 February 2009]

4 How does it work?

Three factors are considered in calculating changes to the assigned DEL using the Barnett Formula:

- The change in planned spending to UK Government department programmes;
- The comparability percentage; and
- The population proportion in each country

Comparability percentages describe the extent to which services delivered by UK Government departments correspond to services within the budget of the devolved administration. For example, the comparability percentage of health is 99.3%,¹⁰ as the vast majority of health related expenditure is devolved to the Welsh Assembly Government. The comparability percentage for transport is 68.3%, as the UK Government retains responsibility for several aspects of expenditure relating to transport.

The **population proportion**¹¹ used originally was based on population estimates from 1976. In 1992 these were recalibrated based on data from 1991 Census. Following devolution, population shares are recalculated annually on the basis of the latest available mid year estimates (MYE) published by National Statistics¹². HM Treasury notifies the devolved administrations of the population proportions that will be applied in advance. Allocations which have already been set, such as those over a spending review period, will not be adjusted to reflect any subsequent changes to the population estimates.

The change in spending for each devolved administration is therefore calculated by:



For example, for the 2007 Comprehensive Spending Review, the Welsh **population** as a **proportion** of England's was **5.84%**. Since the **comparability percentage** for transport was **68.3%**: if **£1 billion** were to be added to transport across England, then **£39.9 million** (**£1bn x 0.0584 x 0.683**) would be added to the Welsh assigned budget.

¹⁰ As detailed in Annex 3: Schedule of Comparable Programme Objectives to the [HM Treasury. Funding the Scottish Parliament, National Assembly for Wales and Northern Ireland Assembly: A Statement of Funding Policy. October 2007.](#) [on 12 February 2009].

¹¹ The population proportions used in the formula reflect the coverage of the UK departmental programme to which they are applied. In the vast majority of cases, the UK departmental programme covers England only and the proportion of England's population is applied. However, where the UK departmental programme covers England and Wales, such as the Home Office and legal departments, then the proportion of the population of England and Wales is applied.

¹² [National Statistics. Mid Year Estimates \(MYE\) of Population.](#) [on 12 February 2009]

This calculation is conducted for each departmental programme in DEL, and the sum of these results represents the aggregate net change to the devolved administration's DEL assigned budget.

The majority of the devolved administration spending is determined via the Barnett formula; however there are a **number of exceptions** where the population-based approach is not considered to be appropriate – sometimes termed '**formula bypass**'. These include some programmes within DEL, all AME, and other expenditure outside DEL. DEL items in the non-assigned budget will be determined separately between the devolved administration, the Secretary of State, HM Treasury and the relevant UK Government department. Other examples of where 'formula bypass' may occur include:

- **Uniform adjustments** made across all departments regardless of population share, such as additional expenditure allocation arising during the financial year, (e.g. NHS pay awards).
- **Exceptional and unforeseen domestic costs** (e.g. natural disaster) – probably would be met from UK Reserve.
- Where some expenditure in the devolved administrations budget **has no comparable** English **counterpart** (e.g. water is privatised in England and Wales, but not in Scotland).



5 Effects on public expenditure – ‘Barnett squeeze’?

The ‘Barnett squeeze’ refers to the fact the Barnett formula should, over time, lead to a convergence of public expenditure per head in the countries of the UK. In theory over the years, each country receives an equal increase in funding per head, so the higher levels of public spending prevalent in the devolved administrations should eventually become level to that in England.

The Treasury Committee in its 1997 report on the Barnett Formula¹³ stated that:

The Treasury agreed that one of the properties of the formula, "all other things being equal", was that it would produce convergence in levels of funding per head. "It will depend on the rate of growth of comparable spending in England.... It also depends on relative stability of the population relativities within the UK. For example, if Scotland's population declines relatively that will tend to offset the convergent effect of the Barnett Formula.

However, as can be seen from table 1 and figure 1, public expenditure per head remains higher in the devolved administrations than in England. These figures show **total identifiable expenditure**¹⁴ per head in practice since 1995-96.

Table 1: Total identifiable expenditure by country; per head and Index (England = 100)

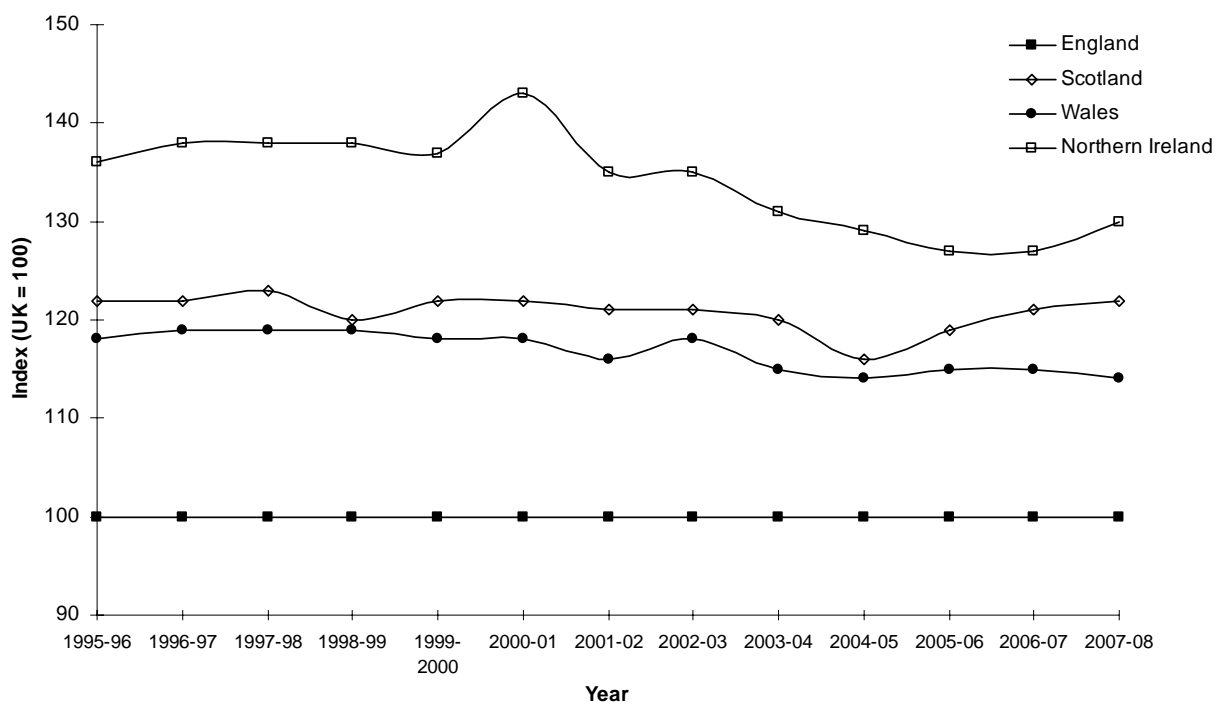
	England		Scotland		Wales		Northern Ireland		UK	
	£ per head	Index	£ per head	Index	£ per head	Index	£ per head	Index	£ per head	Index
2007-08	7,535	100	9,179	122	8,577	114	9,789	130	7,790	103
2006-07	7,076	100	8,544	121	8,172	115	8,990	127	7,308	103
2005-06	6,802	100	8,077	119	7,796	115	8,672	127	7,012	103
2004-05	6,442	100	7,458	116	7,315	114	8,294	129	6,624	103
2003-04	6,026	100	7,213	120	6,945	115	7,868	131	6,225	103
2002-03	5,522	100	6,696	121	6,515	118	7,437	135	5,726	104
2001-02	5,171	100	6,273	121	6,000	116	7,003	135	5,358	104
2000-01	4,660	100	5,684	122	5,506	118	6,644	143	4,846	104
1999-2000	4,391	100	5,377	122	5,184	118	6,004	137	4,562	104
1998-99	4,165	100	4,993	120	4,947	119	5,750	138	4,321	104
1997-98	3,984	100	4,886	123	4,728	119	5,512	138	4,142	104
1996-97	3,937	100	4,813	122	4,683	119	5,441	138	4,093	104
1995-96	3,871	100	4,716	122	4,571	118	5,252	136	4,019	104

Source: Members' Research Service calculations from [HM Treasury, Public Expenditure Statistical Analyses \(PESA\)](#)
2007-08 shows planned expenditure.

¹³ [Treasury Committee, The Barnett Formula, 22 December 1997, HC341 1997-97](#) [on 12 February 2009]

¹⁴ **Total identifiable expenditure** is that which can be recognised as having been incurred for the benefit of individuals, enterprises or communities within particular regions. This covers expenditure by the UK government, the devolved administrations, local government and public corporations.

Figure 1: Total identifiable expenditure by country (England = 100)



From figure 1 it can be seen that there appeared to be little, if no convergence during the 1990s. However, in recent years there has been some evidence of convergence in Northern Ireland, a slight convergence in Wales and almost no convergence in Scotland.

It should be noted that as these figures are based on total identifiable expenditure, that they include expenditure by the UK government on non-devolved matters, such as defence and social security. Therefore they do not wholly represent allocations via the Barnett formula.

Other studies have attempted to combat this issue by examining total identifiable expenditure, minus social security and agriculture,¹⁵ or information based on budget inputs.¹⁶ These studies have also shown little evidence of convergence.

5.1 Transparency

It is difficult to verify whether 'Barnett squeeze' is occurring in practice. This partly reflects the lack of comparable data on Barnett-funded services in the devolved administrations and equivalent English data. A 2005 report by the Centre for Public Policy Research

¹⁵ [Institute for Public Policy Research \(IPPR\) North, *Fair Shares? Barnett and the politics of public expenditure* \(July 2008\)](#) [on 12 February 2009]

¹⁶ [Centre for Public Policy for Regions \(CPPR\), *Discussion Paper 10, The Barnett Allocation Mechanism: Formula plus Influence?* \(December 2005\)](#) [on 12 February 2009]



(CPPR)¹⁷ stated that one of the main issues around the Barnett formula was the lack of transparency and hence potential for scrutiny:

...whilst transparency would normally be a key element of a formulaic approach, the operation of Barnett is opaque and difficult to monitor. In particular, there is no clear evidence that relative public expenditure convergence has actually occurred, nor that politicians desire such convergence.

The report goes on to state that:

In the early years of its operation, the formula was obscure and little understood. More recently how the formula is technically constructed has become common, if occasionally misunderstood, knowledge. But how the actual spending increases in England lead to the subsequent increases in the sums available to Scotland, Wales and Northern Ireland remains unclear. The detailed procedure cannot be verified independently and the relationship between published process and the budget outcomes is shrouded from scrutiny.

This report also suggests that 'Government insiders' have stated that convergence was never a desired outcome of the Barnett formula. However, if the formula is strictly adhered to, then arithmetically, convergence would result. The report takes this as evidence that there is an alternative allocation process at work.

5.2 Population levels

Convergence will only occur in the long term if the relative population between devolved administrations remains constant. Until 1992, the 1976 population estimates were used for the Barnett formula; although Scotland's population was declining relative to that of England, this would have worked against convergence resulting in a relative increase in Barnett funding per head in Scotland as the inherited spending base would have been divided amongst a lower population.

In recent spending reviews, population figures used in the Barnett calculations have been updated. Even with the use of the most recent population estimates, if the devolved administrations population relative to England is in decline, this also results in increased spending per head. The mid year estimates (MYE) of population used in the 1998, 2000, 2002, 2004 and 2007 spending reviews are detailed in table 2. These show that since 1996, the relative populations of Scotland and Wales have been growing more slowly than that of England.

Table 2: Mid year estimates of population

	mid 1996		mid 1999		mid 2001		mid 2003		mid 2007	
	Thousands	% population of England	Thousands	% population of England	Thousands	% population of England	Thousands	% population of England	Thousands	% population of England
England	48,519	..	49,033	..	49,450	..	49,866	..	51,092	..
Scotland	5,092	10.5	5,072	10.3	5,064	10.2	5,057	10.1	5,144	10.1
Wales	2,891	6.0	2,901	5.9	2,910	5.9	2,931	5.9	2,980	5.8
Northern Ireland	1,662	3.4	1,679	3.4	1,689	3.4	1,703	3.4	1,759	3.4

Source: [Mid year estimates population, National Statistics](#)

¹⁷ *ibid*

5.3 'Formula by-pass' or 'formula plus'

A possible reason why convergence may not have occurred is formula by-pass. The model producing convergence assumes that the formula is strictly applied. However, if payments are made outside the Barnett formula, the trend towards convergence would be reduced.

A recent report¹⁸ suggests that the process for determining whether expenditure is subject to the Barnett formula is unclear, stating that:

Decisions sometimes appear arbitrary and cause tension, for example, there is currently disagreement between the DAs [devolved administrations] and the Treasury regarding whether the regeneration funding for the Olympics should be subject to the Barnett formula.

It is suggested that the seemingly arbitrary decisions as to when the formula should be applied can create tensions between the devolved administrations and the UK Government. This is a particular concern now that, for the first time since devolution, there are different parties in power in Westminster and Holyrood, and therefore a different political context in which the financial arrangements for devolution must operate.

In their report,¹⁹ the CPPR present an alternative 'formula plus influence' method to the allocation of funds to the devolved administrations. They suggest that:

In our approach, as far as the now devolved administrations are concerned, the Barnett formula generates a floor allocation of funds. The now devolved administrations in addition use resources in an attempt to augment the allocation through influence behaviour. Whilst the Barnett formula operating alone produces convergence in per capita public expenditure, the impact of the influence behaviour to generate additional revenues that are then incorporated into the base for Barnett calculations in subsequent years. The central government can determine the overall allocation of funds to the now devolved administrations through varying its responsiveness to this influence behaviour.

¹⁸ [Institute for Public Policy Research \(IPPR\) North, *Fair Shares? Barnett and the politics of public expenditure* \(July 2008\)](#) [on 12 February 2009]

¹⁹ [Centre for Public Policy for Regions \(CPPR\), Discussion Paper 10, *The Barnett Allocation Mechanism: Formula plus Influence?* \(December 2005\)](#) [on 12 February 2009]

6 Criticisms of the Barnett formula

The Barnett formula has come under fire for a number of reasons, some of which are discussed in detail below. A summary of some of the suggested main strengths and weaknesses of the Barnett formula is shown in [Annex B](#).

6.1 Accounting for 'need'

The Barnett formula had often been criticised because it does not take account of 'needs'. A recent report by the Institute for Public Policy Research (IPPR) North report²⁰ states that:

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.

Lord Barnett himself has recently said:²¹

A fairer system would be based on need, taking account of factors such as levels of income in each part of the UK, which are reportedly higher in Scotland than in many English regions.

Such criticism of the current arrangements has led to calls for an updated needs assessment. The last official assessment of need was conducted in the late 1970s, when legislation for devolution was being considered. HM Treasury co-ordinated an inter-departmental study,²² which attempted to assess the extent to which expenditure per head in Scotland, Wales and Northern Ireland, would need to be higher than that in England, in order to give a comparable level of services. The exercise was based on the six main services which were to be devolved under the 1978 devolution Acts: health and personal social services; education (excluding Universities); housing; other environmental services; roads and transport (excluding railways); law order and protective services (excluding police). A range of 'objective factors', including the age distribution of the population, road lengths, recorded crime and number of sub-standard dwellings were used to determine need. It should be noted that many factors including the definition of public expenditure have changed considerably since the 1970s and thus applying conclusions to the current situation is problematic.

There have been a number of calls for an updated needs assessment. The House of Lords Constitution Committee, in its 2002 report on devolution,²³ recognised 'serious difficulties' presented by continuation of the Barnett formula and envisaged that any alternative would incorporate:

...an assessment of the needs of the devolved administrations and the different regions of England.

²⁰ [Institute for Public Policy Research \(IPPR\) North, *Fair Shares? Barnett and the politics of public expenditure* \(July 2008\)](#) [on 12 February 2009]

²¹ [Lord Barnett, *I only meant the Barnett formula to last a year, not 30*. Times Online, 11 January 2009](#) [on 12 February 2009]

²² HM Treasury, *Needs Assessment Study – Report*, 1979

In their 1997 report on Barnett formula, the Treasury Committee concluded that the needs assessment should be updated:²⁴

The Committee was disappointed that no Government studies have been made in relation to the appropriateness of the Barnett Formula and how it relates to needs. The Committee only took evidence relating to the formula. We believe, however, that it is time to bring the needs assessment up to date; this would help to show whether the Barnett Formula remains the appropriate method of allocating annual expenditure increases (or savings) to the four nations of the Union. There may be good reasons why this formula should continue to be used in the future as it has for the last 20 years, but it is an argument that cannot finally be settled until it is clear that total expenditure, not just the increase, is still being allocated according to relative need. It is important there should be maximum possible agreement on this in all parts of the UK.

There are significant problems associated with conducting an objective needs assessment. The process of deciding upon and weighing together a number of measures would be inherently subjective and highly contentious. The Audit Commission concluded that needs assessment can be neither 'perfect' nor 'fair'.²⁵ It has been suggested that moving to a needs-based allocation would not solve the alleged unfairness; it may simply switch the argument from the unfairness of the Barnett formula to the unfairness of the needs assessment.

6.2 Equity

There have also been a number of criticisms of the Barnett formula for its perceived lack of equity. This has particularly been the case since devolution as the devolved administrations can pursue different policies from that of the UK Government. Some have alleged that the current system produces public spending outcomes which are unfair. The view seems to be that higher public spending, particularly in Scotland, enables funding of more generous social policies than those available in England.

For example, a recent report by ippr North,²⁶ suggests that financing of the devolved administrations in the UK is neither 'fair nor equitable', and is no longer appropriate for devolution. It goes on to suggest that the Barnett formula is increasingly not seen to be fair by the public, and that in England there is evidence that an increasing number of people believe Scotland receives 'more than its fair share'. The report calls for the Barnett formula to be replaced with a more transparent and equitable funding system.

Similarly, a report from the Taxpayer's Alliance,²⁷ suggests that, in comparison to England, public spending is 22% higher in Scotland, 14% higher in Wales and 30% higher in Northern Ireland, and states that:

²³ [House of Lords Select Committee on the constitution, *Devolution, Inter-Institutional Relations in the United Kingdom*, 16 January 2003, HL 28 2002-03](#) [on 12 February 2009]

²⁴ [Treasury Committee, *The Barnett Formula*, 22 December 1997, HC 341 1997-98](#) [on 12 February 2009]

²⁵ Audit Commission (1993) *Passing the Bucks*

²⁶ [Institute for Public Policy Research \(IPPR\) North, *Fair Shares? Barnett and the politics of public expenditure* \(July 2008\)](#) [on 12 February 2009]

²⁷ Taxpayers' Alliance, *Unequal Shares: The Definitive Guide to the Barnett Formula* (September 2008) can be accessed via the following link: <http://tpa.typepad.com/home/research-by-the-.html> [on 12 February 2009]



In an era of devolved government, such spending gaps are impossible to justify to English taxpayers.

However an article in the Western Mail,²⁸ following the release of documents from the Scotland Office under a Freedom of Information request, suggests that Wales has been under funded relative to need:

....according to a Treasury calculation, Wales in 1976-77 was allocated 6% less than it would have been if funding was based on need. In 1984, Treasury officials wrote: "The results imply that, relative to England, 'actual' expenditure in 1976/77 exceeded 'need' by about 3% in Scotland, by about 6% in Northern Ireland, and fell short of 'need' by about 6% in Wales.

²⁸ [Martin Shipton, *Wales under funded for decades - report*. Western Mail 23 Jun 2008](#) [on 12 February 2009]

7 Calls for review

Due, to the criticisms discussed in the previous section, there have been many calls for the Barnett formula to be reviewed. Lord Barnett himself has stated:

What has become known as the Barnett formula has to go. When I introduced it, as chief secretary to the Treasury, I did so to make life a little easier when negotiating public expenditure settlements for Scotland, Wales and Northern Ireland.²⁹

However, the UK Government have consistently stated that they have no plans to review the formula:

Mr Paul Murphy: To ask the Chancellor of the Exchequer whether he plans to review the Barnett formula for allocating the block grant to Wales. [150229]

Andy Burnham: The Government have no plans to review the Barnett formula.³⁰

7.1 Scotland - Commission on Scottish Devolution

The [Commission on Scottish Devolution](#) (Calman Commission) is conducting an independent review of the experience of Scottish devolution, including the financing of devolved expenditure and alternative fiscal options. Sir Kenneth Calman was appointed as Chair in March 2008. The Commission is taking an evidence-based approach and their remit is as follows:

To review the provisions of the Scotland Act 1998 in the light of experience and to recommend any changes to the present constitutional arrangements that would enable the Scottish Parliament to serve the people of Scotland better, improve the financial accountability of the Scottish Parliament, and continue to secure the position of Scotland within the UK.

The Commission will report to the Scottish Parliament and the UK Government. The Secretary of State for Scotland (Des Browne) indicated that the UK Government will work with the Scottish Parliament to support the Commission:³¹

I warmly welcome the appointment of Professor Sir Kenneth Calman to the Chair of the Commission. It has an important remit and it is essential we allow it to carry out its work independently and with due consideration of the issues. The UK Government and Scottish Parliament will rightly offer the support it needs to operate thoroughly and effectively as it carries out its work programme.

The Commission had its initial meeting on 1 April 2008,³² where it was agreed to create four task groups looking at functions, principles, financial accountability and engagement. The remit of the Financial Accountability Task Group is as follows:³³

²⁹ [Lord Barnett, I only meant the Barnett formula to last a year, not 30. Times Online, 11 January 2009](#) [on 12 February 2009]

³⁰ [HC Deb 18 July 2007 c443W](#) [on 12 February 2009]

³¹ [Scotland Office Press Release, Secretary of State welcomes appointment of Chair of Scottish Parliament Commission, 25 March 2008.](#) [on 12 February 2009]

To assess the strengths and weaknesses of the present system for financing devolved expenditure (in respect of financial accountability and otherwise), and any alternative fiscal options which might provide improved financial accountability.

In particular, this includes considering the potential costs and benefits to Scotland of any alternative system, and the issues of equity and the economic and fiscal consequences for Scotland and to the UK as a whole.

With regard to the improvement of financial accountability, the Commission will be advised by an independent group of experts chaired by Professor Anton Muscatelli, Principal of Heriot-Watt University. This Independent Expert Group has produced a report which looks at current financial arrangements in the UK and analysed the principles of how sub-national governments are funded around the world.³⁴

The Calman Commission produced its first report in December 2008.³⁵ With regard to improving the financial accountability of the Scottish Parliament, the Commission has come to no conclusions as yet and are seeking further evidence. However, the report does state:

The Commission recognises that there are three generic mechanisms that may be used to fund the Scottish Parliament – the assignment of tax revenues, the devolution of taxes and block grant from the UK Government. The mix of funding mechanisms to be used will be determined by the balance between the conflicting principles, and so, ultimately by the sort of Union which Scotland forms with the rest of the UK.

We have given preliminary consideration to how the individual funding mechanisms might be used in Scotland, and to the question of borrowing powers for the Scottish Parliament. We regard the maintenance of an economic Union in the UK as in the interests of Scotland, we have looked at the effect of each of them on the free flow of trade inside this integrated single market. This has led us to seek further views and evidence, for example in relation to some aspects of tax devolution.

So our consideration of finance follows from our discussion of the nature of the Union. As well as being an economic Union, the UK has a shared social citizenship. Greater tax devolution would be associated with less shared social citizenship, while high dependence on grant funding implies some common expectations about the need for welfare services like health and education. We have not reached a view on the appropriate point in what is a spectrum of possibilities, but we do recognise that this must reflect the expectations of the Scottish population. In the next phase of our work, with further help from the Independent Expert Group, we will identify the possible combinations of the funding mechanisms and their implications for the nature of the Union.

The Commission aims to publish its final report during 2009.

³² Minutes of meetings are available on the Commission's website via the following link:
<http://www.commissiononscottishdevolution.org.uk/papers.php> [on 12 February 2009]

³³ [Commission on Scottish Devolution, Financial Accountability Task Group, Minutes of First Meeting, 30 May 2008.](#) [on 12 February 2009]

³⁴ [First Evidence from the Independent Expert Group to the Commission on Scottish Devolution, November 2008.](#) [on 12 February 2009]

³⁵ [Commission on Scottish Devolution, The Future of Scottish Devolution within the Union: A First Report, December 2008.](#) [on 12 February 2009]

7.2 Wales – Independent Commission on Funding and Finance

The *One Wales* agreement³⁶ set out the commitment to establish a Commission to review how the devolved Wales is funded. It stated that:

There will be an independent Commission to review Assembly Funding and Finance, to include a study of the Barnett Formula, of tax-varying powers including borrowing powers and the feasibility of corporation tax rebates in the Convergence Fund region, including the implications of recent European Court of Justice Rulings in this area.

In July 2008, the Office of the First Minister issued a press release announcing that Gerald Holtham is to Chair the Commission on Funding and Finance.³⁷ The remit of the [Independent Commission on Funding and Finance for Wales](#) is as follows:

- Look at the pros and cons of the present formula-based approach to the distribution of public expenditure resources to the Welsh Assembly Government; and
- Identify possible alternative funding mechanisms including the scope for the Welsh Assembly Government to have tax varying powers as well as greater powers to borrow.

Initially the Commission is intending to review the Barnett formula, before broadening its work to take into account issues such as tax-varying and borrowing powers. The Commission has stated that it intends to publish an interim report in the summer of 2009, which will be published and debated in the National Assembly, prior to undertaking more detailed work towards the end of 2009. Further information can be found on the Commission's website.³⁸

7.3 House of Lords Barnett Formula Select Committee

The House of Lords Barnett Formula Select Committee³⁹ was appointed on 10 December 2008. The remit of the Committee is to examine the purpose, methodology and application of the Barnett formula as a means of determining funding for the devolved administrations of the United Kingdom, to assess the effectiveness of the calculation mechanism to meet its purpose, and to consider alternative mechanisms. It should be noted that the Committee will exclude consideration of:

- the overall system of funding the devolved administrations - particularly the question of whether greater tax-raising powers should be accorded to the devolved administrations,
- other political aspects of the devolution settlements, and
- the distribution of funds within the different regions of the United Kingdom.

³⁶ [One Wales: A progressive agenda for the government of Wales. An agreement between the Labour and Plaid Cymru Groups in the National Assembly, June 2007.](#) [on 12 February 2009]

³⁷ [Welsh Assembly Government Press Release, Chair of Commission on Funding and Finance announced, 8 July 2008.](#) [on 12 February 2009]

³⁸ [Independent Commission on Funding and Finance for Wales](#) [on 12 February 2009]

³⁹ [House of Lords, Barnett Formula Select Committee](#) [on 12 February 2009]

In February 2009 the Committee issued a call for evidence.⁴⁰ The Committee are currently taking evidence and will report once all evidence has been considered.

8 Alternative funding mechanisms

Those who have criticised the Barnett formula have made suggestions of alternative funding mechanisms which could be employed to fund the devolved administrations. For example, the Taxpayers' Alliance⁴¹ state that the reason that Barnett has failed to close the spending gaps in different regions of the UK is due to:

...a massive centralisation of taxation powers in the hands of Westminster politicians.

They go on to suggest fiscal decentralisation as an alternative method of funding the devolved administrations:

The real solution to the "Barnett problem" lies not with some revamped formula, or even any of those complex needs assessments. The real solution is fiscal decentralisation. Alongside the devolution of spending authority, Westminster must finally devolve some of its tax raising powers.

In that way, those that benefit from higher local spending would also be required to pay for it. Not only is that fairer, but local taxpayers would then be the judge of whether their local public services justified the cost. And they would no longer be dependent on the murky, largely unaccountable deals of politicians hundreds of miles away in Westminster.

The report from ippr North⁴² suggest that an alternative hybrid model, combining full fiscal autonomy with a needs based grants system would be the best option for reform:

Under such a system a combination of devolved and assigned taxes would ensure that DAs were responsible for raising more of their own revenue, while a needs-based top-up block grant would ensure greater equity.

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, they recognise that such reform would have to be staggered due to the asymmetry of devolution in the UK, for Wales it is suggested that:

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...

⁴⁰ [House of Lords Barnett Formula Committee publish call for evidence \(3 February 2009\)](#) [on 12 February 2009]

⁴¹ Taxpayers' Alliance, *Unequal Shares: The Definitive Guide to the Barnett Formula* (September 2008) can be accessed via the following link: <http://tpa.typepad.com/home/research-by-the-.html> [on 12 February 2009]

⁴² [Institute for Public Policy Research \(IPPR\) North, Fair Shares? Barnett and the politics of public expenditure \(July 2008\)](#) [on 12 February 2009]

The following sections consider the three main mechanisms which have been put forward for funding sub-national Governments; **tax assignment**, **grant-based systems** and **fiscal autonomy or federalism**.

8.1 Tax assignment

Tax assignment can either:

- Allocate taxes raised through economic activity within a devolved territory to the devolved administration; in the UK this would require HM Revenue and Customs to determine the revenues raised in the devolved countries of the UK; or
- Assign tax receipts in fixed proportions from the central to the devolved administration; this would require some means of apportioning the taxes raised between the countries of the UK.

It should be noted that the tax assignment model does **not** allow for the devolved administration to determine the tax base or tax rates. However, a more autonomous variation of this model may allow for a sub-national government to vary the rates of national tax within an otherwise centralised system (such as is the case with the Scottish Variable Rate⁴³).

This model provides a level of financial accountability to a devolved government, as revenues are, to some degree, dependent on the economic performance of the region. However, overall taxation levels remain within the control of central government. Thus, central government retain control over macro-economic and fiscal policies. The consequence of this is that the devolved government is not accountable to the electorate for decisions on taxation, and the revenues are controlled to a large extent by the fiscal policies of central government.

The financing of public expenditure by tax assignment would be unlikely to deliver equivalent public services across the UK, as different regions would have different tax capacities. This would need to be addressed by some form of 'equalisation' payment⁴⁴ from central to devolved governments.

8.2 Grant based systems

In this model, central government provides funding for the devolved administration by means of a grant to achieve fiscal equalisation. There are two variations of fiscal equalisation under this model:

⁴³ **Scottish Variable Rate** – the ability to vary the basic rate of income tax by up to 3 pence in either direction.

⁴⁴ Systems of **fiscal equalisation** are generally intended to deliver equity between regions, and involve the redistribution of resources between the regions.

- *Vertical fiscal equalisation* – where the devolved administration has spending powers and responsibilities but central government retains revenue raising powers. Therefore a grant to achieve vertical fiscal equalisation is made from central government to the devolved administration in order that it can meet its expenditure.
- ◆ *Horizontal fiscal equalisation* – this occurs where central government provides funding for a devolved administration in order to facilitate equal access to public services across all the regions. This involves the redistribution of resources from more prosperous to poorer regions. This can be done on the basis of equalising income or on the basis of need.

The current system in the UK is an example of vertical fiscal equalisation. However, in this case it would appear that the devolved administrations' spending is determined by the size of the grant from central government, rather than the grant allocations being determined by spending requirements.

Vertical fiscal equalisation can be operationally simple, in contrast to the horizontal system, which can be difficult and contentious to quantify, especially if done on the basis of need. However, financing a devolved administration via grant from central government does not deliver full financial accountability, as decisions on expenditure are disconnected from taxation decisions. Again, similarly to tax assignment, the grant-based model results in the expenditure decisions of the devolved administration being impacted upon by the fiscal policies of central government.

8.3 *Fiscal autonomy and fiscal federalism*

Full fiscal autonomy refers to the situation where devolved governments have responsibility for raising all of their own revenue, and therefore the administration would have full tax raising, as well as borrowing, powers. It is important to distinguish between 'full' fiscal autonomy and 'some' fiscal autonomy. Administrations with 'full' fiscal autonomy have control over all taxes. However, those with lesser degrees of fiscal autonomy would have control over only some elements of taxation.

Fiscal federalism generally relates to a situation where some degree of fiscal autonomy is present, but in the context of a federal, rather than a unitary, state. This implies a very different constitutional design than that currently operating in the UK.

The major advantage to full fiscal autonomy is that it provides a direct link between revenue raising and spending decisions, thus giving full financial accountability. However, it may also result in differing tax levels within the devolved nations, which may contravene EU State Aid rules.⁴⁵ Full fiscal autonomy, with differing fiscal and economic policies would, to all intents and purposes, be the same as independence. Thus, full fiscal autonomy is incompatible with the continuation of the Union in the UK.

⁴⁵ Within the EU the scope for different tax levels operating within a member state is constrained by the EU State Aid Rules. In principle, a preferential rate or tax system applying to a particular region may constitute state aid.

8.4 *Borrowing powers*

Should a devolved administration be funded by any method other than block grant, which provides certainty of funding, then it is likely that the administration would require borrowing powers in order to smooth changes in financing requirements. This would allow the administration to deal with any potential economic shocks which may impact on potential taxation revenues. The power to borrow may also allow greater flexibility in terms of financing capital expenditure.

Granting borrowing powers to sub-national governments has the potential to undermine national macroeconomic policy, as regional borrowing may not be consistent with central fiscal policy. Thus, it is likely that any borrowing powers granted at sub-national level would have to be subject to some level of control by, or negotiation with central government.

Annex A: Statement of Principles

The UK Government applies certain principles in allocating public expenditure between the countries of the UK. These are based on the Statement of Principles to govern changes to the devolved administrations' budgets set out in the Chief Secretary of HM Treasury's reply to a Parliamentary Question on 9 Dec 1997.⁴⁶ Although this does not refer to Northern Ireland, being prior to the Good Friday Agreement, the principles apply equally to Northern Ireland.

1. All UK tax revenues and analogous receipts are passed to UK Consolidated Fund. Decisions about the allocation of UK public expenditure rest with the UK Government. This does not apply to the Scottish Variable Rate of Income Tax or local taxes which are matters for the relevant devolved administrations;
2. Changes in budgetary provision of the devolved administrations funded by UK tax revenues or by borrowing will generally be linked to changes in planned spending on comparable public services by departments of the UK Government;
3. This linkage will generally be achieved by means of the population-based Barnett Formula. This largely removes the need to negotiate directly the allocation between Treasury Ministers, Secretaries of States and Ministers of the devolved administrations;
4. The allocation of public expenditure between the services under the control of the devolved administrations will be for the devolved administrations to determine;
5. The devolved administrations will be fully accountable for the proper control and management of their public expenditure allocation and for securing economy, efficiency and value for money through scrutiny by the relevant Parliament or Assemblies and the detailed accountability and audit procedures listed in the Devolution Acts;
6. The devolved administrations will meet all operational and capital costs associated with devolution from their allocated budgets;
7. If levels of self-financed expenditure by a devolved administration grow significantly more rapidly than comparable expenditure in England over a period and in such a way as to threaten targets set for public expenditure as part of the management of the UK economy, it will be open to the UK Government to take the excess into account in considering the level of grant to the devolved administrations. This principle will not apply to the Scottish Variable Rate of Income Tax;

⁴⁶ [HC Deb 9 December 1997 c510-513W](#) [on 12 February 2009]



8. Where decisions taken by any of the devolved administrations or bodies under their jurisdiction have financial implications for departments or agencies of the UK Government or, alternatively, decisions of UK Government departments or agencies lead to additional costs for any of the DAs, where other arrangements do not exist automatically to adjust for such extra costs, the body whose decision leads to the additional cost will meet that cost;
9. The UK Government continues to reserve the right to make across-the-board adjustments to the budgets for the devolved administrations in cases of a uniform general adjustment to public expenditure programmes of departments of the UK Government;
10. Consistent with the arrangements for the departments of the UK Government, the devolved administration will normally be expected to accommodate additional pressures on their budgets. Unforeseen pressures should be catered for by offsetting savings and re-allocating priorities; and
11. Responsibility for contributions to and distribution of receipts from the European Commission rests solely with the UK Government.

Annex B: Summary of Strengths and Weaknesses of the Barnett formula

STRENGTHS	WEAKNESSES
Devolved administrations have a high degree of financial autonomy; are free to allocate budgets as they wish.	Lack of accountability; there is no clear relationship between taxes paid and services received.
Devolved administrations need not manage revenue risk; UK Government remains responsible for borrowing to meet any shortfall in tax revenues.	A devolved administration has little influence over the size of the block grant and revenues are not related to management or performance of the devolved administration's economy.
Removes the requirement for devolved administrations to negotiate with HM Treasury at each spending review.	Overall budget is not needs-based; i.e. no regard to differences in economic structure, topography or patterns of social disadvantage.
Provides a degree of protection and certainty of funding over the three year spending cycle.	Policy choices are constrained by having public spending decisions made by the UK Government.
Simple and objective method of resource allocation.	Formula is opaque and difficult to monitor.
	Produces public spending outcomes which are perceived to be unfair.
	When different parties are in power in devolved administrations and UK, this adds to complexity.