

THE BARNETT FORMULA AND PUBLIC SPENDING IN SCOTLAND: POLICY AND PRACTICE

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INTRODUCTION

For twenty years, Scotland has experienced distinctive arrangements for determining public expenditure under the control of the Secretary of State for Scotland. In recent years, the levels of public spending delivered by this system have been questioned by English MPs of both major parties, whether Conservatives disaffected by the 'dependency culture' which high public spending was deemed to promote, or Labour MPs envious of the Scottish totals and desirous of similar outcomes for their own areas.

The approach used for determining Scottish totals is known as the Barnett formula. Some Scottish expenditure remains planned on a UK basis, and some 96% of the Scottish programme is allocated on a 'block and formula' basis. This system has been regarded as having three advantages for the Scottish Office. First, the formula only applies to changes in expenditure; therefore the base forms the dominant factor of any year's allocation. Second, the formula removed the requirement for annual negotiations with the Treasury. Third, within the resultant total, the Secretary of State is free to reallocate resources (Midwinter et al 1991). The result has been that Scottish expenditure has maintained the high levels (relative to the UK average) delivered through political bargaining in the 1960s and 70s (Rose 1982).

Barnett is not, however, a 'needs-based' model, but simply a formula which provides a 'broad brush' mechanism for allocating changes to public expenditure across the constituent nations of the UK. The longevity of the

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The Barnett Formula and Public Spending in Scotland

system was recently confirmed when the devolution White Paper announced it would be retained as the basis for funding Scotland's devolved parliament, and that 'Scotland will continue to benefit from its appropriate share of the public expenditure', which 'will be determined by a method which is objective, transparent and widely accepted' (Scottish Office 1997, p.21).

The House of Commons Treasury Committee argued that a new needs assessment study would help to show if Barnett remained the appropriate method for resource allocation (CH 1997-8, p.341); Lord Barnett himself made a case for review on the grounds of the convergence of income levels across the UK; whilst John Major (1997) argued that Scottish spending levels could not be defended on the basis of needs alone, and that Scotland is 'significantly overfunded'. In the light of this, a pro-devolution think tank - the Scottish Council Foundation - argued that a review was necessary now, as

revising a formula may well fall in the future to a government at Westminster which is hostile to devolution and resentful of Scotland's share of public expenditure. Such a government may be tempted to cut the Scottish grant below the level of need perhaps to per capita levels. (Scottish Council Foundation 1997)

The advocates of needs assessments seldom demonstrate any awareness of the inherent conceptual and technical problems of carrying out such an exercise for only four countries. Whilst politically it has been recognised that Scotland has higher needs, the extent of this has never been established with any precision. The Audit Commission (1993) has recognised the difficulties, by concluding there is no such thing as a 'perfect' or even 'fair' approach to needs assessment, and in practice governments resort to a 'least worst' system. Treasury evidence to the Treasury Committee concurred:

There is no scientifically objective way of saying which factors justify which level of expenditure - in the event the question of what is fair is a question for political judgement. (CH 1998, p/4)

Even formulae using the most advanced statistical techniques available require interpretation and judgement over the political acceptability of their outcomes (Keating and Midwinter 1993; Carr-Hill and Sheldon 1992). It is this inevitability of contesting interpretations over imperfect data and techniques which demonstrates the benefits of Barnett - its simplicity, transparency and comprehensibility are important characteristics.

Scottish Affairs

However, a new economic orthodoxy critical of Barnett has emerged recently. This critique argues that Barnett is a formula for achieving convergence in per capita expenditures; that recent administrative reforms have tightened up Treasury control of Scottish spending to enforce convergence; and that convergence is inappropriate given Scottish spending needs. The failure of the system to deliver convergence between 1979-92 reflected a number of factors which the Treasury has now corrected. Bell et al (1996) argued that:

the way in which the Barnett formula currently operates will eventually lead to equal per capita expenditure in the territories (though ... the rate of convergence can be slow). This is not necessarily appropriate since it takes no account of variations in need across different parts of the country, nor in differences in the cost of delivery of services.
(Bell et al 1996, p.29)

The administrative changes introduced since 1992 are seen as closing a number of means of bypassing the formula, and the recalibration of population shares to reflect the 1991 census further reinforces the 'Barnett squeeze'. Thus:

The important point to note is that the Barnett formula now has teeth, in a way it did not have originally, and that it is already delivering - and will continue to deliver - a squeeze on Scottish public expenditure.
(Cuthbert and Cuthbert 1998, p.3)

However, these authors offer no empirical evidence of a squeeze in practice, but rely on hypothetical illustrations of the mechanics of the formula in operation. Kay (1998) does offer some evidence which, for the period 1995-96 to 1998-99, found 'little in the way of an implied Barnett squeeze on Scottish public spending' relative to England, despite real cuts in spending. In fact, this is Barnett working in the manner we would expect. Kay however forecast a 'Barnett squeeze' (i.e. in the expenditure relative) over the three years spectrum of plans covered by the Comprehensive Spending Review, whilst experiencing real growth in expenditure. He concludes:

this implies a major fall in Scotland's relative share of public spending in these areas over a short period.
(Kay 1998, p.37)

Unfortunately, Kay's data is reliant on proxy figures for English spending. However, *ceteris paribus* we would expect a decline in the Scottish

The Barnett Formula and Public Spending in Scotland

expenditure relative. Indeed, we would regard this operation of Barnett as offering real advantages to Scotland, as our share of reductions is based on our share of population, not the UK budget, in times of restraint, and offers slower but real growth in spending in times of expansion (Midwinter and McVicar 1998). Reduction of the relative will occur in a context of growth. As a recent paper by Gavin McCrone (1999) noted, the strict application of the Barnett formula would result in gradual convergence. The key question is, however, will Barnett be strictly applied?

BARNETT IN PRACTICE

Fortunately, there have been a number of studies and parliamentary investigations which have examined the origins, purposes and performance of the Barnett formula. This section draws on this body of evidence. The block and formula approach is applied to 96% of the Scotland programme. Those outwith the block - agriculture, fisheries and foods, and the nationalised industries' external financial limits -are negotiated annually with the Treasury. Changes to the system since 1982 have resulted in a reduction in the population ratio applied from 11.76% to 10.66% of the English programme, and a slow expansion of the programmes under the control of the Secretary of State (Scottish Office 1998).

When the Treasury needs assessment study was published, block expenditure in Scotland was 22% above the English per capita figure. The conventional view is that Scottish Secretaries performed well in defending their spending turf. Parry argues that:

between 1975-6 and 1979-80, the Scottish Offices environmental services programme fell in real terms by 11.1 per cent, housing by 11.1 per cent, education by 5.2 per cent and transport by 2.6 per cent, but in all these programmes Scotland's relative position improved over the period. Cuts elsewhere were more severe, and Scotland's position was more than adequately protected.

(Parry 1982, p.108)

He argues that Scottish Office officials saw advantages in moving from political bargaining to a formulaic approach, particularly after the 1979 devolution referendum reduced the salience of the Scottish issue. Parry regarded the new approach, based on smaller increases and decreases, as providing protection to the Scottish position, as it gave Scotland 'less than its

Scottish Affairs

fair share of cuts' (p.116). This position reflected the decision by the Secretary of State to adopt the principle of 'what we have we hold', by

using the formula to head off the full impact of cuts at the price of falling behind English growth rates should public expenditure increase.
(Parry 1982, p.114)

Heald's 1994 study confirmed the success of this strategy within a cycle of growth and decline in public spending, concluding that 'the empirical evidence shows a continued advantage to Scotland in terms of both per capita identifiable expenditure and (proxied) per capita block expenditure'. As Heald notes, however, this is consistent with the Treasury's objective which was to prevent further relative gains for Scotland and Wales after devolution (p.162).

Heald goes on to show that the predicted 'convergence' of per capita expenditures did not occur, because of Scotland's relative population decline and a number of spending decisions which bypassed the formula. As Heald rightly notes, predictions based on the strict application of the formula create an overly mechanical view of a political process. He showed that Scottish block spending rose to 30% above the English norm in the first two Thatcher administrations. Heald concludes:

The Barnett formula protected Scotland's block expenditure relative and at a time of diminished Scottish political influence within the United Kingdom.
(Heald 1994, p.171)

Despite the increased focus on Scottish spending by English Conservatives after the 1987 elections (Cooper 1995) this relative was maintained in 1993-4.

The economic orthodoxy argues that the decision to retain the Barnett formula for determining the Assigned Budget will work to Scotland's disadvantage, as the bypass loopholes are now closed; the impact of population decline is marginal; and the strict application of the formula will result in convergence. Regrettably, this concern with predictive power is achieved at the expense of political realism, and these arguments rest on shaky assumptions.

Convergence is not a policy objective. The critics are confusing a property of the system in times of growth, with the objectives of the approach. As we have seen above, these were to prevent further Scottish gains through

The Barnett Formula and Public Spending in Scotland

bargaining. This issue was discussed at length by the Scottish Affairs Committee. The Conservative Secretary of State, Ian Lang, saw the formula as advantageous, particularly as it was accepted within Government that Scottish needs were higher, but the formula approach also recognised Scottish spending, although reflecting the high relative level, was even higher than the relative need justified. Lang went on to

emphasise that as part of the agreement to make the change it was recognised that spending needs in Scotland were higher and that convergence would not fall below that relatively higher spending need.
(para 2)

This position remains Government policy under Labour. Donald Dewar has confirmed that there has never been any intention of reaching a point where per capita spending in England and Scotland is exactly the same (private correspondence with author). Labour see the present system producing fair settlements (i.e. politically acceptable) in the absence of precision in needs assessments.

The Scottish Affairs Committee also heard of a number of expenditure decisions which bypassed the formula, including the special arrangements for water and sewerage in Scotland; and additional expenditure announced by the Chancellor of the Exchequer in 1993, whereby 'although not under the block and formula arrangements, Scotland received some £70 millions extra' (para 28). Pointing to such developments, Ian Lang observed these were far more relevant than the recalibration of the population ratio:

So far as the Barnett formula is concerned, the impact of the Barnett formula has been beneficial ... [T]he change which I agreed with the Chief Secretary resulted in a net loss of £17 millions. Set this against the ad hoc deal I was able to negotiate with the Treasury of some £340 millions.
(para 8)

Lang also noted that transfer of responsibilities from UK departments are negotiated on a current cost basis, not the formula basis. In the case of Scottish higher education, this reflected the distinctive nature of Scottish degree programmes and their concomitant higher costs. Lang himself opposed the calls by Conservative backbenchers to abolish the Barnett formula, and, as David Heald observed, the recalibration of the population ratio in the formula was a 'far better outcome' for Scotland than its abandonment (Heald 1994, p.25).

Scottish Affairs

This review of practice has shown that a central assumption of Barnett's critics - namely that full convergence is a policy objective - is wrong. The underlying policy assumptions are that Scotland has higher needs than the UK average, but these are not so great as its expenditure advantages, and so the Barnett formula is seen as a means of reducing this advantage in the context of spending growth. We can argue about the extent of Scottish additional needs, but the judgement is essentially political (Midwinter 1999). The 'Barnett squeeze' is in practice simply slower growth, not cutbacks with any implication for public services. The Cuthberts' notion that Barnett is a 'bomb' under the Scottish Parliament is difficult to take seriously.

BARNETT AND THE SCOTTISH PARLIAMENT

The plans for funding devolution were announced by the Labour Government in its Comprehensive Spending Review. After two years of real reductions - the result of sticking to the Conservative's expenditure plans - the trajectory is one of modest growth. Over the next three years, the Scotland programme will rise from £12.7 billions to £13.6 billions, a real terms increase of 2.3%.

We would expect that this trajectory of growth would result in some narrowing of the Scottish per capita relative to England. Kay (1998) assesses the gap as 6% less over the four year course of a Parliament than if Scotland received the same percentage increase in England. On past experience, we would expect the degree of convergence to be less than that, because of the impact of population change and ad hoc policy decisions, both of which act to Scotland's advantage more often than not (Heald 1994). Kay's analysis acknowledged that population change would have such an effect, but that it would be 'marginal'. We agree, but as Kay earlier observed these margins 'represent the battleground for improving/maintaining services' (p.33).

Over the period, the Government's expenditure plans envisage Scotland's share of the UK budget falling from 7.8% to 7.6%. Over the same period, the Scottish share of the UK population is projected to fall by .16%, broadly in line, and certain to influence the expenditure relative with England. At the moment, Scotland receives 10.66% of the English expenditure increases based on 1991 census population shares. By 2002 this is forecast to fall to 10.23%. The result of this will be to narrow the degree of convergence on the expenditure relative. It will in practice be minuscule, and remain marginal to expenditure decisions. England's population will grow by 1.6% over the same period, whilst the Scottish fall is 0.4% - a 2% difference (Office for National Statistics 1998).

The Barnett Formula and Public Spending in Scotland

However, we would wish to stress again that the expenditure relative is an outcome of political decisions, not a target. Kay's (1998) argument that Scotland should retain the expenditure advantage which exists in the current year into the future and that there should be no redistribution in favour of countries with growing populations is clearly inequitable given the predominance of population as a driver of expenditure need. This was recognised by a Mr Weale of the Treasury in his evidence to the Treasury Committee that 'demographics tend to be what drives spending need in a range of public spending programmes' (p.14).

In practice, the Barnett formula will not have the deleterious effect on the Scottish Parliament that recent critics have claimed. But devolution does create 'uncharted waters' (Midwinter and McVicar 1996). We have noted that Scotland has consistently benefited from in-year budget decisions which are determined on non-formula basis to reflect existing commitments. Despite the claims that such avenues have been closed, they clearly remain, as Scottish Office evidence to the Treasury Committee showed:

There are a number of circumstances in which the formula does not apply and one of them is in-year increases. We have no entitlement. If we think we have a good case for an increase to match an increase in England, clearly our Secretary of State is likely to make representations about that. (Treasury Committee 1997, p.25)

A recent example of this emerged in the 1999 budget when the Chancellor announced additional increases from the Capital Modernisation Fund. English block proxies were not included, but the increases were greater for the Scottish Office than with the Irish or Welsh Offices. The Scottish figure of £165m (£32 per capita) compares with £50 million for Northern Ireland (£30 per capita) and £80 millions for Wales (£27 per capita).

What is uncertain is how such allocations might be made after devolution. If the Scottish Parliament remains an integral part of the Whitehall expenditure community then the prospects of maintaining such arrangements must be good. If devolution weakens access to Whitehall in return for autonomy in Scotland (Keating 1996) then the outcomes will be less certain.

Analysis of Scottish spending has to be placed firmly in its political context, in which the political acceptability of outcomes is more important than the mechanics of the formula. Formulae can always be adjusted or 'refined' to deliver political objectives. The great advantage of the Barnett approach is its

Scottish Affairs

simplicity and transparency, so that any political adjustments to it can be seen, openly debated, and understood.

For the next four years, the continuation of the block and formula system provides for stable but modest expenditure growth, not the illusory squeeze identified by its critics. The only squeeze will be on the expenditure relative statistic, not spending. Over this period any erosion of the expenditure relative will be accommodated within a context of spending growth, which offers real benefits in terms of financial management. We would expect to see some modest degree of convergence. We would not expect a reappraisal of the formula in this Parliament, and remain convinced a robust defence of Scottish spending needs can be made, given the inevitability of imprecision in needs assessment. As Parry observed back in 1982:

Central to the issue is the definition of 'need'. This is the legitimate justification for variations in expenditure, but it is not well operationalised as a concept and tends to be an amalgam of political and socio-economic judgement.
(Parry 1982, p.113)

However, we remain firmly of the view that in the long term the instability in budgetary politics created by devolution is a greater threat to Scotland's expenditure levels than their erosion by modest formulaic drift under Barnett. In short, the reduction of Scotland's spending requires a political decision that its higher level is excessive and should be reduced. This conceptual ambiguity remains. Despite advances in statistical techniques, any formula can be subjected to criticism by a skilled analyst, challenging the selection and weighting of indicators. The role played by successive Scottish Secretaries in voicing the Scottish case should not be underestimated, and we cannot see that Office holding the same sway in UK Cabinets after devolution. In the long term, reduced political influence at Westminster rather than the Barnett formula is the key issue.

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Scottish Affairs

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