

THE BARNETT FORMULA AND ITS CRITICS REVISITED: EVIDENCE FROM THE POST- DEVOLUTION PERIOD

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1. INTRODUCTION

Since the devolution of power to Scotland, Wales and Northern Ireland in 1999, a stream of papers and reports have argued for the replacement of the Barnett Formula, which is used in the setting of block grants to the devolved administrations, with a needs-based formula, either within the current system, or as part of a reformed system based on equalisation grants and extended fiscal powers. In 1999, I argued in **Scottish Affairs** (Midwinter 1999) that criticisms of the Barnett Formula had become an economic orthodoxy, in which the formula was portrayed as a mechanism for achieving convergence in expenditure per capita and in which the tightening up of Treasury controls would enforce such convergence as this closed the means of bypassing the formula which had offset its squeeze property. I argued that this critique reflected an unduly mechanistic interpretation of the resource allocation process, and that any convergence would be modest, as political pressures would continue to influence budget outcomes.

Since then, theoretical criticisms of the formula have increased, unsupported by any empirical evidence of a convergence effect in practice. The main criticisms of the Barnett Formula refer to its impact in practice, and its likely future impact. On the one hand, it has *overfunded* Scotland and Northern Ireland, relative to their needs as set out in the Treasury Needs Assessment Study of 1979. This is said to be unfair to areas, such as the North-East

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England, which also have high expenditure need. A second argument is that the formula will result in uniform spending levels per capita in the long-run, and that would be inconsistent with need, whilst destabilising to the devolution settlement.

The first argument rests on concepts of territorial equity, and a normative view that a needs based model would redistribute resources to disadvantaged areas. From a Northern Ireland perspective, Tomlinson has argued against the continued use of the Formula, as

a needs-based formula is preferable to one based on population estimates, notwithstanding the difficulties of agreeing this with the Treasury, and the probable resistance of Scotland to changing the present regime.
(Tomlinson 2002, p.25)

Similarly from Wales, Morgan (2001) criticised the Barnett Formula as it does not reflect need, yet delivers higher expenditure per capita to Scotland than Wales and North-East England, although both have lower levels of GDP per capita than Scotland. He argues for a new needs assessment formula to remedy these 'glaring anomalies'. McLean and MacMillan (2003) make similar arguments regarding Wales and the North-East, and argue for a common basis for government spending across the UK.

The second argument rests on an economic interpretation of how the model will work in future. Bell and Christie (2002) see Barnett as a failure as no convincing economic case can be made in its defence. Muscatelli (2001) discussed 'life after Barnett', which he claimed could not provide a long term basis for devolution, as it has no inherent logic and no explicit relation to spending needs; whilst Ferguson et al (2004) assert that it was not designed to bear the weight of the central mechanism for distributing resources to the major devolved authorities, and discontent is such that reform seems inevitable.

However, the empirical basis to such arguments is slight. Those who have argued for reform on grounds of equity have done little more than compare spending levels in Scotland and Northern Ireland with their assessed needs figures in the Treasury study of 1979, and/or their GDP per capita levels. Neither provides a particularly convincing basis for change. We shall examine the Treasury study in some depth later in the article, but GDP per capita is used by government as an indicator of economic performance rather than as an indicator of expenditure need. Most current formulae use a range

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of measures of poverty and deprivation as indicators of higher need, and these are more direct measures than GDP which is at best a crude proxy for income/poverty. Regrettably, the economic case for reform has been largely theoretical, rather than demonstrating that Barnett is having the effect as claimed or that an acceptable needs formula is a practical proposal.

Such studies are also problematic in terms of their methodology, as they tend to *assume* that full convergence of expenditure per capita will occur, and then calculate the hypothetical resource implications for Scotland. Bell (2001), for example, claims to show how the formula will cause per capita spending in the devolved administrations to converge on English levels, and simulates how long this will take. In the short run, he calculates that Scotland's lower percentage increases delivered around £1 billion less between 2000-2003, than if it had received the same percentage growth as England. This is called the 'Barnett Squeeze'. In practice, by contrast the Scottish Budget grew in real terms over the period and there was no squeeze. Nevertheless, this hypothetical £1 billion was reported in the Scottish press as a real loss. The problem is applying the concept of a 'squeeze' to what would simply be lower relative growth. If convergence did occur in a context of spending growth, this would not be a squeeze on spending in the conventional meaning of the term in budgetary studies, which is a 'reduction'. Analysis is further hampered by the refusal of the UK Government to publish comparable devolved expenditure levels for England. However, on BBC's Newsnight Scotland of 3 October 2005, Professor Bell agreed that the predicted squeeze had not occurred in practice.

A recent paper (Ferguson et al 2005) conducted a similar exercise to assess the economic impact of the Barnett Formula. Unfortunately, rather than assessing the impact of the budget outcomes on the Scottish economy since devolution, the authors simulated the effect of 'strict adherence to the Barnett Formula' in the same way. The paper focuses on the 'economic implications of achieving Barnett equilibria' (i.e. convergence) despite the fact that this has *never* been a policy objective under Conservative and Labour governments – and conclude that equalising spending to the English level would reduce the Scottish Department Expenditure Limit (DEL) by 11.26%, and result in a '4.6% reduction in Scottish GDP, and a 5.0% reduction in Scottish employment and population' (p.23). These hypothetical projections were reported in the Scottish press as 'squeeze on Scottish Budget to cost 120,000 jobs' (**Scotsman**, 22 March 2005).

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This is, of course, a problem which arises when theoretical arguments which are politically sensitive are reported in the media. Ferguson et al focus on the properties of the model with simplified assumptions, rather than analysing the impact of spending growth on the Scottish economy. It deservedly brought a response from the Executive based on practice, not theory, that

What the academics are considering is a theoretical long-term possibility. ... This paper assumes that Barnett convergence implies a real cut in Scottish expenditure – all the evidence is that what is happening is that English spending is converging up to our levels, while Scottish spending per head continues to rise in real terms. (MacMahon 2005)

In my view, researchers have a responsibility to seriously consider the policy assumptions underpinning government strategy, something these authors conspicuously failed to do. The paper did not – as was claimed in the press – demonstrate ‘there was a Barnett Squeeze over time’. Rather the authors created their own convergence assumption, to reach conclusions which were misleading to the media and public.

Problems of interpretation are not confined to researchers as the most recent official review by a House of Lords Committee (2002) shows. This report was concerned with the constitutional implications of the financial arrangements in terms of the autonomy of the devolved administrations, the transparency of the system and the processes which should be pursued if reform became necessary. It notes (para.80) that the Barnett Formula attracted almost unanimous support from witnesses from the devolved administrations and the UK government. Nevertheless, it rehearsed the conventional orthodoxy about slower rates of spending growth constituting a ‘Barnett Squeeze’, which narrows the financial room for distinctive policies, and will eventually lead to convergence of expenditure per capita with England. Despite the absence of any empirical data to support these judgements, it concludes that this is ‘a mathematical inevitability, not a decision about policy’, and this will become a source of tension in the devolution settlement (para.104). It therefore favours a further needs assessment.

These views are difficult to square with the origins and development of the formula, and the empirical research into its impact (Heald 2002). It is necessary, therefore, before setting out the evidence, to elucidate the underlying principles of the financial arrangements, and the mechanisms and procedures by which they are applied.

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new budgets. In addition, the formula does not apply to supplementary estimates, such as *in-year allocations* which may have a specific economic purpose (e.g. Gordon Brown's Capital Investment Programme in 1997 was based on unemployment levels); to *interdepartmental transfers* for work undertaken on behalf of other departments (Scotland gains significantly in this for NHS treatment of English domiciles); or to *annually managed expenditure*.

The principles underpinning the formula are now set out by HM Treasury in its Statement of Funding Policy, which is revised for each Spending Review exercise. Since the first of these in 1998, Northern Ireland's population share is now also relative to England, at 3.41% (Edmonds 2000, p.12).

In summary:-

1. Funding for the devolved administrations budgets is normally determined within spending reviews alongside UK departments and in accordance with the policies set out in the Statement of Funding Policy;
2. The block grants (or assigned budgets) are contained within the devolved administrations Departmental Expenditure Limits (DELs). Changes to these spending allocations are determined by the quantity of the change in planned spending in UK departments; the extent to which the relevant UK programme is comparable with the services carried out by each devolved administration (the comparability percentage); and each country's population proportion.
3. These arrangements largely remove the need to negotiate directly the allocation between HM Treasury and the devolved administrations. The allocation of public expenditure between the services under the devolved administrations is for them to determine;

and

4. Devolved administrations will have access to the UK reserve in the same way as UK departments, to deal with exceptional circumstances. The general expectation is that devolved administrations will manage additional and unforeseen pressures within their budget totals.

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The financial arrangements for devolution offer significant autonomy over resource allocation, and fiscal autonomy at the margins, whether through the tax-varying powers, or non-domestic rating. As Heald and McLeod (2003, p. 147) have observed:

In comparison with other unitary states, there is a highly centralised and unified control over public expenditure and taxation, ... very little fiscal activity eludes this highly centralised control ... A consequence for UK devolution finance is that the expenditure basis is paramount. There is thus no guarantee that tax increases by subnational governments would necessarily enable higher expenditure. ... Only the Scottish Variable Rate of Income Tax is excluded from this rule.

The Barnett Formula's role *within* that system is consistent with the UK experience of the Goschen Formula in the past, with the continuing practice throughout the last century of using English allocations as a benchmark, and, most importantly, with the incremental approach to financial planning which focuses on marginal adjustments to the existing baseline.

Critics from a territorial equity perspective argue that Barnett was designed to promote convergence in expenditure per capita across the UK, but has failed to deliver this, and this is unfair to the English regions, and so that it should be replaced by a needs-based formula. Critics from an economic perspective argue that the process has been tightened up and convergence will now occur in the post-devolution period. This is inequitable, they argue, and they tend to favour a needs-based equalisation grant within a system of greater fiscal devolution

3. THE CONVERGENCE ISSUE

The House of Lords report asserted that Barnett would 'provide for public spending across the UK to converge on a single uniform level of spending' (House of Lords 2002, para.89). The convergence property of the formula was first identified by David Heald in 1980, and yet in 2002 Heald was still noting the lack of evidence of convergence in practice, but arguing that this may now change as a result of the high rates of expenditure growth in the post-devolution period (Heald 1980; Heald and MacLeod 2002). This interpretation is repeated uncritically in a number of papers (Bell et al 1996; Bell 2001; Muscatelli 2001), although Tomlinson (2001) reports it is now squeezing programme budgets in the case of Northern Ireland.

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Empirical evidence supports that view. Heald's (1994) study showed that the reality was *divergence* from England in the 1980s, because of the aforementioned volume planning system which compensated baselines for cost increases; because of what Heald called 'formula bypass' – expenditure determined outwith the formula; and population change. The last of these is of vital importance to understanding why the outcomes diverge from the path presented by the model. To demonstrate the convergence effect, Feguson et al (2003) operate on two wholly unrealistic assumptions – that the population share employed in the formula is fixed, and that the formula is rigorously applied. In practice, population shares change annually, and some expenditure is allocated outwith the formula in every budget exercise as a matter of course, through Annually Managed Expenditure, supplementary allocations *within* a budget year, and interdepartmental transfers.

These authors wholly misinterpret my own previous work on Barnett. They claim that my support for the block and formula approach 'appears at least to be predicated upon a belief that the current regional distribution of expenditures is not in fact governed by the Barnett Formula' but by 'a formula combined with discretionary adjustments' which affect the 'squeeze' and thus 'Barnett equilibria are little more than theoretical *curiosa* and of no practical relevance'.

In practice, there is no evidence that politicians ever intended to promote convergence to a uniform level. Rather, they sought closer alignment between allocation and the 1979 needs assessments. It is indeed my view that, for Scotland, the concept of Barnett equilibria has had no practical relevance, as it is neither a policy objective nor a financial target of the UK Government, and there is *no* empirical data which suggests it is likely to occur over time.

My own view in fact is that the *baseline* is the main determinant of the new budget, combined with additional expenditure outwith the formula and Barnett-determined spending, whilst change in population relativities affect the per capita figures. As Heald and McLeod observe:

population relativities change through time, and this brings about different convergence limits for each country ... Scotland's relative population continued to fall, thereby mitigating the predicted falls in the expenditure index. ... Contrary to some claims it was never intended to equalise spending per head. (Heald and McLeod 2003, pp.150-151)

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The importance of population change in delivering non-uniform outcomes cannot be overstated, as the convergence effect would only occur if population relativities remained stable. In practice, however

Changes in population relativities are not reflected in underlying spending baselines, although they are in the calculation of spending per head. This has tended to offset convergence in the case of Scotland, whose share of the UK population has declined over the life of the Formula, and to accelerate convergence in the case of Northern Ireland, whose share of the total population has grown. (HM Treasury 1998, p.v)

Heald and McLeod (2002) expect this pattern to continue, recognising that the indexes of per capita expenditure are much affected by the population denominator. If researchers continue to use simplified models to simulate spending convergence, rather than examining empirical trends, then their findings will continue to be hopelessly wrong. McLean and MacMillan (2003), for example, argue that Wales may have seen spending convergence under Barnett, when in fact their own data shows an index for 1999-2000 of 111, which is evidence of *divergence* from the Welsh position of 106 in 1999. This stems from the basic error in the conventional orthodoxy of assuming that lower percentage increases in the Department Expenditure Limits of the devolved administrations are evidence of a Barnett squeeze. What matters is not the increases, but the allocation as a whole, and their division by the population denominator into spending per capita. As Heald and McLeod (2002, p. 160) rightly observed,

attempts to quantify the so-called Barnett Squeeze are at best misconceived and at worst, political mischief making; they assume that Scotland has an entitlement to the same rate of increase as in England, irrespective of existing levels of expenditure per capita.

It is now possible to compare outturn expenditure per capita across the four nations of the UK in the immediate post-devolution period. Expectations that devolution would result in 'greater adherence to Barnett in future' (Ferguson et al 2004) were wrong, simply because, from 1992, Barnett was already being applied to all the incremental increases (not just to real growth but to nominal growth), and population shares had already been updated. Evidence of convergence should have emerged in the 1990s, but did not (Midwinter 2004), because of the population changes discussed above, but also because 'formula bypass' is not something exceptional applied to obstruct

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convergence, but a regular element of decision-making such as specific initiatives, interdepartmental transfers, exceptional costs or spending with different objectives to the DEL allocations.

A more realistic interpretation of how the system was revised in 1992 was provided by the former Scottish Secretary, Ian Lang, in evidence to the Scottish Affairs Committee (Lang 1993). Lang's evidence reported that UK governments had always acknowledged that spending needs in Scotland (and Wales and Northern Ireland) were higher even prior to the 1979 Needs Study. Therefore, the Barnett Formula was not introduced with a view to converging the relative spending levels north and south of the border, although it was recognised in 1979 that Scotland's spending was above its needs assessment. In 1992, these higher spending needs were still acknowledged, and 'the Government's policy is that provision for Scottish programmes will not be allowed to change in relation to relevant English expenditure in such a way as to reduce Scotland's share of provision below a level reflecting the higher needs' (Scottish Office 1992).

Lang concluded that the impact of reducing Scotland's population share from 11.76% to 10.66% was marginal – a loss of £12m – compared with an 'add-on' of £340m of additional spending he was able to negotiate that year with HM Treasury as Scotland's share of a deflationary capital works programme (because of higher unemployment), and funding in compensation for subsidies provided to allow water privatisation in England. Such political bargaining cannot be captured in a simplified model. Moreover, although the economic theorists regard such spending as being non-systemic, in fact it reflects the way negotiations proceed by using England as a benchmark in which *comparable* expenditure is dealt with through Barnett, whilst additional non-comparable expenditure is negotiated.

Finally, it is necessary to stress that convergence remains a property of the Formula in certain conditions, rather than an objective of policy. As two Treasury officials wrote:

There is no built-in convergence factor. Convergence is simply an arithmetic feature that the percentage increase will tend to be less in those devolved administrations when baseline levels of spending per head are higher than in England, so equal increases will represent smaller percentage increases. The higher spending per head is not a result of the

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Barnett Formula but of historic baselines inherited from the past. (Dunn and Parkinson 2002, p.2)

This can be further examined for the first post-devolution parliament from 1999-2003. Qualifications need to be made as only proxy data is in the public domain, through the Treasury annual Public Expenditure Statistical Analyses (PESA), which presents identifiable expenditure per head in the devolved nations and English regions.

These figures include significant sums of public money spent by UK Departments in Scotland, and the degree to which identifiable expenditure is comparable varies between the three nations. Block expenditure for England is also unavailable on a regular basis, and this gap is one source of academic disagreement over trends. So strict comparison is not possible, but relative trends can be identified. In the case of major services such as education and health, comparability is over 90%. In other services such as trade and industry, it is only between 20% and 30%. Moreover, a large element of agriculture spending is funded by the EC, so although within UK spending it is over 80% comparable, it is doubtful whether it should be included in such comparisons. This is the general approach used by analysts, as in Heald (1994), McCrone (1999) and Midwinter (2004). The one exception is McLean and MacMillan (2003) who simply excluded social protection spending from the PESA statistics. Not surprisingly, as the three nations all receive above average allocations in agriculture, they appear to have significantly higher expenditure indexes than the UK average (Wales = 111; Scotland = 122; and Northern Ireland = 146). However, when agriculture is excluded, the gap narrows with Northern Ireland falling to 143, and Wales falling to 109, whilst Scotland's index is unaffected. There is a further problem of including trade and industry as its Barnett comparability is in the 20% range for all three nations. For this analysis, therefore, two expenditure measures are used:

- Measure A is 'identifiable expenditure per capita minus social protection and agriculture spending' – which McCrone (1999) regards as the best available proxy for Barnett-related expenditure;
- Measure B is the same as A with trade and industry also excluded.

From Spending Review 2000 (HM Treasury 2000), we can map out the percentage increases in Departmental Expenditure Limits for the three nations, but not England, so the UK DEL is used as a comparator. In all three

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nations, spending increases were below the UK average, although Wales was close to it.

Table 1
Planned Growth in DELs in Spending Review 2000

| | 1999-2000 | 2002-2003 | % Change |
|------------------|-----------|-----------|----------|
| | £bn | £bn | |
| Scotland | 13.9 | 17.4 | +25.1 |
| Wales | 7.1 | 9.1 | +28.1 |
| Northern Ireland | 4.9 | 6.0 | +22.4 |
| UK | 176.8 | 229.3 | +29.7 |

As Heald (2002) argued, it is the percentage increases which have formed the basis of political complaints about Barnett, particularly in Northern Ireland. The impact at outturn is recorded in the PESA statistics and converted to per capita terms. Using Measure A in 1999, Scotland's position is broadly stable – falling 1 point, whilst Wales *increases* by 1 point, and Northern Ireland falls significantly. Using Measure B, Scotland remains stable, Wales decreases, whilst Northern Ireland again records a significant fall.

In summary, the lower percentage increases do not convert into a uniform pattern of expenditure per capita convergence, with Scotland's remaining stable, Wales evidence mixed, and Northern Ireland falling. This is broadly the expenditure effect that the relative population trends of decline in Scotland, stable in Wales and growth in Northern Ireland would suggest. Post-devolution, the uniform trend to convergence is still not found in the empirical data. Moreover, all of these comparisons are made on a Northern Irish figure which includes law and order, a reserved power, and Northern Ireland's expenditure on this is almost twice the English level because of the special problems there. This reduces the Northern Ireland spending index to 125 – much lower than 134 on Measure A – and to 117, again much lower than 128 on Measure B.

Table 2

Changing Expenditure Indexes 1999-2003 Outturn

| Measure A | 1999-2000 | 2002-2003 |
|------------------|-----------|-----------|
| Scotland | 122 | 121 |
| Wales | 109 | 110 |
| Northern Ireland | 143 | 134 |
| UK | 100 | 100 |
| Measure B | | |
| Scotland | 121 | 121 |
| Wales | 109 | 107 |
| Northern Ireland | 134 | 128 |
| UK | 100 | 100 |

Source: PESA 2004

4. THE NEEDS ASSESSMENT ISSUE

Arguments for the replacement of Barnett with a needs-based formula are also part of the conventional orthodoxy. Even when advocates are aware of the limits to needs assessment, the problems are overlooked, and the assertion made that this would form a more rational basis for resource allocation. For example, Gavin McCrone (1999) argues that assessing need is no straightforward task and leaves much room for judgement, with an inevitability of disagreement. Nevertheless, he sees the assessment of needs as the only basis on which higher expenditure levels can be defended. In reality, needs assessment does not solve the problem; it simply changes the focus of the argument.

It is worth recalling the background to this issue. Labour's 1977 White Paper on devolution finance argued that the basis for determining levels of devolved expenditure should be needs, and such assessment should be as objective as possible. However, it noted that 'assessing needs and relating them to

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expenditure are not exact sciences: a good deal of room for judgement will always remain' (para.68). Nevertheless, it favoured developing a formula approach on the basis of relative need then expressed as a percentage of comparable English expenditure, and announced that studies were in hand to collect the necessary information on needs and standards of public services (para.91).

When the Needs Assessment Study was published, however, it clearly fell short of the required rigour. Thain and Wright saw it as 'heavily qualified with assertions that it was very difficult to measure "needs" objectively and that it was difficult to weight "subjective" factors'. (Thain and Wright 1994, p.309). The report makes clear that the needs assessment exercise would inform judgements rather than determine allocations as

no neat formula could be devised to provide for shares for Scotland (and England, Wales and Northern Ireland) in varying circumstances from year to year. The task involves judgements of great complexity and political sensitivity. (HM Treasury 1979, p.24)

Indeed, the report is full of caveats about the limitations of the exercise.

The key points in the study were that

- in no service was it possible to express the main policies in terms of the achievement of clearly defined standards;
- provision according to needs does not mean that identical provision is made in all areas;
- not all factors taken into account were quantifiable;
- it is not therefore reasonable to construct a single coherent model of policies, standards and levels at service to which could be related all the objective information needed to determine relative expenditure needs;
- the results were by no means final;
- and
- the departments who have carried out the study agree that the methods of assessment are a long way from providing a wholly definitive means of expressing the relative expenditure needs of the four countries.

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The approach used was mainly a client-group method, which identified client numbers as the primary determinant of need (e.g. numbers of schoolchildren) and additional secondary factors (e.g. sparsity, poverty) which add to the costs of service delivery. Deviations from this approach were necessary, in services such as roads and housing, where the physical infrastructure (e.g. roads networks and housing stocks) were used as objective factors driving expenditure. The results of the study record all three devolved territories as having needs higher than the English average, and Northern Ireland and Scotland's spending levels were above their needs, whilst Wales was marginally below

Table 3
Needs and Spending Indices 1979

| | Needs | Spending |
|------------------|-------|----------|
| Scotland | 116 | 122 |
| Wales | 109 | 106 |
| Northern Ireland | 131 | 135 |
| England | 100 | 100 |

Source: HM Treasury 1979, para 6.5

It is not surprising, given the incremental nature of public spending, and the imprecision in measuring need, that the study was used to inform expenditure judgements, not determine allocations. Once it is understood that needs assessment offer only broad orders of magnitude rather than exact measures, the attractiveness of needs assessment models is greatly reduced. In 1979, the Government adopted the Barnett Formula in the absence of devolution, whereby 'the Treasury accepted that the current balance of spending between the UK and the territories was sufficient to justify entrenching it through introducing a population formula' (Thain and Wright 1994, p.309).

Nevertheless, politicians continue to be attracted to needs models, particularly if they believe the areas they represent will benefit from such an exercise. Both the Treasury Committee Report of 1997, and the House of Lords Report of 2002, recommended updating the 1979 study. Whilst some analysts believe it is possible 'to construct a much more detailed assessment than was possible in 1979 due to the more extensive range of statistics that are available to

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proxy needs' (Bell and Christie 2002, p.130), doubts remain over the feasibility of constructing a definition of a standard level of service in the context of devolution.

My own view is more pessimistic about the prospects for objective needs assessment, as the more sophisticated regression-based techniques used for the NHS and local government lack statistical validity in the case of only four nations. Moreover, such techniques are well-recognised as being unable to identify and measure unmet need (Midwinter 1999b). The rigour of the needs assessment model used by the Treasury is unlikely to be greatly enhanced if revisited today, and political requests to 'bring the needs assessment up to date' (House of Lords, para.12) will not deliver an objective resolution to the problem, as need itself is a political concept which requires political judgement as to what constitutes need. The Treasury's evidence to the Treasury Committee acknowledged that

there is no scientifically objective way of saying which factors justify which level of expenditure and there is no doubt that the Formula is a rough and ready way of allocating resources. In the end, the question of what is fair is a question of political judgement. (Treasury Committee 1997 Minutes of Evidence, 13 November, p.14)

For the Treasury, the Barnett Formula is simply a broad brush mechanism for allocating changes in public expenditure. The objective in introducing the Formula in 1978 was to more closely align expenditure with needs, not to promote convergence, i.e. equalise spending per head (Treasury Committee 1997, p.11).

Post-devolution, the Treasury position is unchanged. There is no intention to review the Barnett Formula, and any such review would have to be proceeded by a similar needs assessment exercise. In fact, some updating of the 1979 methodology has been undertaken, but not published, and not agreed with the former territorial departments. My information is that whilst Scotland's needs index remains broadly stable after the 1994 update, the needs index for Northern Ireland has fallen significantly from 130 to 123, mainly because of improvements in the housing stock since 1979, but also because of a minor shift to the deprivation weighting in the health model. This is very close to its current spending levels (Midwinter 2002).

Needs assessment would not resolve the problem, it would simply change the politics of resource allocation away from the unfairness of Barnett to the

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inequity of the needs formula. In this section, the importance of political factors in delivering change in the public finances is highlighted. Choices between spending and funding alternatives are inevitably political, rather than objective comparisons of options, as no such neutral basis of decision-making exists.

Whilst financial decisions may be discussed in the language of economic or organisational reality, decisions in practice will reflect political priorities, interests, and pressures. Devolution remains a priority for the UK Government, which has a vested interest in establishing its credibility. The Conservatives, having been vehemently opposed to it, have been coming to terms with it, and in the 2005 Election, stressed their desire not to undermine the new settlement, indeed stressing they had no intention of reviewing Barnett, and would maintain Labour's assigned budget levels determined under the current block and formula approach. The Liberal Democrats, however, are long-standing proponents of devolution, and favour a needs-based equalisation grant and greater fiscal autonomy.

So although, as has been recognised by other writers, devolution funding is now more politically sensitive than prior to devolution, political responses to perceived inequalities can be made *within* the current system. Heald and McLeod (2003) argue that the politics surrounding territorial public expenditure has intensified.

It is helpful to consider how the politics of the Barnett Formula have evolved. As Heald and McLeod (2002) have also noted 'the Barnett system is best viewed, first, as a political accommodation, and secondly, as a means of containing political conflict' (p.148). When Barnett was introduced in 1978, for Scotland only, it was viewed by the Treasury as a means of preventing further gains by the Scottish Office as had been delivered by negotiation over the previous twenty years, whilst the Scottish Office saw administrative advantages in obtaining a block allocation which it could allocate according to Scottish priorities, whilst avoiding the need for detailed negotiation with the Treasury. The devolution debate of the 1970s, however, increased awareness of the higher per capita spending levels in the three territorial departments, and this intensified when those areas rejected the Conservative agenda under Margaret Thatcher. When devolution returned to the political agenda in the 1990s, John Major wrote that he

feared that by exposing the reality of the favourable spending treatments given to Scotland, devolution would stir up English resentment leading to

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a backlash. I was already aware that there was considerable discontent within English departments about Scottish money. Most of this was confined to griping behind the scenes about the size of Scottish funding. (Major 2000, p.419)

The block and formula arrangement formed the basis of devolution finance, and was widely regarded as a sensible interim arrangement, although it was argued that it could not provide a basis for financing eventual English regional government (Hazell and Cornes 1999). Decline of English regionalism as a political issue, however, markedly reduces the need for reform in future, particularly as much of the criticism of Barnett came from MPs from North-East England. The issue now is whether the perceived unfairness of Barnett by politicians from Northern Ireland, Wales, Northern England, and London, can be addressed within the current system, or whether reform is necessary.

Firstly, it has to be clear that Barnett does not influence English regional allocations, as the devolved budgets are based on English totals. When Barnett is criticised by the English regions, it is the Scottish, Welsh or Northern Ireland expenditure advantages that are seen as unfair in comparison with their own, and these are determined largely by their historic baselines, not the formula, whereas in England, as the Treasury reported to the Treasury Committee,

the structure is such that individual services have their allocations of expenditure determined by individual formulae. (Minutes of Evidence, 23 October 2002, p.78)

Indeed, the data presented by McLean and MacMillan (2003) reports a negative relationship between allocations and GDP in England. This suggests that if there is an imbalance of expenditure and need, then the problem is one for Whitehall, not the Barnett Formula.

London's case, with the highest level of spending in England, is not particularly convincing, as it appears to be made, not on the grounds of need, but on the imbalance between spending and revenue raised in London. It scores 128 on Measure A, and 130 on Measure B, *higher* than all three devolved administrations. The North-East England's case is more plausible, as it has the highest level of social protection spending in the UK, although much less geographically remote than Scotland, which also affects costs. In 1999, the North-East scored 106 on both measures, and this had risen to 109

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on Measure A, but only 107 on Measure B. This is because its allocations for economic development rose significantly, from 24% above the English average in 1999 to 115% above it by 2003: as this is the programme for which GDP per capita is most relevant as an indicator, it is clear the Government has already responded to pressure.

To sum up, the evidence presented in this paper contradicts McLean and MacMillan's argument that the present arrangements unduly favour Scotland and Northern Ireland to the disadvantage of London, Wales and North-East England. Their interpretation is flawed, as the spending measure they use provides misleading comparisons because it includes agriculture spending, which is largely determined by the EU, economic development, which is largely determined by Whitehall, and in the case of Northern Ireland, also law and order, which is a reserved function.

These important aspects of identifiable expenditure are not driven by Barnett, and McLean and MacMillan's categorisation of this measure as 'public spending per head on devolved services' is inaccurate. When more appropriate proxies are used, the expenditure advantages of the devolved administrations are diminished. Scotland's 'devolved expenditure' relative is 20% above the North-East on their measure, but only 10.5% or 13% above on the more reliable measures. By contrast, London's expenditure is 6% below Scotland on the flawed measure, but 7% or 9% above on the alternative measures. The 'unfairness' of Barnett is not so self-evident as its critics claim, once the evidence is disaggregated and analysed.

6. CONCLUSIONS

The replacement of the Barnett formula by a needs based formula is not inevitable. Arguments that it will result in convergence of expenditure per capita across the four nations of the UK are not supported by the most recent empirical evidence. The argument that the Barnett Formula is unfair to English regions is not supported by the empirical data, and, moreover, it does not determine allocations to them. If there is unfairness, it lies within the operation of the range of formulae used in resource allocation within England itself. When the House of Lords reported it had noted that 'the effects of the formula across the UK as a whole, including the regions of England are unequal' (para.95), they were wrong. When they argued it was indefensible, they were also wrong.

The Barnett Formula

Whilst Barnett does not meet the theoretical objections of some economists, from a budgetary perspective, the block and formula approach is clearly defensible as a simple and objective way of allocating resources, which broadly reflects the higher expenditure needs of Scotland, Wales and Northern Ireland

Under the devolution arrangements, devolved administrations can re-open the block and formula approach if they are concerned that their funding levels are inadequate relative to need. Northern Ireland is perhaps most likely to trigger this mechanism. Yet the Northern Ireland Economic Council concluded in 2003 that

any approach to HM Treasury should be taken with utmost care. The mechanics of the Barnett Formula need to be fully understood before engaging in criticism of its application. ... Triggering a formal needs assessment is fraught with danger and everyone should be aware that it may be a double-edged sword. (p.iii)

However, the evidence reported here suggests all three countries now incur spending levels above their needs assessments, including Wales, whilst only Northern Ireland is following a convergence path. If it continues, then Northern Ireland's politicians may raise it with the Treasury as it is entitled to, but in practice, it could be dealt with through an ad-hoc adjustment to Northern Ireland's allocations rather than a more wide-ranging needs assessment exercise. Certainly, no area in the UK could be confident of gaining from such a review. Moreover, the retreat from regional government in England makes the continuance of Barnett more likely, and it is no surprise that both major parties committed themselves to its retention in the May 2005 General Election. It is clear that continuing with the existing arrangements did bring stability to devolution finance. The retention of the baselines – in common with UK departments – as the basis of the exercise ensures change is at the margins, and therefore manageable. If Barnett is replaced in the long-term, it is likely to be focussed on allocating the increment of growth than the budget as a whole. This approach was fundamental to the Goschen Formula; the twenty years of bargaining between 1959 and 1978 when baselines were the starting point, but England remained the benchmark, and again in the present block and formula system. Barnett, like Goschen, has proved very durable. If it is reformed, it will not be to meet the niceties of economic theory, but to respond to real problems of resource allocation. But with its

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combination of *stability* from the baselines, and the *flexibility* available in ad hoc adjustments, it may well survive much longer than its critics expect.

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