NI Assembly DFP Committee

REVIEW OF THE OPERATION OF THE BARNETT FORMULA

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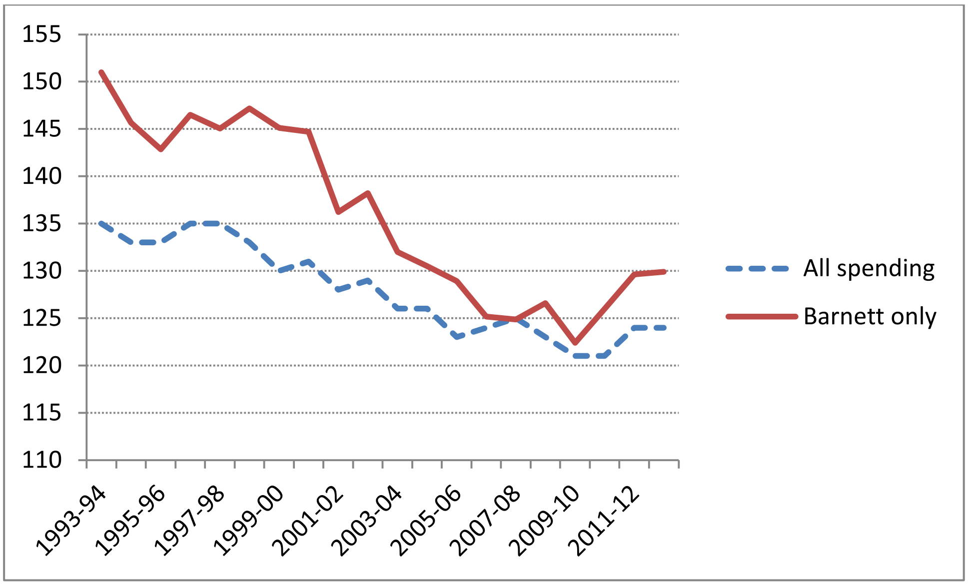
How the Barnett Formula Works

The Barnett Formula works by allocating any given addition to relevant English public spending across the devolved regions in proportion to those regions' share of UK population. For instance if relevant English expenditure rises by £1000 million and Northern population relative to England is 3.4% then NI will get a £34 million increase in its public expenditure. This is transferred as a total 'block' to be spent as decided by the devolved administration and not necessarily reflecting the composition of spending in England. Relevant public spending includes those parts of public expenditure 'identified' as relevant to the regions and hence excluding most of national defence, the costs of monarchy etc. For Northern Ireland, other costs such as the London underground and redevelopment aspects of the London Olympics and similar regionally specific costs are also excluded. Finally, and important demand-led expenditure (mainly social security benefits and pensions) are not allocated via the Barnett Formula.

Chart 1 Public Expenditure per head in Northern Ireland (UK =100)



Each of the devolved regions started at the beginning of the Barnett era (in 1979) with a share of UK public spending higher than their share of UK population. Northern Ireland's expenditure per head was for instance almost 50% above that in England. An annual addition to spending in these regions equal (but not greater than) their share of UK population should inevitably means that their share of UK spending will fall over time. This effect is known as the Barnett squeeze. Over the last 20 years total identifiable spending per head in NI has declined from 135% of the English level to 124% in the latest data ((chart 1). The spending allocated by the Barnett Formula alone (i.e. excluding social protection) initially declined more rapidly, but since 2010 the decline has been reversed (chart 1).

The Barnett squeeze occurs more rapidly when English spending is rising steeply either due to increases in real expenditure or due to inflation. The worst situation for NI would be if real spending was stagnant or falling while prices were rising. NI would then be hit twice, once by the real fall which would affect all regions and secondly by a falling share of national spending due to inflation. In practice the squeeze may be slowed due to special or top up payments such as the special package made by Gordon Brown in 1999 to ease the transition to devolution in Northern Ireland (and granted on the assumption that Belfast Port would be privatised). The recent Treasury agreement on additional spending in NI will have the same effect, albeit partly offset by extra borrowing by the Northern Ireland government.

The Barnett squeeze also works in reverse. If public spending is falling nationally then NI's share of that spending will tend to rise. This is what has been happening recently and it is why NI's share of UK Barnett 'identifiable' spending per head has risen over the last 4 years from 22% above the UK average in 2009/10 to 30% above in 2012/13 (chart 1). Since public spending will decline further after 2015 if the Coalition Government is re-elected, this means that NI's share will continue to increase as long as the Barnett Formula remains in use. The likelihood that public sector inflation will be low also helps NI.

Another influence on the Barnett squeeze is the growth of population in each region. Faster population growth than the UK average tends to intensify the squeeze because the higher historic spending levels are diluted across a larger number of people. Conversely a falling or slowly growing population in a devolved region tends to offset the Barnett squeeze. Scotland's share of UK public spending has been squeezed less than in NI for this reason. Scotland's population was falling for many years and even with higher migration into the UK since 2004 still grows slowly. In contrast NI has had faster population growth than GB since the late 1970s. However NI's population growth rate has fallen sharply since the onset of recession in 2008. At the same time population growth has remained high in England due to immigration and growing birth rate (partly from immigrants) to the extent that English growth is now higher than that in NI. This will additionally help NI and we can expect NI's level of public spending per head grow at least as fast as in England over the next few years.

How High is Public Spending in NI?

On the latest H M Treasury figures, Northern Ireland has a level of public expenditure 24% higher than the UK average and 28% higher than England. The NI Executive and Assembly can decide how to allocate this money over functions and departments, albeit heavily constrained by public expectations on comparability of services with GB and by EU regulations and subsidies. Table 1 below shows how the NI spending decisions affect per capita expenditure relative to the UK average in individual PE programmes.

Northern Ireland has higher, often much higher, per capita spending than GB in all programmes except the small science and technology programme. In some cases higher expenditure is clearly related to need. NI has for instance 12% more children of school age than GB and this fact is reflected in spending. As NI's number of children has come down over time so has spending per head relative to the UK. Education costs are raised in NI by a more fragmented school system than in England, by employing older teachers and by a lower level of private schooling, but these costs do not seem to be reflected in the level of spending. Another case is agriculture where NI has proportionately over three times as many people working in agriculture as in GB (although income from agriculture is proportionately much less than three times higher).

Table 1 Public Expenditure per Head in NI (UK =100) 2013/14

	1996/7	2012/13
1. General public services		**181**
2. Defence		-
3. Public order and safety	**222**	**163**
4. Economic affairs		**160**
of which: enterprise and economic development	*274*	*236*
of which: science and technology		*78*
of which: employment policies		*205*
of which: agriculture, fisheries and forestry	*339*	*325*
of which: transport	*75*	*105*
5. Environment protection	**100**	**86**
6. Housing and community amenities	**225**	**288**
7. Health	**111**	**109**
8. Recreation, culture and religion	**49**	**182**
9. Education	**138**	**113**
10. Social protection	**119**	**116**
TOTAL identified expenditure	**135**	**124**

Other cases are more difficult to understand including higher spending per head on health. NI has a relatively young population and hence avoids some of the high costs of medical and social care for the elderly. The proportion of working-age people with a limiting long-term illness is only a little above the UK average[1] and life expectancy is only a little below the UK average. Northern Ireland has more favourable profiles in these respects than several GB regions with similar levels of health spending. It is true that sparse rural populations raise costs. NI is the most rural of UK regions but

[1] The Poverty Site www.poverty.org.uk

the difference from Wales and South West England, both regions with proportionately lower spending on health, is again not large[2].

Spending on police, prisons and justice was understandably high during the ‘Troubles’, but remains high today even though crime levels are relatively low. Similarly, spending on economic development, training and employment remains double that in GB despite a rate of unemployment only 4% higher than in GB and actually lower than most of northern and midland England. There is arguably a need to bring higher paying jobs into NI, which has the UK’s lowest regional wage rate but much of the economic development budget does not directly address wages. Although there is some relationship between per capita GVA and economic development spending for English regions, each of the devolved regions has spending levels 3-4 times higher than the English regions despite having similar levels of GVA per head.

The changes instituted after the Scottish referendum have made the Barnett Formula more controversial and placed it under increased scrutiny, with more calls for its replacement. The most obvious replacement would be a system based directly on measured ‘needs’ for public spending. The examples in previous paragraphs show that it cannot be assumed that a needs assessment exercise would conclude that NI could justify its current level of public expenditure 28% higher than in England. The Holtham Commission on Public Expenditure in Wales argued that after years of the Barnett squeeze the Formula now gives Wales less than would be the case if the formulae used for English local authorities were applied instead. The Holtham Commission’s report estimated that Welsh spending levels were 14% above those in England. Although Welsh spending levels have not continued to decline relative to England as Holtham anticipated, the level remains below the estimated level of need. A similar exercise to estimate local needs could be undertaken for Northern Ireland, but it is no longer obvious that ‘need’ in Northern Ireland would be much above the Welsh level at 14% above England[3].

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[2] Ni has 41% of its population in settlements of less than 10,000 people. The Holtham Report shows Wales and the South West at 35%.

[3] Holtham calculates that public expenditure needs in NI were 23% above the English average, (Fairness and Accountability: A New Funding Settlement for Wales. July 2010. Annex 4). Most of the extra need in NI above that in Wales was due to lower income. This analysis can however be criticised. It was based on an estimate of spending across 137 LA areas in Great Britain using 5 variables as indicators. These variables were: the proportion of children, elderly people and ethnic minorities plus tax credit claimants to measure poverty and the proportion of people in settlements with less than 10,000 people as a measure of rurality. Much of the data was for 2001. A more important criticism is that tax-credit benefit take-up is used as a measure of incomes. Also a low weight is given to the proportion of elderly people despite the fact that well over half of health costs are directed at the elderly, and health spending is 40% of all Barnett-relevant public expenditure. The equation excluded NI. It also under-predicted spending in Scotland by 14%

Northern also gains from Public Spending Flows Outside the Barnett Formula?

Although debate about public spending in Northern Ireland tends to centre on The Barnett Formula' it is important to note that over a third of public spending is not covered by Barnett. Instead, this is 'demand-led' and paid out from Westminster in proportion to need. By far the largest components of demand-led spending are social security benefits and pensions. Together these now amount to close to £7 billion a year. Social Security spending has recently become controversial over opposition within the NI Executive to applying national cuts in benefits, and H M Treasury's threat to reduce the Barnett' Block' to compensate for higher social security spending in NI.

Any future reform of the system of allocation public spending to devolved regions is likely to have to include 'demand-led' spending within its remit. As a result it is important to know whether the high level of social security spending reflects genuine need. It was noted in table 1 above that NI's spending on social protection was 16% above the UK average. It is also 18% above England. This total

Table 2 Social Security Benefits Payments 2012/13

	Actual	Pro rata	Difference
DLA, Attendance & Carers Allowance	1183	627	556
ESA	298	202	97
Incapacity benefit	197	98	99
Income Support	324	161	164
JSA	219	160	59
Pension Credit	334	224	110
Child benefit & child tax credit	1441	1342	99
Housing Benefit & council tax Allowance	662	842	-180
Other sickness benefits	71	53	18
Maternity pay & allowance	70	41	5
Other Benefits	89	84	5
TOTAL BENEFITS	**4889**	**3834**	**1033**
State pension	1909	1900	9
TOTAL	**6798**	**5964**	**834**

Source: DWP 2014 Social Security Spending in the UK Including Scotland. (columns 2 & 3 are authors calculations based on population and unemployment).

is composed 72% of benefits and 28% of state pensions. Pension's payments per head of total population are 15% less than the UK average reflecting the smaller proportion of elderly people in NI, but benefits payments are 31% higher per head of population.

Table 2 shows benefits payments in 2012/13. The first column shows the actual payments. The second column calculates what the payments would have been in proportion to NI's population of working age with a simple adjustment for such things as the number of children and retired people and unemployment rates. The final column calculates the difference, i.e. the excess or deficit

spending relative to need. The calculations indicate a higher than 'expected' level of spending in NI for every benefit except housing benefits (due to low costs of housing in NI). The NI 'excess' was lowest for benefits in which the criteria were most objective e.g. child allowance (but not child tax credits) and benefits paid to retired people including state TV licences and winter fuel allowances.

The calculations indicate that NI gains around £1 billion per annum more than its adjusted population share of national spending on benefits. The 'excess' arises largely ain those benefits related to disability including Disability Living Allowance, Attendance Allowance, Carers Allowance, Employment and Support Allowance (ESA) , Incapacity benefits (being phased out), and Income Support (which in NI goes largely to those on ESA). Taken together, the calculated excesses on these six benefits amounted to £916 million in 2012/13. Across GB regions there is a relationship between incapacity benefits claimants and numbers with work limiting illnesses (highest in former mining areas) but in NI the number of incapacity benefit claimants is much higher than predicted from this measure. The Rowntree Trust Report on Poverty and Social Exclusion in NI in 2012 showed that 7.5% of working age people claimed Incapacity benefits with half of those having mental health diagnoses. In both cases these were 50% higher than in GB, and claims in NI were higher for all diagnoses.

What is clear is that NI has a pattern of claiming disability-related benefits higher than other UK regions, leading to much higher expenditure. There is some suggestion that this is related to the 'Troubles'. For instance research using data from the NI Study of health and Stress (NISHS) argued that NI has the highest recorded international levels of post-traumatic stress disorder (PTSD), ten times higher than South Africa and two and a half times higher than the Lebanon[4]. Data for 2008 indicated that 18,000 people (1% of the population) reported (PTSD) symptoms related to the conflict during that year. Such numbers would represent around 15% of ESA/IB claimants or 9% of DLA claimants. These numbers could not account for the 65% higher level of NI expenditure on ESA/IB or the 100% higher level on DLA. Moreover, any current impact of the troubles should be offset from a lack of mining-related disabilities which are significant in wales, Scotland and several English regions.

The high level of claiming of DLA benefits in NI is particularly striking at 10.1% of the eligible population in NI compared with 4.9% in GB or 6.8% in Wales[5]. Claimant rates vary widely across local

[4] The Economic Impact of Post-Traumatic Stress Disorder in Northern Ireland 2011. Psychology Research Unit, Ulster University.

[5] DSD 2013 Welfare Reform Bill Section 75 Update. April 2013 table 28

authority areas from 7.8% in Coleraine to 14.8% in Strabane. On a preliminary analysis the variation across LA areas does not seem to be related to the proportion of those on GP lists who have a registered condition or to average wage levels, but is significantly related to the proportion of those who stated in the 2011 Census that they have a limiting long-term health condition[6].

UK Government Welfare Cuts

The Coalition Government is implementing a programme of welfare cuts as part of its austerity programme to reduce the level of public debt (and also to reduce complexity and improve incentives to work). These are focussed on invalidity benefits and have been estimated to take 10% (£19 billion per annum or £460 per person of working age) out of the UK welfare budget[7]. The cuts will be spread over a number of years but are expected to be concentrated in 2014/15. Because NI has particularly high levels of invalidity-related benefits Fothergill and Beatty estimate that NI will lose £750 million or £650 per working-age person, the highest level of loss of any UK region. In detail the DSD estimate that a quarter of DLA recipients in NI will receive no awards under the new PIP system, and continuing beneficiaries will on average receive less[8]. However the recent refusal of the NI Executive to implement some of these cuts will reduce this loss. Similarly the recent agreement with the UK Government will prevent these losses being reflected in reductions in the NI Block. Much of the additional finance is planned to come from borrowing and asset sales, but previous experience from e Gordon Brown settlement in 2001 suggests that these repayment intentions may themselves be renegotiated.

Any excess in claiming of benefits in NI could be deemed to contravene parity agreements with the UK government. The legal position has recently been outlined by DSD as follows[9]:

'The Northern Ireland social security system is heavily subsidised by Great Britain. Contributory benefits are financed from the Northern Ireland National Insurance Fund. However, the revenue raised for the fund through the collection of national insurance contributions has been insufficient to meet the cost of contributory benefits in Northern Ireland for many years. The Northern Ireland Fund has to be balanced each year by a compensatory payment from the Great Britain National Insurance Fund. The amount of financial assistance from the Great Britain National Insurance Fund and the money received to fund non-contributory benefits, which are demand led and financed out of taxation, can exceed the total amount raised in income tax in Northern Ireland. The funding, which

[6] Data from NISRA Table SO16 Sex and age by general health and limiting long-term illness. The number of DLA claimants per head of population is also statistically significantly related to the proportion of the population who described themselves as Roman Catholic in the 2011 Census of Population, even when allowance is made for the numbers with limiting long-term conditions.

[7] Fothergill and Beatty The Impact of Welfare Economy on the NI Economy. CRESR Sheffield Hallam University. NICVA Centre for Economic Empowerment Research no.4. Oct 2013

[8] DSD Welfare Reform Bill Section 75 Update. April 2013

[9] DSD Welfare Reform Bill Section 75 Update. April 2013

amounts to nearly £4 billion per annum, is predicated on the maintenance of parity and this is outlined in HM Treasury's Statement of Funding Policy'.

It is unclear where welfare reforms and recent political agreements will leave the question of parity.

Does a large Subvention Reduce pressure for public sector reform?

Reductions in public spending can and are achieved in a variety of ways. These include cuts in the volume of public services, reductions in government investment, cuts in public sector wages, cuts in costs of procurement, reductions in employment relative to expenditure (i.e. increases in productivity), and cuts in the number of welfare recipients or the generosity of benefits. In the UK since 2010 my estimate is that 40% of the overall cuts have been in wages. There is evidence that NI has resisted some cuts in public sector wages and in benefit payments[10]. The recent agreement with the UK government involving extra funding for NI suggests that the Barnett squeeze may be further offset in future.

One factor that should be borne in mind however is that financial austerity can promote reform in the methods and efficiency of delivery of public services. The UK Coalition government asserts that this has occurred since 2010 with, for example, reductions in crime levels despite lower numbers of police. Such claims would need to be carefully examined and some spending reductions may lead to greater needs elsewhere. The most obvious example is the impact on NHS bed-blocking of the large reductions in support for elderly care (via the large cuts in budgets for local authorities in England).

None-the-less it is also sensible to view high public spending levels in NI as reducing pressures to increase productivity, and to support populist policies. For example the pressures to amalgamate denominational schools in NI would be greater with a smaller education budget, and support for small local hospitals would be more difficult with a smaller health budget. Grant aid, and low industrial rates, for existing firms in NI might also come under stronger scrutiny if budgets were tighter. NI has managed to avoid these changes in the past and will probably do so for the immediate future. However if the Barnett Formula were to be replaced by a needs-based allocation of UK public expenditure these pressures would be likely to increase.

[10] NISRA Statistical Bulletin. Pay Statistics for the NI Civil Service 2014. This shows that NISC pay rose by 3% between 2013 and 2014 (3.2% for the Senior Civil Service). These increases were well above the Treasury Guidelines for civil service pay in England 2013 which were 1% per annum including annual increments.

Corporation Tax

The planned devolution of corporation tax (CT) to NI will involve a deduction from the Barnett Formula to compensate the Treasury for losses in tax revenues. This will include not only losses of corporation tax revenues themselves, but also associated losses from other taxes. For instance it is expected that some farmers and other small businesses will change their status to corporations to reduce their tax bills. As a result, even if the impact on corporation tax revenues is estimated correctly, NI will lose more from the reduction to Barnett than it will recoup from corporation tax revenues even if the CT rate remains unchanged.

The Treasury can be expected to strive for the best deal for the UK and hence the worst deal for NI. It is thus important that all proposed adjustments to Barnett are transparent to the NI Assembly before the new arrangements are finalised. My view is that DFP officials are not in a strong position to negotiate the best deal for NI, and political pressures will be needed to ensure a reasonable adjustment to the Barnett Formula. One particularly important issue is whether the Treasury takes account of potential increases in income tax, VAT etc. resulting from the faster economic growth expected in NI following a reduction in CT tax rates. Without a specific adjustment to the Barnett adjustment these gains will flow directly to the Treasury and will not benefit NI.

Once the tax is devolved to NI a decision will need to be made on what should be the new CT rate for NI. The optimal reduction in the rate will depend on calculations of the projected gains to employment and incomes, and hence CT revenues, from faster economic growth in NI. These gains can then be set against expected direct losses of CT revenues. Most of the estimates of the potential gains from lower CT rates have come from modelling work undertaken by myself and Professor Neil Gibson at the UUEPC. This has been undertaken on limited budgets and with limited data. I recommend that a new study be undertaken with more extensive data once the NI Executive has the power to alter the CT rate.

The main gains targeted via a reduced rate of CT in NI are expected to come from a greater flow of new FDI firms into NI, although there may also be some gains from existing firms in NI. Any reduction in the CT rate in NI will also lead to a windfall gain to existing firms from lower tax, irrespective of whether they increase their investment as a result of lower tax. The Assembly should consider whether some or all of the windfall gain should be recouped, for instance via higher business rates. Recouping the windfall gains would greatly reduce the tax revenue losses associated with a reduction in the tax rate.