



Northern Ireland
Assembly

Committee for Finance and Personnel

**OFFICIAL REPORT
(Hansard)**

Barnett Formula

08 February 2012

NORTHERN IRELAND ASSEMBLY

Committee for Finance and Personnel

Barnett Formula

08 February 2012

Members present for all or part of the proceedings:

Mr Dominic Bradley (Deputy Chairperson)
Mrs Judith Cochrane
Mr Leslie Cree
Mr Paul Girvan
Mr William Humphrey
Mr Ross Hussey
Mr Paul Maskey
Mr Mitchel McLaughlin
Mr Adrian McQuillan

Witnesses:

Mr Gerard Holtham	Expert Witness
Professor Iain McLean	Expert Witness
Mr Alan Trench	Expert Witness

The Deputy Chairperson: I welcome the expert witnesses: Mr Gerard Holtham; Professor Iain McLean; and Mr Alan Trench. You are very welcome, gentlemen. Will you introduce yourselves briefly?

Mr Gerard Holtham (Expert Witness): Good morning. I am Gerald Holtham. I am here because I was the chairman of the independent commission set up by the Welsh Assembly Government in 2008 to look into the operation of the Barnett formula, among other things. We spent two years, on and off, doing exactly that and reported in 2010.

Mr Alan Trench (Expert Witness): I am an honorary senior research fellow at the constitution unit at University College London; I was formerly a research fellow at the University of Edinburgh. I write a blog called 'Devolution Matters', which tries to address some of these issues in a way that is widely available on the internet. I have advised several Westminster Committees on devolution questions, including the Lords Select Committee on the Barnett formula in 2009, of which mention has been made.

Professor Iain McLean (Expert Witness): Good morning. I am Iain McLean. I am a professor of politics at Oxford University and have published extensively in this area. I was a member of the independent expert group that reported to the Scottish Calman commission and worked on the public finance aspect of that report.

Mr D Bradley: Thank you very much, gentlemen. We have the following four themes for discussion: reform versus replacement of Barnett; a basis for a new system; transparency and dispute resolution;

and transition and review. If you do not mind, we will take them one at a time. After each of you has given us a presentation on reform versus replacement, we will have members' questions. We will then move to the second theme, and so on. I will ask Mr Holtham to begin.

Mr Holtham: If someone asks you whether the Barnett formula is fair, you can answer only with a shrug. There is no particular set of principles behind the Barnett formula; it was dreamt up by Joel Barnett in the 1970s to solve a short-term problem and has survived ever since. It is a largely arbitrary procedure. It is, therefore, difficult to say how to reform it, because, as I say, no principle underlies it. If you were to approach it by saying that the distribution of public expenditure around the state should be determined by, let us say, need, you would have a basis for trying to construct a formula. However, in this case, we do not have such a principle and, therefore, reform is difficult.

Most people who have looked at it can see procedural improvements. There are ways that your fourth item could be reformed. However, the core of the formula itself would be difficult to reform; it would need to be replaced by a formula based on a principle. The obvious principle is relative need, which is how expenditure is distributed in England.

For example, if you vote that a certain amount will be spent on health, how does the Department of Health decide what to spend in Sunderland and what to spend in Cornwall? It does not use a Barnett formula; it has a complicated formula with the numbers of young and old, the statistics for chronic illness, and, on the basis of need, it allocates the health money to the various regions of England. The same is true for local government support. The revenue support for local government is based on a series of needs-based formulae. Therefore in England an attempt is made to distribute public spending regionally on the basis of need; whereas the devolved Administrations are stuck with Barnett.

Moreover, Barnett does not apply to the whole block grant; it applies only to the annual change. You get a largely arbitrary block grant, which is what history gave you. The consequential that Mr Pidgeon talked about apply to the change in expenditure. If the UK Government decided to increase expenditure on health, or on an area of health, by £5 per head, if your consequential was 1 you would get £5 per head.

If your original block implies more expenditure per head than in England, the Barnett increment gives you the same change in expenditure per head in pound terms as in England. Think about the consequence: they spend £100 per head and decide to spend £5 more; but even though you spend £120 per head, you still get £5 more. Therefore what to them is a 5% increase is to you a 4% increase. That is a characteristic of the Barnett formula: it will slowly, over time, squeeze you down to the same level of expenditure per head as in England. It will take years and years — decades perhaps — but that is the process. Figure 1 in the report shows that all the devolved authorities have much higher expenditure per head than England, but it is slowly coming down.

If your needs are not falling relative to England, there is no reason why the block grant should. It is certainly in the Welsh, and also in the Northern Irish, interest to reform the Barnett formula by replacing it with a needs-based one.

Mr Trench: Let me talk not so much about the arithmetic of the Barnett formula and the amounts of money allocated through it but about the machinery that surrounds it and how it operates.

I am very critical of how the formula operates, and Mr Pidgeon expressed some of my criticisms earlier. It is untransparent. It is prone to widespread and, seemingly, arbitrary decision making by the Treasury with regard to what triggers a consequential and whether the formula may be explicitly bypassed or not — which are two different things, I might add — on decisions regarding matters such as end-year flexibility, among others.

There is a whole range of second-order issues surrounding the administration of the block grant that make it very hard to say that it is fair in procedural terms because the central figure in the spider's web is HM Treasury. The Treasury makes all the decisions, but it is very hard to see the basis for those decisions, what calculations it made and what facts it took into account in doing so.

That is neatly highlighted by an earlier example: what happened to consequentials for regeneration spending for the 2012 London Olympics, which, if it were ordinary regeneration spending, would have triggered substantial consequentials for Scotland, Wales and Northern Ireland. They did not, because, as far as I understand, Andy Burnham, the Chief Secretary to the Treasury at the time, simply decided during the 2007 comprehensive spending review that the total spending envelope for the Olympics would be excessive if consequentials were included; so he found a mechanism to exclude them. I can elaborate on that if members wish, and I have done so on the blog 'Devolution Matters'.

One needs a system that becomes more transparent on information about how it works, what money flows through it and how that money flows; some of that is echoed in the report of the House of Lords Select Committee. The information situation is better than it was five years ago, but it is still far from satisfactory. I commend the Northern Ireland Executive for the Northern Ireland net fiscal balance report that they have published for the past three years. Although those reports have shortcomings, they are an attempt to replicate in a Northern Ireland context the exercise undertaken by Government Expenditure and Revenue Scotland (GERS) by the Scottish Executive. That provides a great deal of very useful information, even if it has shortcomings in detailing what is going on. We need better information.

We also need to review the machinery. We need much clearer decision making that engages the devolved Governments much more than at present. We have the Joint Ministerial Committee that Mr Pidgeon mentioned and we have a quadrilateral meeting of finance Ministers, which takes place about twice a year. That is a relatively low level of engagement. Contrast that with Canada, where there is a much more decentralised system that does not depend so heavily on the decisions of central government. There, you would have finance Ministers meeting four times a year at least; that would be backed up by related meeting of their officials and so forth.

Professor McLean: I do not need to add much, because the main points have already been made. I am in favour of replacement not reform for the reasons that my two colleagues have given.

Picking up on the convergence point that Gerry made, it is clear that the intention of Joel Barnett and his officials in the 1974-9 Labour Administration was to do not one thing but two. The fundamental thing that they wanted to do was to get an assessment of relative needs, and they started that exercise in the four territories. That provoked a huge push-back from Scotland, so the exercise was not complete at the time of the change of Government in 1979. Therefore very little was published.

What concerned Treasury officials at the time, and all three of us have talked extensively to them about this, was perceived overspending, primarily in Scotland. They may have thought that there was some overspending in Northern Ireland, but Northern Ireland was not the target of this move.

The Barnett formula was designed deliberately to have the convergence properties that Gerry described to you. It is clear that the intention of the officials at the time was to apply Barnett until such time as sufficient convergence had been achieved and then to switch to a needs-based formula. Joel Barnett has disavowed his own formula and is on record as saying that he thought that it would last a year or perhaps 20 minutes; it has lasted more than 30 years. It was designed to work in conjunction with, or until it was superseded by, a needs assessment. That needs assessment never happened.

Where do we go from here? We have the option of either an expenditure- or a revenue-based system. However, that comes under one of the later questions, so I will stop there.

The Deputy Chairperson: Mr Holtham and Professor McLean, you both favour scrapping the existing formula and replacing it with a needs-based model. Mr Pidgeon said that one of the advantages of the formula is its simplicity. Would a needs-based formula not be too complex, unwieldy and difficult to manage and may not deliver in the end?

Mr Holtham: It is possible, but it need not be. The commission that I chaired undertook an exercise to apply all the very complicated formulae in England for education, health and local government revenue support to Wales to see what Wales would get if it were an English region. We discovered that it would get a few hundred million pounds a year more, which is not a massive amount, relatively speaking, but it is still 3% or 4% more than if it had been in England instead of being devolved and in Wales. In other

words, the Barnett squeeze has taken Wales below the point that it would probably be at if there were a needs-based formula.

The next question was: do we have to go through a fantastic needs assessment rigmarole to get a reasonable formula? People say that the wonderful thing about Barnett is that it is nice and simple and has one variable — population — that determines expenditure. They think that you would have to replace it with a formula containing a million factors. Why? Why not go from one to three or four? Three or four would be a hell of a lot better than one. We took the variation in spending in local authority areas across England, which had been determined by those very complicated formulae, and asked how far we can explain the variation with a simple formula. At the end of the day, only four or five factors really drive need. The first is demographics: do you have a lot of young people or old people? Demographic structure will affect need. The second is poverty: if you have a great deal of social deprivation, it requires all kinds of social services. The third is health: if you have a lot of people with chronic health problems, as revealed in census returns, you will spend more money. The final factor is sparsity: it will cost much more to supply social services in the highlands of Scotland than in populous cities.

Therefore demographics, health, poverty or deprivation, and sparsity tend to drive the need for public expenditure. We found proxies for those four things and found that we could explain 96% of the variation in expenditure per head across English regions with an equation containing just those variables. Ninety-six per cent is not perfect, but it is a hell of a lot better than the Barnett formula, which pays no attention to need at all. It does not have to be perfect; quite good is a big improvement on what we have. Therefore, in my opinion, it is possible to derive relatively simple and tractable formulae that take those main factors into account. Barnett does not do that.

You still have a problem of how you weight those factors together. We did it by running a regression equation on the data and saying that, implicitly, the British Government are putting a weight on the factors because those are the weights that explain the variation that we see. That is rough and ready and, of course, would be only a starting point. You would then have a very tedious and heated negotiation about what weight should be put on different elements. However, we should not be defeatist: if we set out with the intention that we will have a simple formula of five or six variables that pick up the main determinants of need, it would be possible.

Professor McLean: I do not have much to add except to say that there is world experience of how to do this. The model that I recommend in some of my writing is that of the Australian Commonwealth Grants Commission, which does the sort of exercise that Gerry described. There is one extra wrinkle that is worth drawing attention to. If you have a small number of indicators of needs, they should not be things that Governments can manipulate; because if Governments can manipulate them, that leads to gaming the system. However, the Australians have ways of dealing with that, which I could speak about at greater length than you would want me to.

The second question to which Gerry drew attention is weighting, and, for that, you need an institutional mechanism. If it were applied to the four territories of the UK, the Scottish Administration, for instance, could say that sparsity matters very much indeed, because Scotland has the sparsest population of the four. Your Executive might say that having a young population matters very much indeed, because you have the highest proportion of young people. Each Administration would be tempted to make political claims for a weighting that favoured them, so you need a neutral arbiter. The Australians do it well, and I could answer more detailed questions on that.

The Deputy Chairperson: Thank you, professor. Perhaps you will comment on one of the points that you made about reform, Mr Trench. You said that one of the faults of the present system is its opaqueness and lack of transparency. What sort of scrutiny mechanisms might lead to greater transparency in the operation of the formula?

Mr Trench: What I want to say was prompted by the comments of my colleagues. The House of Lords Committee that I advised would strongly echo what Mr Holtham said about using a simple basis with a relatively small number of indicators. The Committee did not think that it was appropriate to identify what those factors should be — although the Holtham commission did — but, in principle, that approach was strongly endorsed. It resulted in significant changes, notably for Scotland.

I disagree to an extent with Professor McLean about the Australian example. Although it is a very interesting one and a useful institutional parallel, I am much less convinced of its value as a model for resource allocation. It is driven by data and succeeds in doing precisely what Professor McLean says it does not: it is open to gaming by Governments that feed it with information that suits them. It also wipes out any advantages that might be derived from tax competition. You can make a political decision about whether that is an appropriate thing for a system to do. However, the Australian system is not supposed to do it to the extent that it does. The Australian system, for reasons that I can elaborate on and have elaborated on in writing, is problematic for those reasons.

You asked about opaqueness and mechanisms for scrutiny. Part of what is needed is much greater publication of information by the Treasury about, for example, what money goes to which Government for which services. At the moment, data and information are scattered over various sources. Details of changes in block grant allocations for Scotland and Wales, but not for Northern Ireland, are published in the annual reports of the Scotland Office and the Wales Office. Those figures are simply put into the public domain; there is no way for anyone outside to assess their accuracy. An attempt was made by Professor David Heald — that name that may be familiar to you; I note that it is cited in some of the research materials — to do that in a paper that was published in 2005. My interpretation of Professor Heald's paper is that he found that the numbers in the Scottish context do not make sense. Empirically, they do not do what everyone says the Barnett formula is supposed to do, but we cannot explain why it works in that way. We need much better publication of information about what goes in and what comes out of that black box and about the changes that are made.

Ideally, we also need to have worked through figures that enable us to assess it — I think that those are published by the Treasury or some UK body — at the centre and in a way that enables us to compare the figures for all three Governments. I am not sure whether that is the case in Northern Ireland, but it is certainly a factor in Scotland and Wales. The key document that governs the workings of the Barnett formula is published by the Treasury after each spending review: the 'Statement of Funding Policy' is purely a record of internal UK Government policy. To the extent that it is approved or endorsed by anybody, it is endorsed by the territorial Secretaries of State. Although there is some negotiation on it with the devolved Governments, it is fairly limited. The Scottish Government has made the quite justifiable demand that the devolved finance Ministers, rather than UK Secretaries of State, should sign off the 'Statement of Funding Policy'. While that system remains in force, they should be able to signify that they agree that that is how money will be allocated. At present, the money simply appears in their bank accounts; they have no part in anything that relates to it other than being concerned about the amount that they get in their pay cheques.

Mr Humphrey: I have a question. First, can you expand on the point that you made about devolved finance Ministers, please?

Mr Trench: In what respect?

Mr Humphrey: There was mention of Burnham's decision in 2007 on the London Olympics and the effect that it has had on the regions. With regard to that decision, how will national Government, the current Tory/Liberal Administration, react to the point that you have just made at the end of your previous contribution?

Mr Trench: As far as I know, the coalition has not even been asked that question; it certainly has not responded favourably to it. That is not a surprise. That is in the context of ongoing debates. Frankly, it is extremely difficult to know what the Treasury thinks at all about many of the key issues of the financing system. One of the remaining major problems with the Scotland Bill, which is before the House of Lords, is that it is still unclear how reductions in the block grant that will be made to allow for the proposed Scottish rates of income tax will, in fact, be calculated and adjusted in subsequent years. That question was addressed in one sentence in the Calman commission's report and in an entire very good and incisive chapter in the Holtham commission's report.

Mr Holtham: The principle to which they try to appeal is whether an activity is to the benefit of the UK as a whole or whether it is expenditure solely in England. Of course, with regard to the Olympics, they

said that it is a wonderful global event that will benefit the UK as a whole. You may have a view on that. However, that was the justification. The point about transparency is very clear.

One thing for which there is no consequential is spending on Kew Gardens because it is the horticultural centre for the UK. Somebody pointed out to the Treasury, "Hang on a minute: expenditure on the botanical gardens in Edinburgh or the national horticultural centre in Wales is met entirely by the devolved Administrations. How come Kew Gardens is treated as being for the UK as a whole?" The Treasury accepted that. It was only a small item, so it took it out. Two years later, it was back in. If you focus on something, the Treasury may give ground; however, when the spotlight moves on, it goes back in. As somebody said, the Treasury is entirely judge and jury in its own cause; it will decide whether something is for the whole of the UK or should have a consequential. Nobody can appeal.

Mr Trench: There have been parallel shifts: for example, in the treatment of spending on London transport generally, in the 2002 spending review, I believe, and in the treatment of Crossrail in the 2007 spending review.

Mr Humphrey: Obviously, we are pleased with some spending on London transport because they are buying their new Routemasters from Ballymena.

Mr Trench: Indeed. Until 2002, that did not trigger consequentials because it was treated as being to the benefit of the UK as a whole. That was so manifestly absurd that it was altered.

Mr Humphrey: Barnett was, obviously, part of Labour's Administration from the mid-1970s to 1979. Look at it from a Tory point of view. I take your point about the London Olympics and the ripple effect; as it ripples out, the further it goes into the UK, the less benefit there will be directly.

In relation to the Tories, if you look at it from a political point of view, the number of seats won in Scotland and in Wales is minimal compared to the effect of the decisions of Back-Benchers about investment in their constituencies. How much of that is a factor, or could be a factor, in any decision?

Professor McLean: There is a great deal of general whinging because, as has been said in your supporting papers, everybody objects to what they think are the consequences of the Barnett formula, whether they are from the east midlands, the north-east, London or any of the three devolved areas. However, once you get into the level of detail that we have been talking about, my impression is that politicians do not get involved to any great extent. Therefore, the attitude of the present Government is not discernibly different from that of the last Labour Government, in my opinion.

Mr McLaughlin: Thank you very much. That was very interesting. I was particularly interested in what you were saying, Mr Holtham. Is it true that the Barnett formula was an attempt to address the issue of parity across all the regions by finding a mechanistic solution? It might not have been perfect, but I am coming back to your idea of a review of the formula that achieves 96% of an outcome as opposed to perfection. The Barnett formula, even in Barnett's own judgement, was not perfect, but it did have the merit of being a simple process. It centralised all the relevant information and data and excluded everybody else from having equal access. In attempting to adjust to changing demography and economic circumstances — and you indicated a limited number of factors that could be applied to a new formula — is there an argument in justifying or rationalising that with the Treasury around parity? We have never achieved convergence or parity.

Mr Holtham: The Treasury denies it. If you ask the Treasury, you will be told that the squeeze is an accident; that it was never part of the design of the Barnett formula. You can believe that or not, as you like. I tend to be in Professor McLean's camp, and think that it was indeed a design criterion. They thought at the time that Scotland, and possibly other areas, were receiving too much money, and therefore it was a process that would slowly reduce it, not in absolute terms but relative to the English allocation, until something more substantial replaced it. It does have the important merit of simplicity: you do not want every budget to be accompanied by interminable horse-trading about who gets what. You have to have a formula that, year in year out, will make the budgetary process manageable. I do not underestimate the importance of having a formula that is reasonably easy to apply. However, you can find a handful of indicators that, as Professor McLean said, are not under the control of the devolved authorities. The census data on how many people you have with a chronic ailment, on

demographic structure or on how much poverty you have, as measured by independent statistical authorities, are not under the control of the devolved authorities, so it is possible to put those into a formula. There would be an enormous discussion as to how much weight to put on each factor, of course, but once you have made a decision on that you can apply that formula, year in year out, and it would be as simple as the Barnett formula.

Mr McLaughlin: That is my underlying question: were you suggesting applying those indicators to each comprehensive spending review cycle, annually or over a longer period, perhaps a decade, or more?

Mr Holtham: You need to have an initial discussion about what weights you want to put on the various factors. A good starting point is to derive weights from current expenditure patterns in England and, indeed, in every authority. In Northern Ireland, local authorities have formulae for allocating expenditures; everybody has formulae that they can use to find out what weights are implied in them. That would give you a set of weights, although you may not like them. There will then be a big discussion about what they should be. Once that discussion has come to a conclusion, you should fix the weights for a reasonable period — five years or 10 years — and then revisit them. That would give you a formula just as simple as Barnett that you can plug in every year. The Treasury just uses an Excel spreadsheet; if it can put in one variable, it can put in five. It is not rocket science.

Mr Cree: The reason for Barnett's longevity is that people thought that it was a Pandora's box, and so were reluctant to tackle it over the years. Professor McLean said that Barnett himself had "disavowed" — it is a good word — the formula. Did he go into detail about the failings of the system other than the fact that it was designed for the short term? Did he have any pearls of wisdom about what might replace it?

Professor McLean: Apart from disavowing it, he has not said much in public about the formula. The House of Lords Select Committee, to which Alan was a specialist adviser, was created following a motion from Lord Barnett. Although he was not a member of the Committee, I believe that he has endorsed the report. Alan could probably say more than I can.

Mr Trench: If you read Lord Barnett's evidence, you will see that he expected the formula to be a short-term fix; it was to deal with the public-spending crisis. Mention has been made of dealing with the issues relating to Scotland in particular. That is certainly true. One can go into more detail about that but not necessarily by drawing on Lord Barnett's experience.

Lord Barnett has been on public record that he regrets how the formula has been maintained and used because of its effect on England. Therefore his concern is not simply that the formula creates unfairness in or between the devolved parts of the UK, or what are now the devolved parts of the UK, but that it has an unfair effect on public spending in England, which results in unfair treatment of outlying parts of England in particular. That appears to be his underlying concern.

The Deputy Chairperson: We move to the second theme: the basis for a new system. We have already explored, to some extent, the needs-based option. Perhaps, in this session, we can concentrate on the merits of changing from an expenditure-based system to an income-based one and on the methods of equalisation that would ensure fairness if such a change were made.

Mr Trench: I am sorry to challenge your starting point, Chairperson, but there are considerable difficulties in simply thinking about the Barnett formula, given that a wide and very diverse debate about how the devolved parts of the UK should function is already under way. One of the big problems is that that debate has become so disjointed that there is one debate in Wales and another in Scotland. Indeed, there are, arguably, two debates in Scotland. Those debates have relatively little direct interaction. There has been no attempt by those at the centre in the UK to engage with that and to say, in any meaningful way, what it is that should be held in common between the various parts of the UK on any level of principle and on any level other than saying, "This is what we have; we like it, and we are not changing it".

I noticed that one of Mr Pidgeon's research papers quotes the standard Treasury mantra that there are no plans to change the Barnett formula but that all aspects of public spending are kept under review. As Professor McLean noted in one of his writings, it sometimes comes up the other way round.

However, that is a position that the Treasury has recited for a long time. What needs to be thought about from a Northern Ireland point of view is: Barnett formula, yes or no; if no, what replaces? It has to be a more wide-ranging approach to what sort of system overall you think works in a Northern Ireland context. Barnett is a very dubious basis for that — certainly for Scotland and Wales — because it relies on allocating shares of consequential spending in England. That implicitly ties the allocation of spending to devolved Governments to what goes on in England.

Devolved Governments effectively become policy takers, dependent on policies that happen to be adopted for England. Whether that is a concern here is a matter for you to decide, but it is problematic in Scotland and Wales where Governments are broadly much more supportive of a social democratic welfare state than the coalition, which wants a smaller welfare state and one that seemingly operates according to the principles of the big society.

If that is your objective, how you maintain a united state that has such varied approaches to welfare is difficult. It is achievable, and we can see in federal systems around the world some radically different approaches to welfare provision. It is an important question that you do not resolve by avoiding.

Professor McLean: There are two advantages in principle in switching from an expenditure-based system to, let us call it, a revenue-based system, where you start with the tax revenue that each devolved Administration gets. The first is that it encourages everybody to make a tax effort, knowing that if you have more realistic taxes and if some activity is less taxed than it could stand but you want to spend more, that is your decision. For instance, the three devolved Administrations already control property taxes but because they get Barnett grants, they do not have an incentive to look closely at their property taxes.

The second advantage in principle of a revenue-based system is that, at the margin you, the Scottish Parliament and the Welsh Assembly would, if the system were properly designed, be balancing the last pound that you may consider raising in tax with the last pound that you may consider spending. Therefore responsibility for taxing and responsibility for spending are lined up, which is how a public finance person would define fiscal responsibility.

That was the motivation behind the Calman recommendation that members will be familiar with: that the UK Government should withdraw a certain amount of pence in the pound of income tax and it would be for the Scottish Parliament to decide how many pence to levy.

However, there are two obvious, huge disadvantages of a switch to a revenue-based system. One is, and Alan mentioned this earlier, that if you make more tax effort, the body that allocates the money can say that since you have more tax revenue, you need less equalisation. That is self-defeating. However, I disagree with him about the Australian system, although this is not the place to go into detail on it. The Australian system does not equalise away all extra tax revenue, certainly not immediately; therefore it does cope with that issue.

A disadvantage that is probably decisive in the case of Northern Ireland, however, is that the equalisation required would be vast; the numbers in Mr Pidgeon's report show just how vast. There is an unfortunate historical precedent with what happened here between 1921 and 1972. The system was, purportedly, revenue-based; however, the then Stormont Administration simply went to the UK Government every year and said: "Here is what we can raise in our taxes; it is far less than our expenditure needs. We will match pound for pound the UK Government's spending on all services that we at Stormont control. Please, can we have the difference?" That difference was given every year without question. That is the worst of all worlds. A switch to a revenue-based system has advantages, but, in my view, it is probably not a realistic option for Northern Ireland.

Mr Holtham: We need to be careful, because people use the same term but have slightly different meanings for it. Let us take one point straightaway: if you had revenue equalisation in Northern Ireland, the revenue per head at your disposal would be the same as the revenue per head in England. That means that if the budget is balanced, expenditure per head will be the same as it is in England. Currently, you get 121%, whereas revenue equalisation will give you 100% — a 21% drop. Why on earth would you move to revenue equalisation if your needs are so much greater?

In that sense, an expenditure equalisation system on the basis of need makes allowance for the fact that different areas may have different needs over and above the fact that their revenues may not be the same. You would get a more complete equalisation from doing it through the expenditure side rather than through the revenue side. That said, it is perfectly possible to have some tax devolution if you want it, with either an expenditure equalisation system or a revenue equalisation system, but there are certain rules of the game that have to be followed to make it work.

Whatever the basis of your block grant, whether it is revenue equalisation or expenditure equalisation, when a tax is devolved, the revenue of that tax at a standard rate — that is, at the rate being applied on to the tax base in the rest of the UK — is deducted from the block grant. Therefore, if you change the tax rate, the consequences fall on you because the deduction is equal to the deduction of the standard-rate tax times the base rate from your block grant, however the block grant is determined. Therefore if you then levy the tax at the standard rate, you are back where you were because you are going to get that revenue, which exactly cancels out the deduction on the block grant. If you change the rate, you will get more or less money, but that is what is supposed to happen; you are taking the consequences of your own decision.

You can have some tax devolution if you want it, consistent with any formula for deciding what the block grant is, but there have to be certain rules of the game as to how that deduction is operated. You must not let them mess with that; otherwise you defeat the object, as Professor McLean said. However, for a relatively disadvantaged area of the UK, such as Northern Ireland or Wales, expenditure equalisation promises a more complete equalisation on the basis of need than a revenue equalisation could.

Mr Cree: You have touched a nerve because you may know that we are looking at the devolution of corporation tax. That would be a serious factor that would have to be taken into account.

Mr Holtham: Yes. I have not looked at the numbers for Northern Ireland, but I looked at those for Wales, and it is a gamble. The receipts for corporation tax in Wales are somewhere between £600 million and £1 billion; if you cut that by half, you are giving up £300 million to £500 million worth of revenue. You have to do that to be consistent with EU regulations; you have to bear the cost of the tax reduction. The central government is not supposed to compensate that by messing around with the block grant because that would be contrary to the Azores agreement. In the Welsh case, and I do not suppose the numbers in Northern Ireland are very different, the question is whether the increase in business over time would compensate for the loss of £300 million to £500 million worth of revenue. That is exactly the calculation that you have to make.

The Deputy Chairperson: Thank you. We move to the third theme: transparency and dispute resolution. We have touched on some of it already, but there may be something that we can add.

Professor McLean: There are bodies and mechanisms in the structure of the UK to which one could appeal. There are potentially two bodies, which are mentioned in Mr Pidgeon's papers, that should become more relevant: the Statistics Authority, which sits on top of the Office for National Statistics; and the Office for Budget Responsibility, which is a fairly recent creation, which has been specifically charged with looking at the budget numbers for Scotland. As far as I know, it has not yet been charged with looking at them for Wales or Northern Ireland. Those bodies could be the basis for a more transparent regime in which, as all three of us have said, the Treasury was no longer judge in its own cause. You could create a new body, perhaps modelled on the Australian Commonwealth Grants Commission, although you have heard that we disagree among ourselves about whether that is an appropriate body. I will leave it there as a starter for five.

Mr Holtham: I do not have much to add, Chairman. It is important to get reform in early; trying to do it through dispute resolution, when the Treasury has run the show right the way through, is a lost cause, as you will either get into terrible judicial arrangements or into a political settlement in which you will lose. It is important that, from the start, the system is put into independent hands. Once the British Government has decided on the allocation to Departments of state in a provisional budget, I would prefer that some body independent of the Treasury, whether a new body such as the Office for National Statistics or the new Office for Budget Responsibility, did the mechanical exercise that is currently done by the Treasury of calculating the consequential and working out the implications.

Such a body would not be tempted to decide that Crossrail, for example, was a lot of money on which to give a consequential and so remove it on some spurious ground or other. There would be much less incentive to cook the books at an early stage. When it came through, the Treasury would probably decide that it did not like all those consequentials going. However, kicking the thing off to a good start makes the politics of the discussion about it much easier. If you are always dealing with a fait accompli, it is very difficult to sort things out. My preference is to get reform at the beginning rather than at the dispute resolution end. I do not have strong views about the nature of the body as long as it is independent of the Treasury.

It would be difficult to get the British Government to accept anything as elaborate as the Australian system. That may be a shame, but it would be hard work to get them to accept that. Therefore, getting them to accept an existing body might be easier, but it is important to do it.

The Deputy Chairperson: Mr Trench, you expressed reservations about the Australian body.

Mr Trench: My reservations are not about the institution of the Commonwealth Grants Commission — the institutional side works very well. The problem is its reliance on data; it uses more than 70 indicators and is very heavily data-driven. However, the idea of an impartial, independent body that gives, as the Commonwealth Grants Commission does, authoritative advice is very attractive and, indeed, was endorsed by the Lords Committee. There are problems with both bodies that have been mentioned. I do not know how the UK Statistics Authority would approach being given such a task, but it would take it a long way from its remit of ensuring high standards and procedural propriety in the preparation of public statistics and what gets the Office for National Statistics kite mark.

The Office for Budgetary Responsibility has two problems. The first is its partiality or impartiality, because even if it is independent of the Treasury, it is still in it; it draws on Treasury staff and is very close to it, so its independence is limited to that extent. It also would be a significant stretch of the OBR's remit, because it is, primarily, an economic forecaster. We are talking about a body that gives very high-level advice, such as the Commonwealth Grants Commission, which technically advises the federal treasurer but whose advice has never been rejected or qualified in any way. In effect, it becomes the decision maker, albeit at one remove. That system, if the UK Government could be persuaded to adopt it, has many attractions, not least because it provides guarantees of impartiality.

The alternative approach, with which Professor McLean and I are familiar, is the Canadian one, where such decisions are made by the federal Government's Department of Finance. Federal Government has come under such political pressure from the provinces in Canada regarding its decisions that it has increasingly adopted transparent methodology and independent expert bodies to advise —

The Deputy Chairperson: To clean up its act.

Mr Trench: Does that explain it?

The Deputy Chairperson: Yes. Thank you very much. We move to the fourth theme: transition and review. The House of Lords Select Committee recommended a period of between three years and seven years for any transition. Is that a reasonable time? What is your view on reviewing whichever process replaces Barnett?

Mr Trench: I will try to be brief. You have to decide what your transition concerns are before you look at the period. Three years to seven years related primarily to the adjustment in the amount of the block grant. In my view, that would be a very rapid transition. With hindsight, it is a matter of regret that the UK Government did not start doing that in about 2002, with a very lengthy transition that could have been cushioned by a period of sustained increase in overall public spending. You could change the administrative machinery with relative speed. You would like a maximum of between three years and five years to do that, although the administrative changes could be put in place much more quickly than that if there was the political will to do it.

Professor McLean: The difficulty is that the three devolved Administrations are going in different directions, and none of us can predict what will happen in Scotland. However, let us suppose that the

Scottish people vote against independence and reject "devolution max", which might somehow be defined by somebody later on. If that happens, the minimum change in Scotland will be, predictably, the Scotland Bill arrangement, which was referred to earlier. That is quite a radical change. The question of how to calculate the remaining block grant for Scotland would still have to be worked on. Neither the UK Government nor any of the parties has grasped the nettle that, in the life of this Parliament, the arrangements for Scotland will change radically, regardless of what happens in Wales and Northern Ireland. That muddies the question of transition in a way that is probably not helpful to members. I am just setting that out as a fact that we have to cope with.

Mr Holtham: As Professor McLean says, we do not know whether Scotland will remain in a structure similar to those of the other devolved areas, which are largely financed by a block grant that is somehow determined with or without deductions for tax bases that have been devolved.

If Scotland remains in such a system, that is the only reason why a long transition period is needed. When we did our exercise in Wales, we applied our simple formula based on the English local authority distributions; the conclusion was not universally popular, but no one has been able to overturn it. The deviation between what Wales and Northern Ireland got under Barnett and what they would probably get under a needs-based formula — assuming that our formula was not too far off where you ended up — was not huge. It was a maximum of 2%, 3% or 4%.

Since then, the convergence in Northern Ireland has gone on. Now, going by the data, it looks to us as though Northern Ireland would not get very much change either way from moving to a needs-based formula. Wales would get a very small increase. The big problem with Scotland was that, according to the data in figure 1, it was getting 117% of the UK average; our data showed that it was getting 120%. I do not know why there is a difference; there has obviously been some data revision. Anyway, the formula said that they should get 105%. Therefore, Scotland was 12% to 15% above where it should be, which amounts to £4 billion a year. That is a hell of a lump to take out of any budget. Three to seven years to reduce that budget is not enough; at least 10 years, perhaps 15, would be needed to reduce it slowly. For Wales and Northern Ireland, however, it could be done in two or three years. The changes are peanuts in the UK Budget. Therefore, only Scotland imposed a long delay on the adjustment. Of course, if it comes out of the system, that is no longer a factor.

As Mr Trench said, administrative changes could be done much more quickly; the bulk of them could be done in three years, except for the Scottish adjustment.

The Deputy Chairperson: I have one final question. You said earlier that the Barnett formula was originally a temporary measure that has gone on and on. The rationale behind it was the convergence of funding of the various parts of the UK. Although Northern Ireland benefits from it now, we will gradually reach a situation in which it will be no benefit to us. How far have we got to go? How much longer will that convergence process take?

Mr Trench: Convergence in the formula is peculiar because of the extent to which it has not happened rather than the extent to which it has. I am not an expert on the arithmetic. However, logically, as I understand it, the arithmetic should have meant that there was extensive convergence during the sustained period of growth in public spending during the first years of the present century. That does not seem to have happened.

Part of the reason is clear: population numbers. Indeed, that is part of the reason why Scottish public spending has grown on a per capita basis as it has. The Scottish population declined throughout the 1970s, 1980s, 1990s and into the noughties. That meant that although the numbers that we use remained static from the 1977-78 spending round until 1992, they were up-rated again only in 1999. Since then, they have been up-rated at every spending review — every two or three years. For a long period, when the Scottish population was falling substantially, the figures were not adjusted, which meant that there was a significant increase in Scottish spending. That was a cause of concern to some members of UK Government.

One of the major tasks of any Scottish Secretary of State was to ensure that the issue was kept off the agenda to avoid the block grant's being cut. Therefore, the first thing that they had to do was to avoid any talk about a needs assessment; the second was to avoid any adjustment to the population figures.

Eventually, they were forced to concede on adjustment to the population figures. That appears to be a very important factor in convergence. However, it has happened to a significantly less degree than one might expect. It is a very odd criterion on which to allocate funding. I disagree with Professor McLean on one point. Although he is right that Treasury officials knew jolly well that this was a factor in how the Barnett formula would work, it is less clear to me whether Lord Barnett understood that. Perhaps the politicians adopted the system for other reasons, but that was one of its virtues as seen by Treasury officials at the time.

Mr Holtham: Two factors have interfered with convergence, although convergence has gone ahead. In this period of fast expenditure growth, convergence grows faster. Of course, it works the other way round: if public expenditure falls, there is divergence, relatively speaking; if public expenditure falls, your public expenditure goes down, but it goes down less than it does in England, so you get a divergence. However, when public expenditure grows, your public expenditure grows, but it grows more slowly than in England. That is the nature of the formula. At the moment, convergence would not be happening with cuts in public expenditure, but it would have been happening in the period of rapid public expenditure growth in the early noughties. I do not know what the story was here entirely; but in Wales it fell from nearly 120% to 112% of UK expenditure. Therefore, there was very rapid convergence in Wales in those 10 years.

Two things interfere with convergence, and one was referred to by Mr Trench. Do not forget that Barnett works on the increment. Therefore if you have a lump sum and your population is falling, that lump sum goes up by population per head and the increment is adjusted for the change in your population, but the lump sum is not. Barnett only works on the change: if your population is falling, your expenditure per head is being buffered and you are not subject to the Barnett squeeze. That happened in Scotland.

The other thing that interferes with convergence is changing responsibilities. If something new is devolved, they will cut a deal with you on how much money you will get for the new devolved function. Of course, if you cut a good deal, as you guys did over policing, for example, where they stuffed your mouths with gold to take that function on, your expenditure per head will go up. As you take on new responsibilities — depending on how good or bad a deal you strike — that will affect it. Since the 1970s, there has been progressive devolution of functions, and that made it difficult to see how far convergence is going. However, if you do not have a declining population — on the contrary, you have quite a vigorous population growth — and if you now have a stable situation as regards what responsibilities are devolved, you will suffer convergence. In our rough-and-ready calculation, you are not very far away now, and you may be roughly where you should be according to needs base. You have done well in the past; however, you are at the point where you will not do particularly well out of the Barnett formula in future.

Professor McLean: That is the bottom line. If Gerard's calculations are right, you are in approximately the right place in relation to need. If public expenditure absolutely declines and there are fewer pounds in year two to spend than in year one, convergence is slowed. However, if it declines only relatively, convergence is not necessarily slow or does not necessarily go into reverse. If you also suffer from relative population increase — if your population is growing faster than that of the other three components of the UK — you will suffer. To a rough-and-ready approximation, I would say that Northern Ireland is pretty close to the tipping point now.

Mr Trench: In looking at convergence, it is very important to distinguish between overall public spending and those services that are covered by the block grant and to which the Barnett formula applies. It is very easy to identify a general convergence that may be driven by or underpinned by social security spending, which is, of course, outwith the Barnett formula. As I recall from the last time that I looked at the figures for Northern Ireland, about 58% or 59% of Northern Ireland public spending was on what you might call Barnetable services. The remainder, some 20-odd per cent, was accounted for by social security spending, which falls under a different procedure.

The other issue, as Professor Holtham mentioned, is that this has gone into reverse in the past couple of years. One important reason for that is the sheltering effect on the block grant generally of the UK Government's policy of preserving in real terms spending on health and schools in England because

they are such heavy areas of devolved expenditure. That explains a great deal of what has gone on in the past couple of years.

The Deputy Chairperson: Gentlemen, thank you very much for your contributions. It was an interesting discussion and we will certainly find your views helpful in our deliberations. Thank you once again and good day.