Northern Ireland Assembly

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FINANCE AND THE DEVOLUTION FISCAL DEBATES

Introduction

Finance is central to the working of any government or public body. The amount of money available to it determines what it may do and how it may do it. The more complex the funding system is, the more likely that system is to shape the behaviour of the government funded by it, and to be hard to change. As a means of allocating money to devolved governments, the block grant and formula system underpinned by the Barnett formula is simple compared with that in many similar federal or decentralised systems (or those used for local government in Great Britain), but it is also more complex in its working and implications than it often appears. Broadly speaking, the formula is (disproportionately) generous at present to Scotland and Northern Ireland, and (disproportionately) ungenerous to Wales.

How long the present arrangements will survive is an open question. While the early years of devolution in Great Britain saw scarcely any discussion of how devolved governments were, or should be, financed, that changed after 2007. The election of a minority SNP government in Scotland triggered wider constitutional debates there leading to the 2014 independence referendum there, while the Labour-Plaid Cymru coalition in Wales established an independent commission to look at how Wales was financed and more recently the Silk Commission. These debates have resulted continued, in a limited measure of fiscal devolution for Scotland in the Scotland Act 2012, and the still-pending UK Government response to the Silk Commission's report for Wales. These proposals have involved leaving intact the Barnett formula as the basis for allocating funding to the devolved governments, but it is coming under increasing strain administratively and political criticism from within England.

Although the formula has proved remarkably durable, its long-term survival has to be viewed as open to question, as is how well it serves Northern Ireland.

This briefing will summarise some of the key features of the devolution finance debates that have developed in Scotland and Wales, and how the UK at the centre has responded to these. It will also look at some aspects of how the Barnett formula works, and how well it in fact serves Northern Ireland's interests.

Scotland

Before 2007, there was no serious financial debate in Scotland. The Scottish Parliament was established with a limited power to vary the standard rate of income tax by up to 3 pence in the pound, a power it had never used, but otherwise continued to rely on the block grant from Westminster. The working of the Barnett formula was (and remains) generous to Scotland, and the Labour-Lib Dem coalitions elected in 1999 and 2003 had succeeded in ensuring that there was no debate that threatened Barnett. The Scottish Executive's funding increased dramatically as a result, with the expansion of public spending across the UK, and convergence on the English level of public spending (which is an arithmetical property of the formula) did not occur either.

The election of the SNP minority government changed that, and led to two separate constitutional debates which focussed principally on fiscal matters. The Scottish Government set up a 'National Conversation' concerned with issues of autonomy and independence. It culminated in a white paper, published in November 2009, which also canvassed the possibility of 'full devolution', meaning the greatest degree of autonomy possible while Scotland remained part of the UK.[1] This would entail 'full fiscal responsibility': all taxes in Scotland would be set and collected by the Scottish Government, which would pay for all public services in Scotland and remit a contribution to the UK Government to pay for remaining UK-wide services (notably defence and foreign affairs). Implicit in this was that most if not all aspects of welfare spending would be devolved, though there was a question about old age pensions. Arguments for this model included introduction of a 'hard budget constraint', and devolving fiscal levers that could be used to spur economic growth.

The discussion of full fiscal autonomy may have been intended to build a wider base of support than the SNP and some professional economists for it. However, if that were the aim, it failed. Various figures flirted with the idea, but then thought better of their early enthusiasm. While the SNP sought to use debates about the Scotland bill as a vehicle for discussing it, the idea remains locked in limbo.

The response of the three pro-Union parties (Labour, the Conservatives and the Liberal Democrats) was to make common cause and establish their own constitutional process. This took the form of a more conventional commission, with membership from all three parties and a number of non-party figures. This 'Commission on Scottish Devolution' (known as the Calman Commission after its chairman, Sir Kenneth Calman) had a remit to review devolution to 'improve the financial accountability of the Scottish

[1] Scottish Government *Your Scotland Your Choice: A National Conversation* (Edinburgh: Scottish Government, 2009).

Parliament, and continue to secure the position of Scotland within the United Kingdom.' It therefore embraced (and linked) two ideas: reinforcing the Union, and 'financial (or fiscal) accountability'.[2]

Fiscal accountability is the principle that no elected government should be responsible only for spending money but not raising it. It draws a direct link between a government's spending responsibilities and its tax-setting ones. This principle makes much intuitive sense; it can be seen as the converse of the American revolutionary maxim of 'no taxation without representation' – 'no representation without taxation'. It is, however, hard to find much empirical support for its existence or effect in the academic literature. It also raises questions of how much tax-raising is necessary to secure 'accountability', and of how that operates.

The Calman Commission addressed this by coming up with proposals for limited fiscal devolution. The centrepiece of these proposals was to devolve 10 'points' of personal income tax, which will become the Scottish Rate of Income Tax. This will happen by reducing the three UK rates of tax from 20, 40 and 50 per cent to 10, 30 and 40 per cent, making a 'proportionate' cut in the block grant, and allowing the Scottish Parliament to set what rate it wished to fill the gap in its funding from the cut in the block grant. That rate could be higher or lower than the vacated tax 'space'. Unlike the Scottish variable rate, it would be hard if not impossible for the Scottish Government to avoid setting some sort of income tax rate (it would have to cut public services dramatically to do so). So: the Scottish Parliament would have to make a choice about the level in Scotland of the most visible tax, and voters would be able to respond to that at subsequent elections.

Income tax was not the only tax Calman proposed be devolved. It also recommended devolution of four land-related taxes: stamp duty land tax, landfill tax, aggregates levy, and air passenger duty, and assignment of half of income tax deriving from savings and investments. Land taxes are particularly suited for devolution, as land is immovable and taxes on land will therefore not distort economic behaviour. In total it claimed that, taken with the already-devolved powers over local taxation (council tax and non-domestic rate) these proposals would mean the Scottish Government would raise about 35 per cent of its total spending.

Unusually, Calman attracted two formal responses from the UK Government. One was a white paper published in November 2009 by the Labour government.[3] The second was an explanatory Command paper published by the Conservative-Lib Dem Coalition in November 2010, when it introduced a bill to implement Calman into Parliament.[4] The two governments' proposals removed air passenger duty and the assigned share of savings and dividends income tax from the package; the Coalition also removed the aggregates levy. The most important difference related to how the amount of devolved tax revenue would be calculated, however. Labour's proposal was that this would be an estimate of revenues produced by the Treasury. The Coalition proposed a short transition period when estimates would be used, but after three years figures for actual revenue would replace the estimates. This was an important step in ensuring that the devolved income tax power would in fact reflect devolved decisions rather than replace reliance on one

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[2] Commission on Scottish Devolution *Serving Scotland Better: Scotland and the United Kingdom in the 21st Century,* Final Report (Edinburgh, Commission on Scottish Devolution, 2009)

[3] Scotland Office *Scotland's future in the United Kingdom: Building on ten years of Scottish devolution* Cm 7738 (London, The Stationery Office, 2009).

[4] Scotland Office *Strengthening Scotland's Future,* Cm 797 (London, The Stationery Office, 2010)

Treasury spreadsheet (under Barnett) with two spreadsheet estimates. It is hard to see how meaningful 'fiscal accountability' could be delivered without doing this.

The Calman proposals have now passed into law, in the Scotland Act 2012. That is in the process of being implemented. The two land taxes will be devolved from April 2015. Income tax devolution will start in 2016, and move to using actual numbers for devolved revenues in 2019 – a long timetable, but needed to ensure that the process is a smooth one. There are some key administrative changes too. HM Revenue & Customs are establishing a list of 'Scottish' taxpayers for the new Scottish rate of income tax (not straightforward); the Scottish Government is establishing a new agency, Revenue Scotland, to administer the new land taxes as well as revenue matters more generally, and the UK and Scottish Governments have established an interministerial 'Joint Exchequer Board' to resolve the practicalities of fiscal devolution. What remains unresolved at least in public, however, is the way the 'proportionate' cut in the block grant will be made after the first year. The two governments appear to have endorsed the principle that it will be adjusted as a percentage share of the UK income tax take (so if the amount were 13% in year one, that proportion will be applied to the block grant calculated in the customary way in subsequent years – even as the Scottish and UK-wide tax takes might diverge). But this has not been recognised in public, nor has the any amount been put on the likely impact of that cut in any published projections.

The situation in Scotland is likely to change further in any event. A Yes vote in the 2014 referendum will result in Scottish independence, possibly sooner than the Scotland Act 2012 would come into effect. (The Scottish Government has suggested independence would take place 16 months later, in May 2016.) As Scotland would become an independent state outside the United Kingdom, it would also obviate the need for fiscal devolution within it. Indeed, Alex Salmond has said on several occasions that the point of independence is to secure fiscal autonomy for Scotland – not outright economic independence. In the event of a No vote, all three Unionist parties have committed themselves to delivering some form of further devolution, with fiscal powers being key to those. Various schemes have been published or are being prepared (the Scottish Liberal Democrats and the 'Devo Plus' group have published final proposals, the Labour Party has published an interim report, IPPR has a project called 'Devo More' underway, and the Scottish Conservatives have established a working group).[5] Outright devolution of income tax is a common theme in all the published proposals to date; the question is what further taxes are devolved, and how that affects the calculation of the block grant.

Wales

The debate in Wales has been much concerned with problems in calculating the block grant. While Welsh Labour had resisted any formal consideration of the block grant, forming a commission to review it was a requirement of the 'One Wales' coalition agreement with Plaid Cymru in 2007. This resulted in the establishment of an expert commission chaired by Gerald Holtham, which reported in 2010.[6] The Holtham report confirmed that Wales was indeed under-funded, though by a small margin. This problem would become much worse if (or as) public spending in England increased, as that would lead to convergence of

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[5] The author is both working with IPPR on the Devo More project, and acting as adviser to the Scottish Conservatives' Commission.

[6] Independent Commission on Funding and Finance for Wales *Final Report: Fairness and Accountability—A New Funding Settlement for Wales* (Cardiff, Welsh Assembly Government, 2010).

Welsh spending on the English level. It also proposed a methodology for calculating a 'fair' grant using a small number of indicators, rather than the highly complex approach that is often associated with assessments of relative need.

Calls for restructuring the Welsh block grant to reflect relative need have not been successful. All the Welsh Government has succeeded in obtaining are various sorts of undertakings from successive UK Governments that it will not allow the situation to become materially worse.

What the UK Coalition Government did do was to deliver its commitment to establish a 'Calman like process' for Wales. This has taken the form of a Commission on Devolution in Wales, chaired by Paul Silk and with membership from all four major parties in Wales (including Plaid Cymru – a major contrast to the exclusion of the SNP from the Calman Commission). The Silk Commission's remit is in two parts, looking first at financial matters and 'fiscal accountability', and then at wider constitutional matters. Its report on Part 1 was published in November 2012, and its work on Part 2 is currently underway.[7]

The Silk recommendations were similar to those of Calman for Scotland: devolution of 10 points of income tax, plus stamp duty land tax, air passenger duty, aggregates levy and landfill tax. The chief difference was that it said the Welsh Government should be able to set different rates of tax for each of the UK rates, not be bound to a 'lockstep'. There have been clear indications from HM Treasury of its support for a Calman-type package – but the 'spring' deadline for a UK response came and went, with only an announcement in late June that there would be a response 'soon'.

The Barnett formula: the problems of convergence and administration

Northern Ireland has largely opted out of these debates. It has pursued devolution of two taxes for their possible economic impact – not to improve autonomy or ensure greater accountability to the public. In the case of air passenger duty, it has been partly successful; it has not succeeded to date with demands for devolution of corporation tax, which would be a very problematic tax to devolve in any case. Underpinning this lack of a debate is the assumption that the Barnett formula is 'good' for Northern Ireland, providing a generous, stable and flexible allocation of funding. It certainly allocates all three devolved governments more generous shares of public spending than on the whole are allocated to England. In the case of Northern Ireland (and Wales), it is also clear that overall funding exceeds taxes raised in those parts of the UK – that is, there is a fiscal deficit for those areas, funded from tax revenues collected elsewhere.

How generous the formula is in reality is harder to say. Thanks to the work of the Holtham we have an idea of the relative needs of the various devolved parts of the UK, and can match that (more or less) with devolved budgets:

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[7] Commission on Devolution in Wales *Empowerment and Responsibility: Financial Powers to Strengthen Wales* (Cardiff: Commission on Devolution in Wales, 2012

	Relative need compared to UK (Holtham estimate)	Current spending on devolved functions
Scotland	104	123
Wales	115	112
Northern Ireland	121	127

There are several imponderables about how the Barnett formula works. One is to identify which government is responsible for how much spending in each part of the UK, where both UK and devolved governments have a role – which is the case for many policy areas other than health and education (very largely devolved), or defence, international aid and foreign relations, or social security (all reserved). This is not available in published official data. Another is the impact of population changes. The formula, after all, allocates a block of funding to governments – but we understand fairness by relating that to the populations for which those governments are responsible. Changes in population as well changes in funding affect spending per person. They can also affect convergence under the formula; it would appear that the long-term trend of decline in Scotland's population (which has arrested since around 2007) explains why there was not convergence there during the 2000s. Population changes – an increase – may help explain the rapid decline of per capita spending in Northern Ireland in the 2000s, as well as an economic 'peace dividend' following the end of the Troubles.

This has two curious effects. First, any increase in spending on comparable functions in England is likely to lead to increased convergence (even if that is only a nominal increase not a real one). Second, spending by all devolved governments has been protected by the Coalition's protection of spending in real terms on health and schools in England, which account for the vast bulk of devolved spending. If that changes after the next UK election, devolved budgets will come under greater pressure, but they will also diverge from English levels of spending as that will imply English spending shrinking at a more rapid rate than devolved spending.

The working of the Barnett formula on the administrative level also raises questions. The formula has no legal or constitutional foundation; however important it may be, it rests on nothing more than a 'Statement of Funding Policy' issued by HM Treasury.[8] The Treasury could quite easily change that policy. Devolved governments have no say in the framing of the statement or the overall policy – to the extent it needs approval, it gets it from the Northern Ireland Secretary, not the Finance Minister. Decisions about the framing of the formula and its application are taken by the Treasury and its ministers, with little scrutiny (there is no audit, for example, and scant information about what changes in spending for England trigger changes in devolved grants or how the amounts of those changes are calculated. The whole system is characterised by a serious lack of transparency and accountability, reflecting its origins as a way of allocating funding within a single government not a mechanism for calculating the funding of politically and constitutionally distinct governments.

[8] HM Treasury *Funding the Scottish Parliament, National Assembly for Wales and Northern Ireland Assembly: A Statement of Funding Policy* Sixth edition (London, HM Treasury, 2010)

The assumption that 'Barnett is good for Northern Ireland' therefore needs treating with a degree of scepticism. Historically, Barnett has provided generous funding to Northern Ireland. However, its generosity is decreasing thanks to demographic and other factors, and the point at which spending matches a reasonable estimate of relative need may not be far away. At that point, life could get very tough indeed for a Northern Ireland finance minister.