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Fiscal sustainability for Northern Ireland

The Elusive Quest?

Why does it feel like Northern Ireland's public finances are in a never ending crisis? It seems as though we are caught in a cycle of both growing demand for public services and very limited growth in the funds necessary to pay for them. Just when it seems like we've dug ourselves out of one hole, we suddenly seem to find ourselves further down in another one.

How has it come to this? Is there a way out of this cycle or is this just the new reality? These are questions that we have tackled in a new research paper looking at how to bring stability and sustainability to NI's public finances.

In order to reach that point we first have to understand how we got here. Many of the issues we are facing are similar to those being experienced in other areas of the UK, but some are unique to NI. While the crisis in NI's public finances might have reached its peak during 2023, the seeds of that episode were sown as far back as 2010 and can even be traced back as far as 1979.

In the first instance, public spending across the UK has seen minimal growth since 2010. In NI, current spending grew by 3.5% in real terms between 2010 and 2024. This is during a period when the demands on many public services have increased by double digits. This has meant that public services have been run down to their bare minimum, with no slack to deal with the unexpected.

While the increases in public expenditure have been constrained across the UK, NI actually saw the smallest increase of any UK region over the last 14 years. It could be argued that this is to be expected given the much higher overall levels of public expenditure in NI. While, it is true to say that, per head of population, we have higher than average public spending in NI, this figure is commonly misunderstood.

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In 2022/23 NI's public spending level was the third highest in the UK, below London and Scotland and just above Wales. Public spending levels were thought to be roughly 20% above average in NI over the last number of years. However, this doesn't mean that NI gets 20% greater healthcare provision in hospitals or 20% greater teaching provision in schools. NI gets 20% more expenditure in NI because it costs more to provide public services here.

Why does it cost more to provide services? Well firstly, in England public services like the NHS are provided on a vast scale that means the cost per head can be minimized. In NI, the devolved government is providing an NHS for a much smaller population and that will always cost more. Secondly, NI has more people than average using those public services because of our demographic and social structure. Thirdly, and importantly, NI has to spend more on areas like policing and justice services because of the legacy of conflict.

For many years the higher cost of providing public services in NI was reflected in the funding that we received from London. However, the extra funding NI was receiving was being slowly chipped away at over the years. This was not by accident, but by design and it was set in train as far back as 1979.

The Barnett formula which determines how funding is allocated to devolved regions in the UK, was designed so that eventually it would eradicate higher levels of regional spending irrespective of the cost of providing public services in those regions. At a

certain point, it would wipe out the extra spend we needed to remain on par with the rest of the UK.

What happened in 2023 then was a perfect storm. We had seen overall UK public expenditure grind slowly in the years from 2010. At the same time, we saw the extra spend NI needed to maintain services was finally eliminated. Without an Executive in place, NI spending breached the funds that were available for it.

This was the situation that led to a wave of strikes by public servants and the curtailment of some publicly funded services in NI programmes throughout 2023. However, rather than acknowledging that the roots of this crisis lay in decisions taken outside NI, the UK government sought to look for solution within NI.

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The Northern Ireland Office, which had budgetary responsibility for NI in the absence of an Executive, sought solutions to the crisis in 2023 by bringing attention to another fact about public finances in NI. They drew attention to the fact that NI had the lowest tax revenue per head in the UK and, if it needed additional resources, it should look at raising more revenue.

In the first instance, it is true to say that revenue raised per head in NI is the lowest of any UK region. When you put this together with NI's higher public spending profile, it means that NI has the largest gap between per head public spending and revenue raised. However, once again, this figure is commonly misunderstood.

Rather than acknowledging that the roots of this crisis lay in decisions taken outside NI, the UK government sought to look for a solution within NI.

Tax revenue per head in NI is not lower because we charge lower rates of tax. All the main rates, income tax, national insurance, VAT and corporation tax are all set at UK level. If all people in the UK pay the same percentage, then why is the yield lower in NI?

This has to do with how taxes are raised. We don't charge taxes on a per person basis, we charge it on the activity or the asset a person has. If a person has a higher income, they'll pay more income tax, if they have lower spending, they'll pay less in VAT. What's driving the lower revenue yield in NI is therefore the fact that the activity in our economy and the value of the assets we have is lower than the rest of the UK. When you measure our taxes against the underlying activity they are levied on, we match quite well.

When measured on a per head basis, tax revenue generated in NI falls below the UK average. When we compare total revenue as a percentage of total economic output, measured as Gross Value Added, the story is much different. For many years, NI raised exactly the UK average, and in some years, higher than the UK average. However, in recent years, NI has fallen back slightly on the revenue/GVA measure. The origins of this trend can be seen when look at the main taxes from which this revenue is raised. Income tax as a percentage of GVA was higher in NI from 2002 all the way up to 2010. Since then, revenue raised in NI through income tax, and national insurance, has fallen consistently below the UK average. What is happening here?

One of the main tax changes in the 2010s was a significant increase in the personal allowance for income tax. This is the portion of income that is excluded from income tax liability. In the 20 years from 1990 to 2010, the personal allowance increased by 115%. In the 10 years between 2010 and 2020, it increased by 93%. This rapid increase since 2010 has meant that unless your income continued to grow at the same pace as the personal allowance, you would pay less income tax. For NI, which has a lower income profile than the UK, these changes had a disproportionate effect. 77% of NI

income taxpayers earn between £12,500 (the personal allowance) and £30,000, and these taxpayers account for 36.4% of NI's income tax revenue. By contrast the same income group only accounts for 71.3% of UK taxpayers and only 21.2% of overall UK income tax revenue. What this also shows is that a policy implemented at UK level had the effect of reducing revenue raised in NI without any involvement of any policymakers in NI.

However, none of this discussion entered the debate in 2023, because the main tax rates are the responsibility of the UK government and the NIO wasn't suggesting any changes to them. Instead, the NIO suggested the Executive concentrate on the limited revenue raising power it has.

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One of the main issues the NIO sought to highlight was domestic water charges. While households in England, Scotland and Wales pay Council tax and Water charges, in NI households only pay domestic rates. The NIO highlighted that the average household in NI paid just under £1200 in rates while the average combined Council tax and water charges bill in England just under £2000. When put in this way, it would seem only fair that households in NI would be expected to pay more. Some even suggested levelling a flat charge of £800 to make up the difference. However, this is to make the same mistake as thinking the average person in NI should pay the same income tax as the average person in England. They should only pay the same amount of income tax, if they earn the same amount of income. The same logic

applies to domestic rates. The average household in NI should only pay the same amount in rates if the value of the house on which the rates are charged is the same.

The average value of a home in England is 67% greater in England than it is in NI. That is where most of the gap in household bills comes from. When you adjust for the differential in house prices, households in NI pay 92% of the average bill in England. NI could increase its domestic rates marginally to ensure we pay exactly the same percentage, but this is not the gamechanger that it many argued it was.

In the end, these revenue raising measures were not taken up and when the Executive was restored, there was a financial package from the UK government that was meant to give greater fiscal stability to the Executive and enable it to ultimately build sustainability into the NI public finances. The financial package included immediate funding to cover shortfalls in the previous years and the gaps in funding that were already apparent in the next two years. Beyond these short term boosts, the UK government did acknowledge that the Barnett formula had brought NI's public expenditure below its required level. They committed to reflecting this 'level of need' in NI's future funding settlements. The route they chose to address public spending needs was to make an addendum to the existing Barnett formula following a similar measure that had been taken up in Wales a decade earlier.

The Holtham formula was the adjustment that was made to devolved spending in Wales in order to ensure that spending settlements each year reflected a predetermined level of need. However, the Holtham formula was not an exercise which sought to determine the differential costs of providing public services in different parts of the UK. It did not seek to understand how different economic and social structures would necessitate a greater intensity of public service provision. Instead, it sought to calculate what social attributes or characteristics determined spending allocations within England. In effect it sought to estimate how much funding Wales would receive, had it been a sub region of England.

This then is the definition of need that was taken up by the UK government when seeking to bring fiscal stability and ultimately sustainability to NI's public finances. While it did result in an increase to what would have been NI's funding settlement, it was still unclear if it could deliver the desired sustainability. That is because the formula identifies need, but doesn't define how that need should be met.

Firstly, the formula identifies characteristics of a population that would necessitate higher public spending. The Holtham formula takes into account things such as the deprivation rate, the proportion of the population that receive welfare and how geographically dispersed the population is. It also accounts for the makeup of the population in terms of age, ethnicity and health status. The problem is that the formula doesn't calculate what burden these characteristics place on the delivery of public services. It looks at how the UK government would fund a population with such characteristics if it existed in England. The Holtham formula determines a level of need, but it defers to existing UK government decisions on how that need is to be met.

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The second issue is the choice of the characteristics that determine need. When the original Holtham formula was being developed, it was comparing spending in England to that of Wales. While Wales is a considerably less affluent region compared to England, there is a large degree of similarity between the two regions. The same cannot be said for Northern Ireland. Indeed, even before the agreement on the financial package with the UK government was reached, it was accepted that higher spending on policing and justice needed to be added to the formula for NI. This was

more than a simple add-on. The Holtham formula wasn't built to accommodate unique factors. It is designed to reflect how UK government decisions are correlated with a limited number of societal characteristics. There was much discussion of the first attempt to introduce a policing and justice element into NI's need level. So much so, that the original author of the Holtham formula was commissioned to re-estimate the formula for NI. Within that updated report, the need level was updated to include policing and justice, but the report also identified a necessity to reflect a greater need for Agriculture spending. At present, this recommendation is still to be taken up by UK government.

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The reason that the UK government has so far declined to reflect higher agriculture spending in its estimate of NI's need factor is because if it were to do so, why would stop there? There are many other areas of need that could be identified under the same terms that agriculture was. The more add-ons, the more unwieldy the formula ultimately becomes, but the real issue is that these add-ons only draw attention to the root causes of the greater public spending need. The need for greater Agriculture spending is because it is a much larger part of the economy in NI compared with England. But there are so many other examples where NI's economic and social structure has the same effect. Professor Holtham, in his most recent report, bemoaned the fact that he was only charged with updating the estimate of need, rather than being able to construct a more considered estimate of actual need. A full understanding of the drivers of higher public spending in NI is necessary to properly construct an estimate of public spending need. The current model of need is likely to offer only short term stability and unlikely to advance NI's public finances toward sustainability.

What then is the route towards fiscal sustainability? In the first instance we need to understand something that is abundantly evident from the experience of the last few years. The NI Executive, on its own, will never be able to deliver fiscal sustainability.

That is not by choice, it is by design given the limitations of devolution. Fiscal sustainability is a joint responsibility between the NI Executive and the UK government. Too often in recent years we have seen the UK government put sole responsibility for the task on the NI Executive. They have done this by conflation the ideas of budget sustainability and fiscal sustainability. Budget sustainability is about managing public spending in line with the funding and income streams that are available. Fiscal sustainability is about having the appropriate revenue raising capacity in order to meet the public spending requirements of society and the economy, and balancing up the two. Budget sustainability is within the purview of the Executive, but it can only be achieved when fiscal sustainability is already in place. The UK government has to ensure, on its part, that its fiscal decisions result in a funding settlement for NI that will allow it to ultimately achieve budget sustainability.

Take the earlier example of income tax and the personal allowance. The UK government should have understood the consequences for revenue raised in NI that would flow from that policy decision. Cuts to rates of National Insurance in the last two budgets of the previous parliament also severely undermined the fiscal stability of the UK as a whole including NI. Rather than acknowledging the impacts of these revenue decisions, the UK government sees NI's limited local revenue base as the only route to fiscal sustainability.

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Could fiscal devolution provide a route to fiscal sustainability in spite of the UK government? There is definitely a case to be made from NI having more influence over the key revenue raising tools, but there are also many risks. The risks, which can be seen in the experience of tax devolution in Scotland, are rooted in the wider devolution infrastructure. In effect, a devolved region takes on a

very large risk and sees limited fiscal rewards from it unless it can over the long-term markedly improve the revenue raised, compared to if it didn't do devolve the tax. Fiscal devolution should only be part of a wider reform to the entirety of the UK's current fiscal architecture.

What would a new fiscal architecture look like? We don't have to look that far to see examples in other countries that have fiscal systems that recognise the different need and different capabilities of devolved regions. Fiscal Equalisation is a well-known concept in sub-national fiscal policy and operates on both the spending and revenue side. It is common in most federal systems and the UK is an outlier in its current approach. In simple terms, it is a system that recognises where certain states or territories have a greater or lesser need of public spending based on the demographic and social makeup of their populations and the economies of scale involved in delivering services for that population. Crucially it also recognises that based on economic structure and those same societal characteristics, a state or territory will not be able to raise as much in revenue. Adjusting for both these elements equalizes the task for every region. Australia and Canada both operate systems of fiscal equalisation, Australia adjusts for both spending and revenue, while Canada seeks to do all of the adjustment on the revenue side.

A system of fiscal equalisation is essential if we are to have a realistic and informed discussion about the level of public services Northern Ireland requires and the costs of providing them. It would also allow for a more honest assessment of our genuine revenue-raising capacity, moving beyond the narrow debate that has dominated in recent years. Crucially, fiscal sustainability cannot be delivered by the NI Executive alone; by design, it is a joint responsibility shared with the UK Government. A properly structured equalisation system would recognise the structural factors that drive higher public spending in NI and the reasons revenue generated here will always be lower. In doing so, it would create the stability needed in the short term while setting a credible path towards long-term sustainability. This would involve a

significant rebalancing of fiscal responsibilities between the UK Government and the NI Executive, without removing accountability from either. And while it would represent a substantial shift in the UK's fiscal framework, it is neither radical nor unprecedented: comparable systems operate successfully in countries such as Canada and Australia. Ultimately, it offers the only viable route to fiscal sustainability for both Northern Ireland and the wider UK.

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