

## Financing Scotland

### Is there a workable financial settlement for Scottish devolution?

A fortunate few are remembered after their death for some achievement of which they are proud; others for something they would rather not be linked with.

Lord Barnett who died on 1 November 2014 had the misfortune to fall into the second group. The 'Barnett Formula' which he gave his name to when Chief Secretary to the Treasury in 1978 lives on nearly forty years later as the basis for allocating public spending to Scotland, Wales and Northern Ireland. Indeed it was given new life when the Prime Minister and other leaders of the 'Better Together' campaign pledged during the referendum campaign that it would continue to be used to fix Scotland's share of public resources.

Yet Joel Barnett himself said recently the formula was 'unfair and should be stopped' because it gave too large a share of spending to Scotland. He described it as a 'national embarrassment, and personally embarrassing to me as well'<sup>1</sup>.

So how could it survive for so long? The answer may be crudely that it works – and it works crudely. It gives an arithmetic answer to a question 'how should we allocate resources between the nations of the United Kingdom?' which does not involve endless soul searching and political wrangling about what is fair and how different needs should be weighed and measured.

How does it do this? The key is that the formula doesn't say what is the right *level* of UK resources going to Scotland (and Wales and Northern Ireland). It just says what the *change* should be. If £100 is added by the Treasury to spending in England on an activity that has been devolved to Scotland, then Scotland gets X% of that added to its block grant – where X is the population of Scotland relative to England (currently 10.08%). The same happens in reverse when spending in England is cut. Where money is given to a department which is partly devolved then a proportionate share of the increase is put into the formula.

So the *increase* in spending per head in Scotland in cash terms ought to be roughly the same as England – but the *base level* of the block grant is just what spending happened to be when the formula was introduced in the 1970s, plus years of subsequent adjustments. Since Scotland enjoyed higher spending per head than England then, that advantage has been preserved (and indeed enhanced by delayed updating of the population factor to reflect Scotland's declining population share).

The issue now is whether it can *continue* to work. Can it bear the weight that will be put on it by the new devolution settlement emerging from the referendum campaign and the Smith Commission report?

Historic constitutional change is happening at dizzying speed and with an astonishing lack of public analysis and debate. The 'vow' made in the heat of the referendum campaign by leaders of the three main UK parties made commitments to further devolution while maintaining Barnett. The PM set up the Smith Commission the morning after the vote – and

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<sup>1</sup> <http://www.telegraph.co.uk/news/uknews/scottish-independence/11100400/My-funding-formula-for-Scotland-is-a-terrible-mistake-Lord-Barnett-admits.html>

also promised English votes on English laws.<sup>2</sup> The Smith Commission duly published its report on 27 November and the PM swiftly welcomed it, promising that draft clauses to implement its recommendations would be brought forward in January.

This settlement will mean that more services (employment and training provision for example) will be devolved and so will fall within the scope of Barnett. Some welfare spending will be devolved for the first time. Scotland will be given the revenue from income tax in Scotland and a share of VAT revenues, and powers to change income tax rates and thresholds. (See annex for detail).

All of this will have fundamental implications for the financial relationship between the UK government and the increasingly assertive nations. Yet, bizarrely, the Commission was composed entirely of representatives of the Scottish political parties and there was no UK voice. Its report, only 28 pages long, does not include any data or analysis of the impact of its proposals.

Where does all this leave Barnett? Suddenly an obscure but very simple formula has been caught up in a welter of complicated adjustments and indexations. Can it take the strain?

**The first source of tension will be the devolution of some welfare spending.** This is currently outside Barnett because the numbers on benefit may move differently in Scotland to England for all sorts of economic, social and demographic reasons. That is why it is paid for at UK level as part of 'Annually Managed Expenditure' (AME) (which, despite its name is not planned within a fixed budget, but simply forecast). This could not continue if the design of benefits was fully devolved because that would leave Scotland free to make benefits more generous at the expense of the UK taxpayer.

The Smith proposal deals with this by limiting devolution to only a relatively small slice of welfare spending which is not much influenced by economic conditions: benefits for carers and disabled people (Personal Independence Payment and Disability Living Allowance). The proposal seems to be that an amount equal to current spending on these benefits in Scotland is added to the block grant and then 'indexed' in future. It is not clear what it would be indexed to.

This would introduce a significant adjustment to the block grant outside Barnett creating plenty of scope for future argument.

**Second, the devolution of tax powers and revenues will introduce even more complexity.** The Smith plan is that an estimate should be made of Scottish income tax receipts and receipts from the first 10% of VAT. This should be paid by the Treasury to Scotland and the block grant correspondingly reduced. And 'future growth in the reduction to the block grant should be indexed appropriately'.

This seems to mean that total Scottish revenues which now consist of roughly £28 billion of block grant would in future be made up of perhaps £11 billion of income tax and £5 billion of VAT, leaving only £12 billion or so of block grant driven by Barnett. Scotland will benefit from

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<sup>2</sup> Early on the morning after the referendum the PM said...'The 3 pro-union parties have made commitments, clear commitments, on further powers for the Scottish Parliament. We will ensure that they are honoured in full. ...Lord Smith of Kelvin...has agreed to oversee the process to take forward the devolution commitments, with powers over tax, spending and welfare all agreed by November and draft legislation published by January. Just as Scotland will vote separately in the Scottish Parliament on their issues of tax, spending and welfare, so too England, as well as Wales and Northern Ireland, should be able to vote on these issues and all this must take place in tandem with, and at the same pace as, the settlement for Scotland.' 19/9/14

rising tax receipts as the economy grows, so it would be unfair for it also to get the full Barnett formula effects of changes to English spending. An adjustment seems to be envisaged but it is not explained. It is not at all clear why the reduction in the block grant would be indexed, as proposed by Smith, or to what.

Even more complex is the handling of UK changes to income tax. Suppose the UK increases the basic rate while Scotland leaves its rate unchanged. Suppose also that the proceeds of the UK increase go to fund a mix of defence (non-devolved) spending across the UK and health (devolved) spending in England. Scotland would appear to gain the benefit of stronger UK defence without paying anything towards it. And if Barnett applied to the increase in health spending the Scottish block grant would benefit from that too! Smith says 'changes to taxes in the rest of the UK, for which responsibility in Scotland has been devolved, should only affect public spending in the rest of the UK.' But no explanation is given and no mechanism is outlined to achieve this. And in practice of course receipts from specific taxes are almost never linked to changes in specific spending programmes.

**A third source of tension will come from the potential new settlement for England.** The Barnett formula rests on the idea that UK Treasury decides budgets for English departments and this is a firm base on which to calculate what Scotland should get. But what if English MPs demand more control over the allocation of spending to English departments and have a different political majority to the UK government controlling the Treasury? English MPs could seek the same block grant arrangements in which case Barnett would have to be recast.

**Finally, change will inevitably focus attention on the Scottish 'advantage'.** On a simple measure of public spending per head that is widely quoted Scotland gets 19% more than England. The latest figures for identifiable spending per head excluding defence are £10,151 in Scotland and only £8,528 in England.

It's worth noting that this commonly used comparison includes spending on 'social protection' - broadly pensions and welfare spending - which is not devolved and so not driven by Barnett. When this spending is excluded, the Scottish advantage rises to 27%. (See table below).

**Public spending per head (2012-13)**

	England	Scotland	UK	England	Scotland	UK
	£	£	£	Indexed England = 100		
Social protection	3,813	4,169	3,891	100	109	102
Health	1,912	2,115	1,937	100	111	101
Education	1,360	1,441	1,373	100	106	101
Public order and safety	462	455	470	100	98	102
Transport	267	539	296	100	202	111
Environmental protection	162	254	171	100	157	106
Housing and community amenities	138	307	165	100	222	120
Recreation culture and religion	117	231	134	100	197	115
Public and common services	93	186	109	100	200	117
Agriculture fisheries and forestry	65	173	84	100	266	129
Enterprise and economic development	47	185	65	100	394	138
Other spending (excluding defence)	92	96	92	100	104	100
<b>Total identifiable expenditure on services</b>						
excluding defence	8,528	10,151	8,787	100	119	103
excluding defence and social protection	4,715	5,982	4,896	100	127	104

Source: Public Expenditure Statistical Analyses 2014, HM Treasury  
Table 9.15 UK Total identifiable expenditure on services by function, country and region, per head

**In conclusion**, the Barnett formula has proved pretty robust over past decades despite the ‘embarrassment’ of its originator. But perhaps the key to its survival has been that it is so simple that the calculation is un-contentious. And as a result it has been able to tick over in the background without too much challenge.

But as devolution lurches forward the new complexity of multiple adjustments will make the calculation inherently contentious. The apparent unfairness to different parts of the UK will stand out sharply. It is hard to see Barnett surviving when it comes under the spotlight. The new constitutional settlement, and the financial settlement which it rests on, must surely deserve wider debate.

BGI

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## The Smith Commission

The report declares that:

- 'The block grant from the UK Government to Scotland will continue to be determined via the operation of the Barnett Formula.' (para 95)
- Some parts of the welfare system, including benefits for carers and disabled people, should be devolved for the first time (para 49) and devolution should be extended to include employment programmes (para 57)
- 'the initial devolution of further spending powers should be accompanied by an increase in the block grant equivalent to the existing level of Scottish expenditure by the UK Government' and 'future growth in the addition to the block grant should be indexed appropriately'. (para 95)
- 'the Scottish Parliament will have the power to set the rates of Income Tax and the thresholds at which these are paid' (para 76) and 'The Scottish Government will receive all Income Tax paid by Scottish taxpayers on their non-savings and non-dividend income.' (para 78) Similar arrangements will apply to the revenue from the first 10% of VAT (para 84), and air passenger duty will be fully devolved (para 86).
- 'The initial devolution and assignment of tax receipts should be accompanied by a reduction in the block grant equivalent to the revenue forgone by the UK Government, and future growth in the reduction to the block grant should be indexed appropriately.' (para 95)
- 'Where either the UK or the Scottish Governments makes policy decisions that affect the tax receipts or expenditure of the other, the decision-making government will either reimburse the other if there is an additional cost, or receive a transfer from the other if there is a saving.' (para 95)
- Changes to taxes in the rest of the UK, for which responsibility in Scotland has been devolved, should only affect public spending in the rest of the UK. Changes to devolved taxes in Scotland should only affect public spending in Scotland. (para 95)

## Report of the Smith Commission for further devolution of powers to the Scottish Parliament

27 November 2014