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POLICY BRIEFING

Funding the UK nations – the Barnett formula and devolved governments

16 November 2015

Tom Lawrence LGiU associate

Summary

This briefing explains the Barnett formula and describes its operation in determining the block grant received by the Scottish and Welsh governments. It analyses the income and expenditure of these governments for one particular year (2013-14). It also describes the powers devolved to these governments before and after this year, right up to the present date. In the Comment section, it makes some observations on how devolution has evolved over the last 17 years, and what the implications are for English local government.

Briefing in full

This is the first of two briefings on funding the British nations. These briefings focus on Scotland, Wales and England, although there are some mentions of Northern Ireland. This briefing looks at the financing of the devolved administrations in Scotland and Wales. The second briefing will look at the way local authorities are financed in Scotland, Wales and England, including the funding received from the devolved administrations and from the UK Government.

The Barnett formula

The Barnett formula is a formula for distributing resources between the nations of the United Kingdom. It is not the first formula to do so: its predecessor, the Goschen formula, was first used in 1888. The Barnett formula is named after the late Joel Barnett (Lord Barnett) who invented it in 1978. As Chief Secretary to the Treasury, he devised it in order to prevent frequent disputes between Cabinet colleagues on the distribution of resources between departments. (Although he did so in the run-up to the referenda on Scottish and Welsh devolution, he has said that this was not the reason he devised it.) The existence of the formula was not public knowledge until

1980, when its existence was revealed in Parliamentary exchanges. It still has no legal status – it is merely a Treasury convention.

To understand the formula, one must consider how departmental budgets are set. Each Spending Review takes the budget for each department for a baseline year and projects it forward for the period which the Spending Review covers. For example, in the last Parliament, the government committed to increasing the schools budget in line with inflation, so it got a small year-on-year increase. Usually, as revenues grow, most departments will see a gradual increase in their budget through the Spending Review period. (As is well known, most departments have instead seen a year-on-year decrease during the current period of deficit reduction.) During the course of the Spending Review period, the UK Government may make policy changes which affect the budgets of various departments. These adjustments are announced in Budgets and Autumn Statements.

The Barnett formula only applies to these cash increases or decreases in budgets, as announced in Spending Reviews, Budgets and Autumn Statements, not to the existing baseline budgets. Before devolution, it was applied to areas where the budgets were decentralised, that is, where the expenditure relating to Scotland, Wales and/or Northern Ireland was met from the budgets of the Scotland, Wales and/or Northern Ireland Offices. Since devolution, it has been applied to areas where the expenditure has been devolved to at least one of the devolved governments.

In principle, the formula is extremely simple. It says that the budget change for Scotland, Wales or Northern Ireland should be equal to that for England multiplied first by a population factor and second by a “comparability factor”. The population factor is simply the ratio of the relevant nation’s population to that of England. Until 1992, these ratios were based on mid-1976 population estimates. However, in recent years, the ratios tend to have been based on population figures published the year before the relevant document (Spending Review, Budget or Autumn Statement).

The definition of the “comparability factor” is slightly more complex. Each Government department has a number of “programme objects” for the Spending Review period. These are the departments’ work streams for the period. As stated in *Funding the Scottish Parliament, National Assembly for Wales and Northern Ireland Assembly: Statement of Funding Policy*:

> *“Comparability is the extent to which services delivered by United Kingdom Government departments correspond to services within the budgets of the devolved administrations in terms of their primary function”*

On this basis, each programme object is assigned a comparability factor. In principle, this could be anything from 0% to 100%, but in practice it is always either 0% or 100%. These individual programme object comparability factors are then weighted by the programme objects budget for the Spending Review base year, to come up with an overall comparability factor for each department.

As described above, the department’s comparability factor times the population factor times the budget change for England, then gives the budget change for the relevant nation. (This is known as a “Barnett consequential” of the budget change for England).

Scotland, Wales and Northern Ireland receive funding from the UK Government in the form of a “block grant”. The Barnett formula determines the year-on-year changes to this block grant.

It is worth noting that some of the current block grant relates to spending decisions in recent years, but the rest relates to decisions made in previous decades. Population has changed over the intervening time; indeed, some of the funding was calculated and awarded between 1978 and 1992 based on 1976 population figures and some dates from before the invention of the Barnett formula. Consequently, the total block grant is not in proportion to current population figures. For example, it is known that Scotland receives more than it would if current population proportions were used for the whole block grant. This is sometimes called the “Barnett gap”. However, as Barnett consequentials are added over time, these out-of-date amounts make up reducing proportions of the whole block grant. This means that if one were to neglect the effects of inflation and assume that the populations of the nations were to grow at the same rate, the gap would reduce over time. This effect is known as the “Barnett squeeze”.

The rate of convergence, though, is affected by inflation and differential rates of population growth. In some circumstances, the gap could even widen. This has been analysed by Professor David Bell of the University of Stirling and is helpfully summarised in a House of Commons research paper from 2001.

Devolved powers

There has been some form of devolution of powers in Northern Ireland since 1921, although this has not been continuous. Devolved administrations in Scotland and Wales were first set up in 1998, following referenda the previous year.

The powers devolved to the Welsh Assembly Government are set out in legislation. These devolved areas include:

- education
- health
- local government
- transport
- planning
- economic development
- social care
- culture
- environment
- agriculture and rural affairs

In the original Government of Wales Act 1998, the Assembly did not have a separate executive. It could not pass primary legislation, only secondary legislation, and that was only with the authorisation of the UK Parliament. This caused difficulties in its operation.

In 2002, the Assembly decided to separate out the executive role as much as possible under the 1998 Act, but this was felt to be insufficient. The Executive therefore established the Richards Commission. This recommended that the bodies be established as separate legal entities, with primary law-making powers. The first of these features was included in the Government of Wales Act 2006. The Act also allowed the Assembly to gain legislative powers in some areas straight away and gradually gain others. Furthermore, it could gain the power to pass primary legislation in all devolved areas if this were approved in a further referendum. Such a referendum was held in 2011 and the vote approved the new powers.

Developments in Wales since 2006 other than this referendum are covered in the section "Recent developments – Wales" below.

In Scotland and Northern Ireland, in contrast to Wales, the legislation sets out powers that are reserved to the UK government; the devolved governments have the powers to make policy in any other areas. The Scottish Government has had primary law-making powers since it was established by the Scotland Act 1998. It describes its powers as including:

- Health
- Education
- Justice
- Rural affairs
- Housing
- The environment

The Scotland Act 1998 also gave it the power to vary the basic rate of UK income tax up or down by up to 3p, although it had no powers to vary thresholds or other rates.

More recent developments in Scotland are considered in the section "Recent Developments - Scotland".

The UK government may still legislate for devolved matters, but only if it has the consent of the devolved legislature affected. This is known as the Sewel convention. The devolved legislatures give their consent through Legislative Consent Motions.

Financing - Scotland

Most of the funding for the Scottish Government comes from the Scotland Office, in

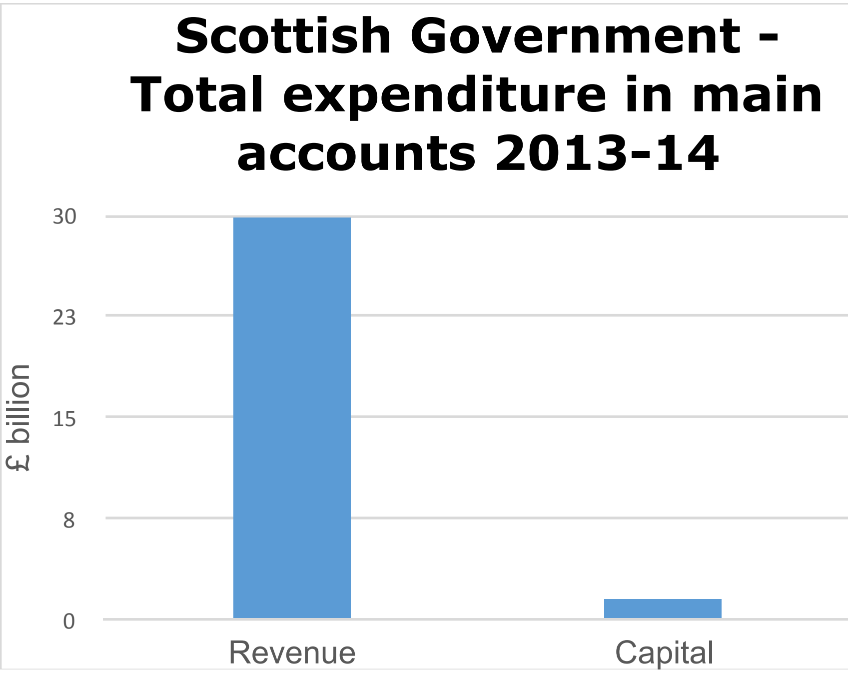
a payment determined by the Barnett formula. In 2013-14, the last year a full set of accounts are available for, this payment was £27.7bn. There was also a payment from HMRC's National Insurance Fund of £1.8bn; this is tpart of the funding for NHS Scotland and is effectively part of the block grant.

Other payments from Government and related sources into the Scottish Government's "Consolidated Fund Account", excluding business rates income, totalled £0.1bn. Business rates income for the year amounted to £2.4bn. The payments from these various sources totalled £31.6bn.

However, this was not the final resource available to the Scottish Government for spending on services. For example, deductions from this total had to be made, such as interest payments and judicial salaries, totalling just over £0.1bn. The Scottish Government also has the use of the "Budget Exchange Mechanism" whereby it can draw on underspends in its budget for the previous year.

The actual spend on "Programme Resources" (revenue expenditure by Scottish Government departments, including payments to third parties) in 2013-14 was £29.9bn. The Scottish Government's capital expenditure amounted to £1.4bn. This is shown in Chart 1.

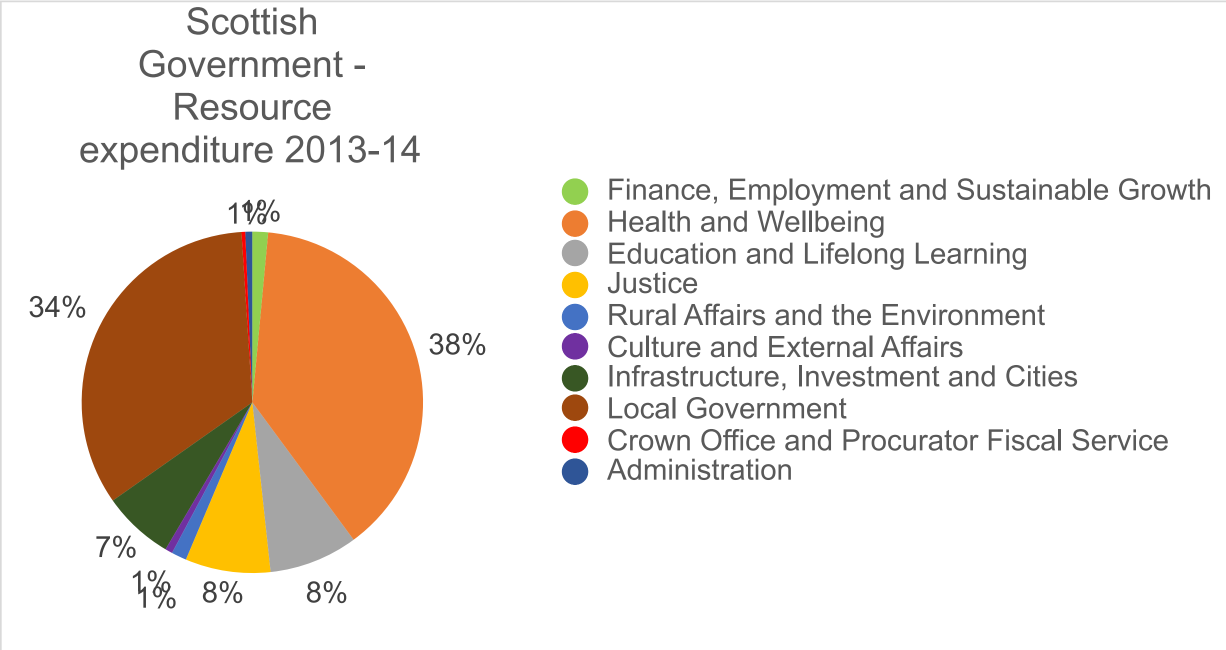
Chart 1 – Scottish Government total expenditure in main accounts 2013-14



The Scottish Government's Consolidated Accounts break this down by portfolio. Resource expenditure under the Local Government portfolio consisted of £2.4bn redistributed business rates income and £7.7bn other expenditure. (The way business rates are pooled and redistributed in Scotland will be described in the second briefing in this series.) Grants to Local Government under other portfolios totalled £0.2bn.

The breakdown of resource expenditure by portfolio in 2013-14 is shown in Chart 2.

Chart 2 – Scottish Government resource expenditure by portfolio 2013-14



Financing - Wales

Most of the funding for the Welsh Government comes from the Wales Office, in a payment determined by the Barnett formula. In 2013-14, the last year a full set of accounts are available for, this payment was £13.5bn.

As for Scotland, there were other payments from Government and related sources into the Welsh Government's "Consolidated Fund Account", and deductions made from it. However, as there was no sum from HMRC and business rates were accounted for differently, all of these were under £0.2bn.

The final outturn in 2013-14 was £13.9bn. It is unclear from the Welsh Government Consolidated Accounts whether this relates entirely to revenue or to both revenue and capital expenditure, but an Assembly research paper on the 2013-14 budget suggests that capital expenditure would be in the order of £1bn. A breakdown of the £13.9bn by ambit is shown in Chart 3.

Chart 3 – Welsh Government expenditure by ambit 2013-14

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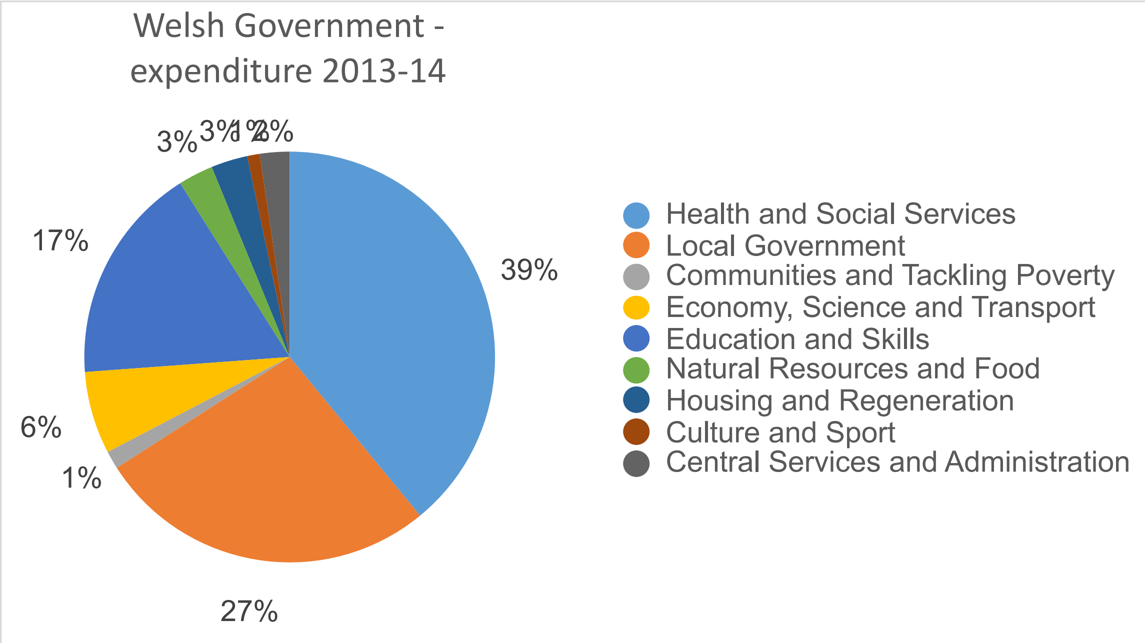

Recent developments - Scotland

The 2007 Scottish Parliamentary elections led to an SNP minority government. In August of that year, the minority government published a paper which was intended to launch a "national conversation" on Scotland's constitutional position. This prompted the pro-union parties to unite together around alternative proposals. In December 2007, they jointly proposed a motion calling for a commission to review devolution in Scotland. It set out a remit for the commission and was passed by the Scottish Parliament.

The UK Government responded by setting up the Calman Commission (formal title "Commission on Scottish Devolution") in March 2008, with a remit similar to that proposed by the Scottish Parliament:

> *"To review the provisions of the Scotland Act 1998 in the light of experience and to recommend any changes to the present constitutional arrangements that would enable the Scottish Parliament to serve the people of Scotland better, that would improve the financial accountability of the Scottish Parliament and that would continue to secure the position of Scotland within the United Kingdom."*

It published its first report in December 2008 and its final report in June 2009. It recommended that the 3p tax variation powers of the Scottish Government be replaced by a new system. There would be a reduced UK income tax in Scotland and a correspondingly reduced block grant. The Scottish Government could then impose a supplement to make up the shortfall or raise whatever amount it felt appropriate. This reduction in the UK income tax would be 10p off both the basic and higher bands; the bands would remain controlled by the UK Government but the new

Scottish rate of income tax (applying to both bands) would be a devolved matter. Income tax on savings and dividends would not be devolved, but half the yield would be assigned to the Scottish Parliament.

The Commission also recommended devolving Stamp Duty, Aggregates Levy, Landfill Tax and Air Passenger Duty. The Scottish Parliament could introduce new taxes with the agreement of the UK Parliament. Like the Holtham Commission in Wales detailed below, the Calman Commission recommended that the block grant be determined by a needs calculation. There were also recommendations on borrowing powers, cooperation between the Governments and Parliaments, areas where it felt that the boundary between devolved and reserved powers had been wrongly drawn, and improvements to the Scottish Parliament.

The UK Government accepted most of the recommendations to it and these became the basis for the Scotland Act 2012. This was presented to Parliament in November 2010 and received Royal Assent in May 2012. This gave full control over stamp duty and landfill tax to the Scottish Government and devolved part of income tax in the way set out by the Calman Commission, as well as allowing the Scottish Government to borrow up to £2.2 billion.

Stamp duty and landfill tax were devolved in April 2015 and the Scottish Government has replaced both with its own version of these taxes: the Land and Buildings Transaction Tax and the Scottish Landfill Tax. The income tax changes are due to come in to force in April 2016.

While the SNP government in Scotland were supportive of the broad direction of these changes as far as they went, they were still holding out for independence. This culminated in the referendum in September 2014. During the campaign, the pro-union parties again united to commit to the Scottish Parliament having "extensive new powers", should Scotland remain within the Union. Following the referendum, the UK Government set up the Smith Commission to oversee the process of implementing this commitment. The report was published just two months later.

The Coalition Government published draft clauses in January 2015 and the Conservative Government published the Scotland Bill on 28 May, to implement the Smith commission's proposals. The bill would, if enacted, devolve Air Passenger Duty and Aggregates Levy and give the Scottish Government power over the rates and bands of income tax (other than savings and dividends). It would also assign a share of the VAT receipts to the Scottish Government. It also has non-fiscal aspects:

- recognising the Scottish Government and Scottish Parliament as permanent;
- devolving powers over certain aspects of welfare and housing-related benefits;
- devolving powers over speed limits, road signs and rail franchising;
- giving the Scottish government control of the functions of the British Transport Police, Ofcom and the Crown Estate in Scotland;
- devolving power to change the Scottish Parliament's electoral system.

The Bill has now passed through the House of Commons; and has begun its passage through the House of Lords. It will also need the consent of the Scottish Parliament.

Recent developments - Wales

The Holtham Commission (formal title "Independent Commission on Funding and Finance") was set up by the Welsh Assembly Government in 2008 as a result of an agreement between the Labour and Plaid Cymru groups in the National Assembly for Wales. Its terms of reference were to:

- Look at the pros and cons of the present formula-based approach to the distribution of public expenditure resources to the Welsh Assembly Government; and
- Identify possible alternative funding mechanisms including the scope for the Welsh Government to have tax varying powers as well as greater powers to borrow.

It published its first report in July 2009 and its final report in July 2010. It criticised the Barnett formula for taking no account of need and recommended that the formula be replaced by one based on need. It also made recommendations in relation to borrowing powers, variation of income tax rates and devolution of other taxes.

The UK Government's response was to set up a commission of its own, the Silk Commission (formal title "Commission on Devolution in Wales") in October 2011. This carried out its work in two parts, reporting on them separately. Part I related to fiscal devolution and Part II related to the powers of the Assembly.

The Part I report was published in November 2012. The remit did not include consideration of the Barnett formula, but the report did make recommendations on increased capital financing powers, including borrowing and bond issuing. It also went through the UK taxes one by one and made recommendations on whether they should be devolved.

The Part II report was published in March 2014. It recommended replacing the conferred powers model of devolution with the reserved powers model used in Scotland and Northern Ireland (see above). It also made specific recommendations relating to number of policy areas, including:

- Economic development, employment and training
- Transport
- Natural resources and the Crown Estate
- Broadcasting
- Policing and Justice
- Healthcare – governance and cooperation between bodies

There were also recommendations in relation to governance, including intergovernmental relations, the civil service and the National Assembly.

The same month, the Government published the Wales Bill 2014, which received Royal Assent in December 2014. It put into law some of the Part I recommendations on fiscal devolution:

- Devolving stamp duty

- Devolving business rates
- Devolving landfill tax
- Providing for a referendum on devolving income tax rate setting.

It also brought in some other changes, in particular around elections to the Welsh Assembly.

The Welsh Government assumed control of business rates in April 2015 and stamp duty and landfill tax are expected to be devolved by April 2018.

Comment

The devolved administrations in Scotland and Wales are now well established, but it must be remembered that they are relatively young. After they were created, the immediate concern was whether they could operate smoothly and efficiently. Some changes were needed in Wales to ensure this, but on the whole, they were left alone for most of their first decade to "bed in".

From about 2008, the pace of devolution has increased rapidly. While developments in Scotland and Wales have taken place in parallel, the processes behind these developments reflect the differing nature of politics in the two nations.

The original powers of the administration in Wales were much weaker than those in Scotland, but Wales has fought hard to catch up in the 17 years since. It could be argued that with the enactment of the Wales Act 2014, it has largely caught up with Scotland – it is certainly in the same ballpark.

Northern Ireland has on paper had devolution for much longer, but its uniquely fractious politics and difficulties over power-sharing have held up progress of devolution. Nonetheless, even Northern Ireland is deeply involved in this trend, with, for example, corporation tax being devolved.

Devolving a fiscal power to a national government means giving that government the choice as to whether to keep that tax as it is or to reform it. The timing of any reform is again subject to political considerations. In some cases, the tax is immediately reformed, such as in the case of devolution of Stamp Duty to Scotland. In other cases, there may be a delay before the relevant government takes advantage of its new powers. For example, the Scottish Government's power to vary the basic rate of income tax was never used. It now seems likely that even with the powers granted under the Scotland Act 2012 coming into force, Scottish taxpayers won't see any change in their bills – instead the Scottish Government is likely to wait until it gets full control over bands and rates under the expected Scotland Act 2015 before acting.

The delays between legislation being passed and its provisions coming into force mean that we have not yet seen the full impact of the current round of devolution in financial decision-making, let alone outturn figures. (Also, if income tax is to be devolved in Wales, we will have to wait for a referendum to take place.) It may therefore be a few years before we see what devolution is capable of.

Nonetheless, it is of interest to English local authorities that these fiscal powers have been granted. There have been numerous calls for devolution of property taxes, such as Stamp Duty, within England – for example, by the London Finance Commission and Core Cities. Some of these bodies have shied away from calling for devolution of income tax powers, such as the creation of a local income tax supplement, on the basis of practical problems regarding how to assign a particular payment to an individual area. The devolution of income tax in Scotland, with the potential for its devolution in Wales too, implies that HMRC believes that it will be practicable to apportion income tax at least at the national level.

As fiscal devolution proceeds, the scale of equalisation required through the block grant will diminish. Nonetheless, some equalisation will continue to be needed. Political parties and the nations look set to continue arguing as to whether this should continue to be done purely on the basis of population or whether there should be some assessment of need involved in it. It may seem fairer to include a needs assessment, but it is not entirely clear what form this assessment should take. As we saw with Formula Grant in England, the details of the assessment can become politically charged. There is always a trade-off between simplicity and accuracy – a simple formula is more transparent and comprehensible, but political negotiation often pushes towards a complex, precise formula.

In addition, there are questions around how the block grant will be adjusted to take account of fiscal devolution. Professor Bell (working with David Eiser) has pointed out that the immediate adjustment when a tax power is transferred is fairly uncontroversial, but there is no unique way of making adjustments in later years, particularly when policy decisions in the UK have Barnett consequentials.

The trends towards devolution in the nations are mirrored in devolution to local authorities. The recent announcements by the Chancellor of the Exchequer and Scotland's Deputy First Minister on devolving business rates powers are examples of this. It will be interesting to see what further fiscal powers will be sought by English local authorities. (Some of the submissions for the pre-Spending Review "devolution deals" deadline – see our recent briefing - related to issues around the fringe of fiscal devolution, but authorities could get more ambitious further into the Parliament.) Currently, local authorities' tax yield is based on property ownership, both domestic and non-domestic. This makes increasing rates politically difficult, as such measures hit the property-rich but income-poor hard. If such fiscal powers are genuinely to increase the proportion of council income that is raised locally in any substantial way, they will need to include more "progressive" forms of tax, such as income tax or corporation tax.

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