Finance Committee

Review of the Budget Process

Submission from Professor Iain McLean

General remarks

1. I am Professor of Politics and a Fellow of Nuffield College, Oxford University. I have published extensively on UK public policy, with a specialism in public finance; Barnett and possible alternatives; and equity and efficiency issues in devolution finance. Full details of my publications are here.

2. I am a member of the newly announced Independent Expert Group which is to report on finance issues to the Calman Commission.

3. I am completing a pamphlet with colleagues at the Institute for Public Policy Research on Barnett and alternatives to it. Because it is relevant to many of the issues raised in your Consultation Paper, I attach an early version, omitting the tables (which are irrelevant to your inquiry). This version is attached in order to give a slightly longer account of how Barnett works and some of its problems than is possible in a Written Evidence document like this.

4. Your consultation questions assume not only that Scotland remains within the United Kingdom, but that essentially the present (‘Barnett’) block-and-formula arrangements continue.

5. I take no position on whether Scottish independence is good or bad, but it would clearly eliminate the problems that your consultation paper addresses.

6. However, your consultation paper reveals deep-seated problems with the Barnett\(^1\) regime. I do not think that the first two of the four CSG principles listed in your paper at para 10 can be implemented under the current regime, viz:

   - power should be shared between the people of Scotland, the Parliament and the Scottish Executive;
   - the Parliament should be accountable to the people of Scotland;

7. Under devolution, power is shared between the people of Scotland, the Parliament, the Scottish Government, and the UK Government represented principally by HM Treasury. The Treasury’s financial

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\(^1\) ‘Barnett’ here is merely shorthand for the arrangements described in HM Treasury’s document Funding the Scottish Parliament, National Assembly for Wales and Northern Ireland Assembly: Statement of Funding Policy issued with each Spending Review, latest October 2007. In these notes I describe this document as the Operations Manual.
control systems make it very hard for the Parliament to be accountable to the people of Scotland.

8. As explained in its Operations Manual (*Statement of Funding Policy*...), HM Treasury treats the three devolved administrations (DAs) as near as possible the same as it treats all Whitehall departments with an England or UK remit.

9. Each Department, including the Scottish Government, has its expenditure divided into DEL (Departmental Expenditure Limits, set at each Spending Review) and AME, (Annually Managed Expenditure, in HMT’s definition ‘a spending aggregate that covers programmes for which multi-year limits are not appropriate or possible’). DEL is set for the spending review period at the start of each review.

10. Hence, as detailed in your document, the sudden decision to defer the Spending Review due in 2006 to 2007 caused considerable disruption to your budget process. Under Barnett, you can start the budget process only when your DEL is known.

11. But it is not just an issue of timetables. DEL for each of the DAs including Scotland is essentially determined by applying the Barnett Formula, having established which English programmes and subprogrammes attract a ‘Barnett consequential’.

12. Thus, unless the formula is bypassed, the block available for Scottish DEL is determined by spending agreed for English departments covering the same functions of government. The Scottish Parliament and people have no influence over those, nor did the old Scottish Office before devolution.

13. Because tax (apart from the Scottish Variable Rate of Income Tax, proceeds of which are expressly excluded from DEL) and benefits are not devolved, the Scottish Parliament and people can in any case not conduct a regular budget scrutiny. To carry out the aims listed in your paragraph 10, MSPs and people ought to be considering full tax-and-spend packages. For instance, as Committee members know, any decision by the Scottish Parliament to switch from Council Tax to another form of local taxation has the implication that Council Tax Benefit – a UK-wide benefit overseen by HMT – would no longer be payable in Scotland.

14. One (possibly, partly) compensating advantage of a UK-wide system of financial control is that the uniform public expenditure database reported annually as PESA (Public Expenditure Statistical Analysis) is maintained on a comparable basis for the whole UK. Its Country and Regional Analysis (CRA) chapters enable stakeholders to find out what is spent on each function of government in each of the twelve standard regions of the UK. For more details see the attached paper.
15. The Scottish Government, and before it the Scottish Executive and Scottish Office, have been responsible since the mid 1990s for producing GERS (Government Expenditure and Revenue in Scotland). On the expenditure side, GERS interlocks with PESA and draws its data from the PESA database. Both PESA and GERS are National Statistics, which imposes quality standards such that they are guaranteed free from political manipulation.

16. GERS, unlike PESA, also contains revenue estimates, which would be invaluable for a fully mature budgeting exercise as discussed above. Its revenue estimates interlock with the estimates for the UK produced annually in the Budget Red Book (‘Financial Statement and Budget Report’), Chapter C.

17. I am therefore somewhat perturbed that the issue of GERS which was due in December 2007 has been delayed, as its absence may hinder informed discussion of possible budgets. This is the case even though the budget exercise is prospective and GERS is partly retrospective.

18. You state in your paragraph 4: the Committee wants to ensure that the Parliament has a process that is suited to any type of government. I therefore next address some of your specific questions on the assumption that the ‘Barnett’ system continues. Following that, I suggest some improvements that would make it possible for the budget scrutiny to run more smoothly.

Comments on some of your questions on the assumption that ‘Barnett’ continues.

19. Should Stage 1 continue to take place in Spending Review years only? Should the Budget Process be linked to the UK Spending Review in this way? Under ‘Barnett’, the Budget Process is inextricably linked to the UK Spending Review. Therefore there is no realistic alternative to continuing Stage 1 in Spending Review years only. The Scottish Parliament should seek an undertaking from HMT that it will not in future unilaterally alter the time-span of Spending Reviews.

20. Is there a viable alternative to the current Stage 1 arrangements that would allow a strategic examination of future spending priorities? Very difficult under ‘Barnett’, because Scottish DEL is almost entirely a function of current English spending priorities. The Scottish Parliament has nobody whom it can ask about future English spending priorities.

21. How do the current arrangements [at each stage] fit with the key principles of the CSG and FLAG? Badly, for the reasons given above.

22. What is the best way to deal with any delays in future UK Spending Reviews? To ensure that they do not occur, by reminding UK Ministers and HMT that the entire budgeting process of the three DAs depends on Spending Reviews being punctual. A (poor) second-best would be
to detach the publication of the Operations Manual from the Spending Review timetable. However, this change would not in itself alter the process of determining Scotland’s DEL.

23. *Does the system provide an appropriate balance between a desire for budgetary stability and an opportunity to influence change?* No, because stakeholders have no chance to propose alternative tax-and-spend packages.

24. *Would there be merit in having a “Parliamentary Budget Office” which could perform a similar role to that of the Congressional Budget Office in the USA (albeit tailored to the needs of the Scottish Parliament) by providing independent, technical advice on budgetary matters not only during the budget process but throughout the year?* Yes.

The budget process on the assumption of greater fiscal autonomy


26. Without trying to anticipate the conclusions of Calman, the National Conversation, or other current attempts to describe Scotland’s fiscal future, it is reasonable to expect that any such fiscal future would involve a larger role for locally raised taxation, and a smaller role for block grant.

27. This could arise either through the assignment of the proceeds of some UK taxes (e.g., VAT; National Insurance; Income Tax); the devolution of the power to tax and to vary tax rates (as, already, with the Scottish Variable Rate power); or some combination of both.

28. So long as such reforms adopted the first principle of fiscal federalism, namely that, at the margin, a decision to spend an extra £ implies the need to raise an extra £ in locally-levied taxation, the Scottish Parliament and people could conduct a budget scrutiny that fully reflected the ambitions of CSG and FIA as set out in your paras 10-11.

29. For such scrutiny, Parliament must ensure that GERS or any successor continues to be published timeously and to retain its status as National Statistics. The expenditure side must continue to be linked to PESA; the revenue side to the UK government’s annual Budget Red Book estimates of the yield of each tax.

30. Under greater fiscal autonomy, the block grant component of Parliament’s budget would be smaller and (presumably) more closely
related to relative needs and relative tax capacity of the four nations (or
twelve regions) of the UK than at present.

31. Assuming (as most reformers propose) that such block grant is
determined by a non-governmental or intergovernmental body (rather
than, as at present, unilaterally under formula by HM Treasury), the
budget scrutiny can and should involve taking evidence from the
Commission or similar body that determines block grant.

32. Much fuller details of such an arrangement are available in my book
*The Fiscal Crisis of the United Kingdom* (Palgrave, 2005). The ippr
pamphlet mentioned in para. 3 above should be available before
Members conclude this inquiry.

Professor Iain McLean
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Public expenditure and gross value added in the regions of the UK.

by Iain McLean, Guy Lodge, and Katie Schmuecker

Introduction

There are many reasons for wishing to know how public expenditure is distributed across the nations and regions of the United Kingdom. The two main questions are: Is the distribution fair? and Is the distribution efficient?

A crude way to ask whether it is fair is to check whether, in general, transfers flow from rich people, and rich areas, to poor people, and poor areas. A more sophisticated way is to ask whether public expenditures secures an equivalent level of public services to citizens all over the UK, irrespective of the region they inhabit. Thus if region A gets more public spending per head than region B, the reason could be:

1. that people are poorer in A than in B, and/or
2. that it costs more in B than in A to deliver a standard level of public services.

There are three main mechanisms for directing public expenditure to poor people rather than rich ones. The first and simplest is by cash transfers. They add up to the biggest single item of public expenditure. Unemployment and invalidity benefit obviously go to poor people (assuming that claims are not fraudulent). State pensions include a means-tested element, so that they, too, are biased towards the poor, although there are also millions of relatively rich pensioners in receipt of the state pensions to which they are entitled.

The second-biggest item of public expenditure is health. From the foundation of the NHS in 1948 until the mid 1970s, the principle of allocation of health expenditure was that each hospital and GP practice got what it got the year before, plus a bit for inflation and growth. But this embedded past inequalities. A Welsh Marxist GP, Julian Tudor Hart, has proposed the ‘inverse care law’: that health spending flows to people in inverse proportion to their needs. He argues that his law applies only to private health expenditure. However, unless checked, it applies to public expenditure as well. Lobbies are formed by the articulate. The articulate are more likely to be rich than poor. The historical pattern of health spending was dominated by the London teaching hospitals, whose consultants were recruited by Nye Bevan in 1948 in order to get the NHS started in the face of stubborn opposition from the British Medical Association representing GPs. In return, they expected their privileges and funding to continue.

In 1976, Health Secretary Dr David Owen drove through a redistribution based more on need. Spending to the regions was to start from a baseline of equal expenditure per head, but topped up in proportion to poverty, so that the poorest areas of England were to get most per head. This principle has been carried through since then, although in practice it is crosscut by other drivers of
health spending, such as the higher cost of delivering it in the south-east, and (perhaps) the continuing power of lobbies.

The third-biggest lump of public expenditure comprises block grant to local authorities, who use it to fund the services for which they are responsible – education, personal social services (PSS), police, fire, housing, and so on. Of these services, education is by far the biggest and PSS a distant second. For decades, the block grant formula, although so obscure that only a few specialists understand it, has contained a ‘needs element’ and a ‘resources element’. Both are designed to skew expenditure per head so that authorities in poor parts of the country get more per head than authorities in rich parts of the country.

The needs element weights needs in proportion to the number of needy people – such as pensioners, children, and members of ethnic minorities – in the local population. The resources element aims to compensate for the fact that some authorities have a more robust tax base than others, and that typically it is authorities in rich areas that can raise the most per head in Council Tax. Their only other tax, business rates, was nationalised during the Poll Tax fiasco in the late 1980s.

The main driver of costs is wage expenditure. Though public sector wages do not differ enormously across the regions and nations of the UK, a high-wage region is likely to face indirect costs, such as the need to pay agency and locum staff when it is impossible to recruit or retain public service workers; and a higher cost of bought-in services. The Department of Communities and Local Government, and its predecessors, have accepted that costs vary across the regions of England. In the formula for settling local authority grants, the Area Cost Adjustment (ACA) play a substantial and increasing part. A second driver of high cost is sparsity of population, which is also allowed for in the local government expenditure formula. It is understood that similar formulae operate in the allocation of NHS expenditure to primary care trusts around England.

The three devolved administrations (DAs) – Scotland, Wales, and Northern Ireland – have their own mechanisms for distributing public expenditure within their territories. However, block grant from the UK Treasury to each of the three DAs is completely unconnected with any of the mechanisms described so far. It is not based on needs, nor on compensating for differential resources. By the so-called Barnett formula (ascribed to Joel Barnett, Chief Secretary to the Treasury 1974-9, but actually devised by Treasury officials and in use since at least 1973), each annual increment in public expenditure to the DAs is based on their population proportion of the equivalent increment in England. Note: increment, not baseline. Barnett was designed to modify a situation, in force when it started, whereby Scotland and Northern Ireland (but not Wales) seemed to be getting a substantially higher share of public expenditure than warranted either by their relative population or their relative needs. The Treasury recognised that this differential was political. Scotland and Northern Ireland posed credible threats to the Union of the United
Kingdom, so governments, to put it crudely, shovelled money at them in the hope of keeping them quiet and peaceful.

The Barnett formula was designed to reduce these differentials. In the long run, it would bring each of the three DAs to a position of equal per capita (EPC) spending with England. As the tables in this article show, it has not done so. Something has prevented Barnett from converging. We believe that this ‘something’ has two main components: entitlements and politics.

Entitlements are things like social security benefits, pensions, and farm payments. They stand outside the mechanisms of public expenditure control to which Barnett applies. Therefore, if a territory has unusually many entitlements, it should get an unusually large amount of money.

But this cannot solve the Barnett puzzle. Although Wales and Northern Ireland are poor parts of the UK, Scotland is not. All three territories get above-average public spending per head. Although Scotland is richer than Wales, it gets more per head. This can’t be due to entitlements. It must be due to something else. Successive governments have seen that Scotland and northern Ireland pose credible threats to the continuation of the union. In Scotland, this takes the form of nationalist challenge, culminating in the formation of the first SNP-led administration in May 2007. In Northern Ireland it takes the form of communal violence, and threats (and in earlier decades the reality) of that violence spreading to other parts of the UK. So, even since Barnett started running, governments of both parties have continued a policy invented by Tory Prime Minister the Marquess of Salisbury in 1886. He called it ‘killing Home Rule by kindness’.

However, not all public expenditure is driven by need. Some is driven by efficiency. Spending is efficient if it maximises bangs per buck. For example, expenditure on coastal defence would not be very effective in Birmingham. Spending on industrial support can be of two opposite kinds. It may be to support ‘lame ducks’, or alternative opportunities in places where lame ducks have failed. Or (increasingly in recent years) it may be aimed at encouraging existing concentrations of growth. The latter idea, for instance, underlies some initiatives of the Northern Way (i.e., the consortium of regional development agencies of the three northernmost English regions). Its attempts to develop Science Cities in Newcastle, Leeds, and Manchester may be criticised in Sunderland, Barnsley, and Barrow but defended on bangs-per-buck criteria. Likewise, it makes more sense for public bodies in London and the South-East than for public bodies in the North to spend a lot of money in relieving congestion.

Data

There are two main sources of data, from different government departments. Each gives information for the UK’s 12 standard regions. These are: the three DAs (Scotland, Wales, and Northern Ireland); and the nine standard regions of England (North-East; North-West; Yorkshire and Humberside; East Midlands; West Midlands; East of England; London; South-East; and South-
The Treasury publishes a thick book every year called *Public Expenditure: Statistical Analyses* (PESA). It contains a chapter (now two chapters) reporting what it calls the Country and Regional Analysis (CRA in Treasury documents). The Office for National Statistics (ONS) also publishes income statistics for the UK’s 12 standard regions, under the heading of Gross Value Added (GVA) per head. For income data at a level below that national government, GVA is a more appropriate measure than the more familiar GDP (Gross Domestic Product) per head. But essentially, they can be regarded as the same thing.

The Country and Regional Analysis (CRA) of PESA has recently improved dramatically. For the three DAs, it has always been possible to give a reasonable estimate of public expenditure per head. Because they have almost no tax-raising powers, almost all the money to fund their programmes comes in the form of block grant under the Barnett Formula. Both the sender and the recipient have an incentive to check the amounts sent with care. Other public expenditure, as noted above, goes direct to entitled persons and businesses, who can be assigned to countries by their postcodes. Since the mid-1990s, the Scottish Executive and its predecessors have published an annual book called *Government Expenditure and Revenue in Scotland* (GERS), which uses the PESA database on the expenditure side. For the revenue side, it has to estimate what proportion of each of the main taxes is raised on activity in Scotland. The Welsh and Northern Irish administrations have nothing so elaborate, although the Northern Ireland Civil Service, at least, keeps detailed data on the flow of public expenditure into its territory.

For the English regions it was much more difficult. Unlike the DAs, none of the bodies at regional level – the regional development agencies (RDAs), regional assemblies, and Government Offices – got block grants. This has changed a little in recent years, with RDAs being given a smallish block grant to carry out their economic development functions. But the big spenders – health authorities and local authorities – do not get their grant through any of the regional bodies, but direct from central government. Government departments varied greatly in the care with which they tracked the flow of public expenditure from their programmes and sub programmes into the nine regions of England.

In 2002 one of us (IM) was awarded a grant by the then Office of the Deputy Prime Minister (ODPM – now Department of Communities and Local Government - DCLG) to investigate the flow of domestic and European funds into the regions of England. We reported in 2003 that we had seen a wide range of practice from excellent to awful. Among the worst offenders was the European Union, which seemed to have no interest, or at least no capacity, to track the regional incidence of the expenditure for which it was responsible. Among UK government departments, the Department for Work & Pensions was one of the best. Since everyone who receives a benefit has a postcode, it is easy to map them into the correct region. Therefore the numbers reported in PESA for ‘Social protection’ are reliable. Some other departments were very sloppy. We discovered that several of them simply divided their reported expenditure in England according to the relative populations of the nine
regions. This resulted, for instance, in London reportedly having the second-largest flow of farm support of any of the nine regions – just because it is the second-biggest. The idea that the costs of the Common Agricultural Policy bring such a generous dividend to everyone that they should be charged equally to everyone who eats food doesn’t really wash.

Following our 2003 report, the Treasury and ONS have put steps in place to improve the CRA numbers. Not only have they ended the nonsense of reporting equal spend per capita when the truth is different, but they have extended the proportion of public spending that can be correctly allocated to a region. The result is that the PESA numbers now allow reasonably direct comparisons between public spending per head in each of the four countries of the UK, and in each of the nine regions of England. The latest set of figures, published in May 2007, has reliable numbers on the new basis back to financial year 2001-02. There are no comparable numbers for earlier years; the numbers previously published for earlier years and used by various analysts (including ourselves) are not reliable enough to make any fair deductions.

Figure 1 shows the identifiable public spending per head for each of the 12 regions of the UK for the last five financial years.

Figure 1 deals with identifiable public spending. What is unidentifiable? Over the years, the Treasury has reduced the percentage it counts as unidentifiable. For instance, the headquarters expenditure of Whitehall departments is neither treated as unidentifiable, nor is it lumped on to London or wherever the HQ office is. Rather, it is apportioned out among the regions in the same proportion as each department’s programme expenditure. Expenditure on things which are in one region but also benefit people in other regions is apportioned out as best as possible – for instance, spending on national museums is apportioned by the mix of their visitors; expenditure on rail support by the pattern of where tickets are bought, and so on.

The core of unidentifiable spending is therefore spending which is intended to provide public goods equally to each citizen of the UK irrespective of residence. This includes defence (by far the largest item); intelligence agencies; foreign affairs; overseas aid; and the running of national systems of taxation – so that the cost of running the Treasury, HM Revenue & Customs, and ONS themselves are treated as non-identifiable.

Figure 1 expresses the expenditure per head in each region in relation to the UK average, which is set to 100. Therefore a region with above average expenditure per head is above the 100 line, and the others are below it. The results are pretty stable. Northern Ireland receives the highest public expenditure per head, although it is converging slowly over the period (probably because the Barnett Formula has been working as intended during those years). Scotland comes next, closely followed by London, then Wales and the North-East. The North-West is the only other region with above-
average public spending per head. England as a whole, and the regions not yet mentioned, are all below the line.

The rank-order of public spending is not that produced by an index of relative need. As already noted, by any plausible criteria Wales, the North-East, and the North-West, are all needier than Scotland, which receives more public spending than any of them because governments are still killing Home Rule by kindness. The relatively high public spending per head in London is probably driven by high relative costs, as measured by Area Cost Adjustment for local government services and the equivalent formulae for health services.

Turning now to measuring the income of each region, the ONS figures for GVA per head are in Figure 2.

As with PESA, we need to know something about how the figures are compiled before we can safely use them. Whereas the PESA figures relate to expenditure over a financial year, the ONS figures are collected annually to relate to a single point in the year (December). Because not even the three DAs, let alone the nine regions of England, are independent countries, there has to be some uncertainty about the figures. As far as possible, the value added by people (labour income) has been assigned to the place they live rather than the place they work. Getting this right is most important for the three south-eastern regions, since millions of people commute from the South-East and the Eastern region to London (and a non-trivial number commute the other way). The value added by capital is more difficult to calculate, as one needs to know not only where firms’ HQs are located, but where their plants are located, and which plants are adding value within the firm. Therefore, through no fault of ONS, it is necessary to treat the GVA per head figures with more caution than the public expenditure figures.

One more qualification is important especially for Scotland. The ONS classifies some GVA as ‘Extra regione’. This refers to value added outside the territory of the UK. The main category is, of course, the processing of oil in the North Sea. The ONS classifies this as ‘Extra Regio’. The Scottish Nationalists would, of course, prefer it to be assigned to Scotland. If it is, it makes Scotland appear a relatively wealthier part of the UK than in Figure 2. Of course, this cuts both ways. If Scotland is (even) wealthier than shown in Figure 2, then its high public spending per head (Figure 1) is (even) more anomalous. The issue is discussed further in the annual GERS, mentioned above, which enable the analyst to calculate the balance of revenue and spending in Scotland in the event that various proportions (up to 100%) of oil revenue were to be assigned to Scotland.

2 Note for pedants. This should be ‘extra regione’. The standard of Latinity in ONS is no up to scratch.
As with Figure 1, the average GVA per head is set at 100. Therefore regions that lie above the 100 line are those adding more value per head than average for the UK, and the remaining regions add less. The richest region (alternatively, the region adding the most value) by far is London, and its relative advantage is increasing. The two other southern regions, South-East and East, come second and third. Scotland comes next, followed by the South-West and the two Midlands regions. The trailing regions are those that have trailed for decades: North-West, Yorks & Humber, North-East, Wales, and Northern Ireland.

These numbers tend to suggest that concentrating efficiency-improving spending in the poor regions is a good idea – but that it has not had much to show for itself over the period analysed. The Treasury has imposed on three departments including itself a Public Service Agreement which says that government policy should aim to reduce the disparities between regions by bringing about faster growth in the lagging regions of England (UK departments are not directly responsible for generating economic growth in the DAs). We may have to witness the interesting spectacle of the Treasury punishing itself for failing to achieve its own PSA target.

What happens if we try to combine the two sets of data? Figure 3 is the result. This requires a bit more explanation than Figures 1 and 2.

\[ R_{ij} = \frac{P_{ij} G_{ij}}{100} \]

where

- \( R_{ij} \) = Public expenditure relative to need of territory \( i \) in year \( j \);
- \( P_{ij} \) = Identifiable public expenditure per head in territory \( i \) in year \( j \) (UK = 100) (from Figure 1);
- \( G_{ij} \) = Gross Value Added per head in territory \( i \) in year \( j \) (UK less Extra Regio = 100) (from Figure 2).
Because the product $P_y G_y$ is divided by 100, Figure 3 is again in index units where the average for the UK is 100. The three regions above the line (London, Scotland, and, for years up to 2004-5, Northern Ireland) are therefore those that are receiving more than they would get if all public spending were designed to assuage poverty. London is diverging from the pack. Northern Ireland is converging on it, perhaps because of the effects of applying Barnett. Wales, England as a whole, and eight of its nine standard regions, are receiving less. The region doing ‘least well’ on this measure is the East Midlands, followed by the South-west and the West Midlands.

Of course, we cannot jump to the conclusion that London gets ‘too much’ public spending. This would be wrong for at least two reasons:

1. The cost of providing public services in London is high; some of the extra spending, whether through Area Cost of Adjustment or otherwise, recognises this;
2. In reality, not all public expenditure is to assuage poverty. Some money is spent for efficiency rather than equity reasons, for instance on relieving congestion or on promoting the human capital of high-earning individuals.

Nevertheless, both of these arguments should also apply, at least in part, to the East of England and South-East regions, so the starkness of the disparity between London and those two regions remains to be explained.

**Time to replace Barnett?**

There is no clear relationship between the way public spending is distributed in the UK and an objective measure of need such as GVA per head. This is true both for the nations and regions of the UK. Furthermore, the new political landscape that has emerged following the 2007 elections in Scotland and Wales, and the reinstatement of devolution in Northern Ireland, is likely to put questions like the distribution of public spending higher on the political agenda.

Barnett is unsustainable in the long run. It is neither efficient nor equitable; it gives perverse incentives to the DAs; their block grant is a function of a number they cannot control; in turn, their decisions have consequences for UK macroeconomic management which the UK government cannot fully control. Briefly:

- *The Barnett Formula is not efficient*... because it gives no incentives to the DAs to seek economic (or more narrowly tax) efficiency. All three DAs manage public expenditure. None of them manages public revenue except in a small way (Council Tax; business rates; domestic rates in Northern Ireland). So in none of the DAs do the decision makers face a budget constraint. A rational politician would rather spend more than less (because a marginal pound of public spending, financed out of somebody else’s taxes, should always improve her chances of re-election) up to the point where Barnett sets a hard
constraint or where the marginal effect of extra taxation in that territory outweighs the marginal benefit from the spending. The largest DA (Scotland) contains less than 10% of the UK’s population. Therefore, extra public expenditure in Scotland would have to cost around ten times the benefit it brings before the Scottish people would rationally rebel against it.

- …nor equitable. Public spending per head, across the twelve standard regions of the UK, might be expected to be inversely related to GDP per head. Instead there is no statistical relationship at all between the two. There are three upward outliers from the general trend. They are Scotland, Northern Ireland and London. Their higher relative expenditure per head probably derives not from greater need but from the more credible threat to the Union of the United Kingdom that they pose, compared to the other nine standard regions.

- it gives perverse incentives to the DAs. The incentive to spend what Australians call a ‘ten-cent dollar’ (five-cent dollars in Wales; three-cent dollars in Northern Ireland) has already been mentioned. The DAs have no incentive to broaden their tax bases because they do not see the proceeds; and they have an incentive to switch their block grants from capital spending (which brings benefits after the next election) to current spending (which brings benefits before the next election).

- their block grant is a function of a number they cannot control because it depends on spending in England on each devolved service. Spending in England is tightly controlled by the Treasury’s biennial Spending Reviews, to which the DAs have no input except over their own blocks.

- but their decisions have consequences for UK macroeconomic management notably because of the temptation just mentioned for the DAs to switch money from capital programmes to current spending. This could interfere with the UK government’s fiscal rules (currently labelled the Golden Rule and the Sustainable Investment Rule, which are likely to be followed by a UK government of any political complexion).