



Northern Ireland
Assembly

Research and Library Service Briefing Paper

Paper 82/10

30 June 2010

NIAR 206-09

Funding the United Kingdom's Devolved Administrations

1 Introduction

This is not intended to be another paper on the somewhat notorious Barnett Formula. Its purpose is instead to examine proposals that have emerged in Scotland and Wales making (notably different) cases for reform of the way those respective administrations' public expenditure is financed.

The paper begins with a brief summary of the current position and of calls for change to the status quo. Two different models for funding within the UK which have been put forward by two Commissions are then explored. One (essentially an Australian-style model) has been called for in Wales. The other (a more Canadian-style regime) has been preferred for Scotland. The logic underpinning the different approaches is considered with a view to shedding light on the question of which – if any - of these models might be more appropriate for Northern Ireland.

2 The current funding regime and calls for change

At present each of the UK's devolved administrations receives a block grant which is based on the previous year's spending and an incremental change. In-year changes in

spending on programmes in England can trigger consequential changes to the devolved administrations' allocations.¹

In the recent past there have been several calls by a variety of committees and commissions for this block-funding mechanism to be changed.² A number of other publications have also concluded that change is necessary.³

In a paper presented to the Political Studies Association's Specialist Group Conference on British and Comparative Territorial Politics in Oxford in January 2010, Heald and McLeod noted that:

*There seems to be widespread agreement that the 1999 system, essentially a block grant determined by the pre-devolution Barnett Formula, is no longer sustainable. The reasons given for condemning the Formula are contradictory, reflecting different assumptions and understanding. The funding system affects England as well as all three devolved administrations and almost everyone perceives it as unfair to them.*⁴

Before proceeding to a discussion of alternative funding options, therefore, it is worth exploring the extent to which the current funding arrangements are fair or otherwise in relation to Northern Ireland.

3. Does Northern Ireland pay its way?

A discussion of the fairness or otherwise of the block grant that Northern Ireland receives is by its very nature political. Whether one views a certain level of funding as 'fair' by right or 'unfair' because of particular needs in one region or another is determined by a variety of factors - such as one's opinion on the constitutional arrangements within the United Kingdom and the merits or otherwise of the Union, for example. This paper is not intended to contribute to that debate. But it is nevertheless useful to look at the contribution Northern Ireland makes to the UK Exchequer relative to what is spent; it is important to have in mind when considering alternative funding mechanisms what the results of the existing mechanisms are.

The Department of Finance and Personnel (DFP) published a report in May 2010 that looked in some detail at the levels of public revenue and expenditure in Northern

¹ For a full description of this process see Assembly Research Paper 49/09 'The Barnett Formula', available online at: <http://www.niassembly.gov.uk/io/research/2009/4909.pdf> (accessed 09 June 2010)

² For more detail see Assembly Research Briefing Note 75/09 'The Northern Ireland Block Grant and Calls to Reform the Barnett Formula' available online at: <http://www.niassembly.gov.uk/researchandlibrary/2009/7509.pdf> (accessed 09 June 2010)

³ See, for example: McLean, I, Lodge, G, and Schumuecker, K (2008) 'Fair Shares? Barnett and the politics of public expenditure' available online at: <http://www.ippr.org.uk/members/download.asp?f=%2Fecomm%2Ffiles%2Ffair%5Fshares%2Epdf> (accessed 24 June 2010) or; Denham, D (2008) 'Unequal Shares: the definitive guide to the Barnett Formula' available online at: http://tpa.typepad.com/home/files/unequal_shares_the_barnett_formula.pdf (accessed 28 June 2010)

⁴ Heald, D and McLeod, A (2010) 'The Taxation and Borrowing Powers of the UK Devolved administrations' presented to the Political Studies Association's Specialist Group Conference on British and Comparative Territorial Politics in Oxford in January 2010, unpublished.

Ireland.⁵ The DFP *Fiscal Balance Report* is extremely helpful in setting context for any discussion of future funding models.

Fiscal Balance Estimate

Table 1 below shows that the estimated fiscal deficit in Northern Ireland was £7.3bn in 2007-08. In other words, Northern Ireland spent £7.3bn more on public services than it raised in revenue. It is immediately apparent that from a total expenditure of £20.3bn, this was a significant proportion – 36% of total expenditure in Northern Ireland was not funded by the Northern Ireland taxpayer.

Table 1: Net Fiscal Balance Estimates: NI, Scotland and the UK, 2007-08 (£m)⁶

£ Million	NI	Scotland	UK
Aggregate Expenditure	20,296	56,459	584,065
Aggregate Revenue	12,958	44,747	540,915
Net Fiscal Balance	-7,338	-11,712	-43,150
Net Fiscal Balance per capita (£)	-4,167	-2,280	-708
Net Fiscal Balance as a % of financial year GVA	-26.1%	-11.7%	-3.5%

Looking at it another way, the table also shows that £4,167 more was spent per person than was, on average, paid in tax. That is a difference of £3,459 per person more than the UK figure of £708.

Fiscal Balance Trend

Table 2 below shows the Northern Ireland fiscal balance from 2003-04 to 2007-08. In nominal (i.e. 'money' rather than 'real') terms over the five years the deficit has increased from just under £6bn to over £7bn. It is worth noting, however, that as a proportion of Gross Value Added (GVA) there has not been significant change; this may be due to improved productivity.

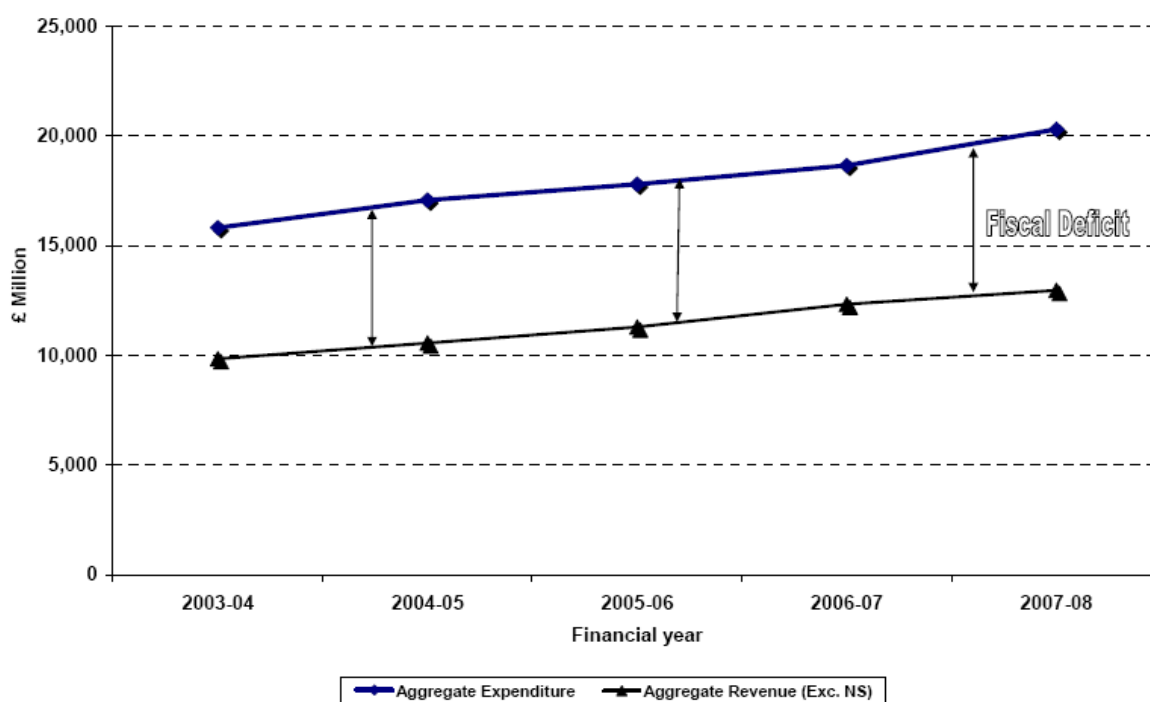
⁵DFP (2010) 'Northern Ireland Net Fiscal Balance Report 2007-08 (Experimental)' available online at: <http://www.dfpni.gov.uk/northern-ireland-net-fiscal-balance-report-07-08-experimental.pdf> (accessed 21 June 2010). For a full explanation of how the figures for revenue and expenditure are calculated see Annexes A and B.

⁶ Source: DFP (2010) 'Northern Ireland Net Fiscal Balance Report 2007-08 (Experimental)' available online at: <http://www.dfpni.gov.uk/northern-ireland-net-fiscal-balance-report-07-08-experimental.pdf> (accessed 21 June 2010) (see page 10)

Table 2: NI Fiscal Position 2003-04 to 2007-08 (£m)⁷

NI					
£ Million	2003-04	2004-05	2005-06	2006-07	2007-08
Aggregate Expenditure	15,814	17,064	17,791	18,649	20,296
Aggregate Revenue	9,839	10,556	11,282	12,322	12,958
Net Fiscal Balance	-5,976	-6,508	-6,509	-6,327	-7,338
Net Fiscal Balance per capita (£)	-3,509	-3,806	-3,776	-3,632	-4,167
Net Fiscal Balance as a % of financial year GVA	-26.1%	-26.8%	-25.6%	-23.6%	-26.1%

Figure 3 below provides a graphical representation of this gap. Over the period as a whole Northern Ireland's fiscal deficit increased from £5,976bn to £7.338bn – 22.8%, more than one fifth. In other words, the gap between spending and the revenue raised got wider.

Figure 3: NI Trends in Aggregate Revenue and Aggregate Expenditure, 2003-04 to 2007-08⁸

⁷ Source: DFP (2010) 'Northern Ireland Net Fiscal Balance Report 2007-08 (Experimental)' available online at: <http://www.dfpni.gov.uk/northern-ireland-net-fiscal-balance-report-07-08- experimental .pdf> (accessed 21 June 2010) (see page 11)

⁸ Source: DFP (2010) 'Northern Ireland Net Fiscal Balance Report 2007-08 (Experimental)' available online at: <http://www.dfpni.gov.uk/northern-ireland-net-fiscal-balance-report-07-08- experimental .pdf> (accessed 21 June 2010) (see page 11)

4. What funding options have been put forward for Wales and Scotland?

In the last year the Holtham (Wales) and Calman (Scotland) Commissions have reported on detailed work into the funding of the respective administrations in the future. The two Commissions' remits differed: the Holtham Commission's focus is narrower, specifically on finance and funding. The Calman Commission's remit, however, was to review the operation of devolution in its fullest sense, including the relationship between the Westminster and Scottish Parliaments.

The Holtham Proposals

The Holtham Commission is due to make its second report in summer 2010. Part of its remit is to:

*identify possible alternative funding mechanisms including the scope for the Welsh Assembly Government to have tax varying powers as well as greater powers to borrow.*⁹

In its first report, however, the Commission has already stated that "we believe that Barnett must ultimately be superseded by a needs-based formula."¹⁰ This is a pretty clear indication that the Commission is likely to propose a needs-based grant model, rather than a transfer of taxation powers from Westminster.

The Holtham Commission published a working paper in December 2009 *Replacing Barnett with a needs-based formula* which built upon that assertion and presented a formula-based approach that:

*would be simple both to operate and understand as well as being complete, i.e. it would capture most relevant aspects of need. Our analysis has demonstrated that it is possible to replicate to a surprisingly high degree of accuracy the funding allocations of very complicated needs-based formulae using only a few key needs proxies.*¹¹

Table 4 below shows the indicators that the Commission's analysis found could be used effectively as indicators of need.

⁹ See the Commission's website FAQs at: <http://wales.gov.uk/icffw/home/about/faq/?lang=en> (accessed 22 June 2010)

¹⁰ Independent Commission for Funding and Finance for Wales (2009) 'Funding devolved government in Wales: Barnett & beyond' available online at: <http://wales.gov.uk/docs/icffw/report/090708barnettfullen.pdf> (accessed 22 June 2010) (see page 30)

¹¹ Independent Commission for Funding and Finance for Wales (2009) 'Replacing Barnett with a needs-based formula' <http://wales.gov.uk/docs/icffw/news/091204needsworkingpaperen.pdf> (accessed 22 June 2010) (see page 1)

Table 4: Summary of indicators included in our assessment of relative needs¹²

	Need indicator	Description of variable	Source
Demographics: indicator 1	Number of children	Under 16 dependency ratio	Mid-year estimates
Demographics: indicator 2	Number of older people	Retired persons dependency ratio	Mid-year estimates
Demographics: indicator 3	Ethnicity	Percentage of the population that is from a black or minority ethnic group	Census
Deprivation: indicator 1	Income poverty	Percentage of the population claiming income-related benefits	DWP benefits database
Deprivation: indicator 2	Ill health	Percentage of the population with a long-term limiting illness	Census
Cost: indicator 1	Sparsity	Proportion of people living outside settlements of 10,000 people or more. In addition, our equation contains a variable to take account of the remoteness of the population of the Scottish islands.	Census
Cost: indicator 2	London weighting	A variable that identifies inner London areas	N/A

The Commission noted that in order to use such indicators to calculate actual funding it would also be necessary to attach weightings to each in order to reflect its importance. This involves political judgement, which the Holtham Commission declined to do:

While we could as a Commission select weights that reflected our own views as to how much importance should be placed on a region's sparsity, how much on its prevalence of ill health and so on, we would quite

¹² Independent Commission for Funding and Finance for Wales (2009) 'Replacing Barnett with a needs-based formula' <http://wales.gov.uk/docs/icffw/news/091204needsworkingpaperen.pdf> (accessed 22 June 2010) (see page 8)

*reasonably be accused of making judgements that lack any empirical justification or political legitimacy.*¹³

Instead, it looked at the actual allocations for devolved administrations of Great Britain (Northern Ireland was not included in the analysis) as the starting point because “these real world funding decisions are based on assessments of need that have been thrashed over the years”.¹⁴ Essentially, the logic is that the actual allocations are the ‘revealed preference’ of governments. In other words, although there may not have been *formal* needs assessments performed, spending allocations have nevertheless been made on the basis of judgments of a perceived need for particular programmes to be supported.

The Commission then employed a technique called ‘regression analysis’¹⁵ to calculate the relative importance of each of the indicators in Table 4. They argued that this generated a weighting that was based on its importance in explaining the “real world spending decisions made by the UK Government and the devolved administrations in Wales and Scotland”¹⁶ and which enabled the creation of an equation that calculated the relative needs of the nations of the UK with minimal independent judgements.

The Commission didn’t claim to have provided the definitive solution to the problem of developing a needs-based funding system but rather it had produced a reasonable starting point for discussion. And in February 2010, Mr Holtham took the step of sending a copy of the working paper to George Osborne, then Shadow Chancellor, after he “confirmed that if elected his party would examine the merits of a new needs-based funding model for the UK.”¹⁷ The Commission’s working paper concluded with the recommendation that:

*The Assembly Government should pursue the introduction of a simple needs-based formula as the means of determining the Welsh block grant.*¹⁸

Finally, the Commission also pointed out that there will be a need for a transitional mechanism to bring the current funding regime to the proposed needs-based regime without dramatic and immediate changes.

According to one commentator the Holtham modelling:

¹³ Independent Commission for Funding and Finance for Wales (2009) ‘Replacing Barnett with a needs-based formula’ <http://wales.gov.uk/docs/icffw/news/091204needsworkingpaperen.pdf> (accessed 22 June 2010) (see page 8)

¹⁴ Independent Commission for Funding and Finance for Wales (2009) ‘Replacing Barnett with a needs-based formula’ <http://wales.gov.uk/docs/icffw/news/091204needsworkingpaperen.pdf> (accessed 22 June 2010) (see page 9)

¹⁵ ‘regression analysis’ includes any techniques for modeling and analyzing several variables, when the focus is on the relationship between a dependent variable and one or more independent variables. More specifically, regression analysis helps us understand how the typical value of the dependent variable changes when any one of the independent variables is varied, while the other independent variables are held fixed. See http://en.wikipedia.org/wiki/Regression_analysis (accessed 22 June 2010)

¹⁶ Independent Commission for Funding and Finance for Wales (2009) ‘Replacing Barnett with a needs-based formula’ <http://wales.gov.uk/docs/icffw/news/091204needsworkingpaperen.pdf> (accessed 22 June 2010) (see page 9)

¹⁷ <http://www.walesonline.co.uk/business-in-wales/business-news/2010/02/27/barnett-replacement-working-paper-is-sent-to-tories-91466-25924155>

¹⁸ Independent Commission for Funding and Finance for Wales (2009) ‘Replacing Barnett with a needs-based formula’ <http://wales.gov.uk/docs/icffw/news/091204needsworkingpaperen.pdf> (accessed 22 June 2010) (see page 17)

Suggests (and here is the political dynamite) that the formula funding derived from this regression model would go to England, Wales, Scotland and Northern Ireland in the ratio 100:115:105:121. Under this (and any other) reasonable needs formula, Wales would receive more block grant [per capita] than Scotland, not less, as at present.¹⁹

It is therefore suggested by the Holtham Commission that a transition mechanism would be devised to cushion the blow.

Table 5 – Identifiable Expenditure: UK Index²⁰

	Index (UK identifiable expenditure = 100)				
	National Statistics				
	2004-05 outturn	2005-06 outturn	2006-07 outturn	2007-08 outturn	2008-09 outturn
England	97	97	97	97	97
Scotland	114	117	117	117	115
Wales	112	113	113	112	112
Northern Ireland	126	124	123	124	123
UK identifiable expenditure	100	100	100	100	100

Table 5 above shows the latest available data in identifiable expenditure across the UK. The 2008-09 index for Northern Ireland is 123, slightly higher than the figure of 121 derived by the Commission. This would imply a move to that methodology would result in a small reduction in funding for Northern Ireland but a much larger one for Scotland – from 115 to 105.

The Calman Proposals

It was noted above that the Calman Commission had a wider remit than Holtham. This section focus only on its recommendations in relation to public finance.

The Calman Commission delegated a lot of its analytical work to an Independent Expert Group (IEG). The IEG produced a number of reports in 2008/9. In its first report, the IEG explored principles of fiscal federalism and set out what it saw to be the advantages and disadvantages of a unitary (i.e. nationwide) tax system – see table 6 below.

¹⁹ McLean, I (2010) 'Calman and Holtham: the public finance of devolution' available online at: [http://www.nuffield.ox.ac.uk/politics/papers/2010/Calman_and_Holtham_\(2\).pdf](http://www.nuffield.ox.ac.uk/politics/papers/2010/Calman_and_Holtham_(2).pdf) (accessed 24 June 2010) (see page 12)

²⁰ Source: HM Treasury (2010) 'Public Expenditure Statistical Analyses' available online at: http://www.hm-treasury.gov.uk/d/pesa2010_chapter9_tables.xls (accessed 29 June 2010) (see table 9.2)

Table 6: Advantages and Disadvantages of a Unitary System²¹

Advantages	Disadvantages
<ul style="list-style-type: none"> • The hard budget constraint linking taxes and public service provision delivers accountability at the national level • Incentive to control costs of public service provision • Minimises tax and expenditure induced migration across regions: • Tax rates would typically not vary across regions, thereby the tax system is efficient • Social security rates would tend to be fairly uniform across regions - so similar people would receive similar benefits wherever they lived; • There would be no necessary connection between total expenditures in a region - social security plus merit goods - and the tax raised at a regional level. So equity between regions would be facilitated by the implicit transfers across regions. • There would be administrative efficiency because there would be a single collection agency. • There would tend to be an efficient level of provision of national public goods. 	<ul style="list-style-type: none"> • No accountability at the regional level • For informational reasons, spending on merit goods may not always adequately take account of needs at a local level. • Even if there were no efficiency considerations driving a fairly uniform level of nominal expenditure on merit goods across regions, scale economies and concerns about high tax consequences could limit degree of equalisation of real per capita expenditures. • Both the mix of public expenditures on merit goods and the levels of provision may not reflect local preferences. • Because there is a single government making all the decisions there are lower competitive pressures to force government to innovate and find better ways of providing services. Put differently, there is limited yardstick competition or benchmarking with other regions.

This discussion essentially set the stage for the Commission to make proposals that related to some level of fiscal autonomy through the total or partial devolution or assignment of taxation. In the context of taxation ‘devolution’ means transfer to a sub-national territory of tax receipts, the tax base and the tax rate, and authority to change them. ‘Assignment’ means the apportionment to a sub-national territory of receipts from a given tax base.

The Commission noted that Scotland already has partial devolution of income tax through the Scottish Variable Rate²² but the power has never been exercised. The IEG investigated means of *requiring* the Scottish Parliament to make a tax decision so that its revenue would be affected if it did not:

One means of achieving this was advocated by Professor Francois Vaillancourt of Université de Montréal, Canada, when he spoke to members of the Commission and the Independent Expert Group in October 2008. This would be for a default position for national income tax in a devolved territory to be (for example) substantially less than the national rate (with block grant from the national government reduced accordingly). The devolved government would then have to make some sort of positive

²¹ Independent Expert Group (2008) ‘First Evidence from the Independent Expert Group to the Commission on Scottish Devolution’ available online at: http://www.commissiononscottishdevolution.org.uk/uploads/2008-12-15-hwu-first_evidence_report-web.pdf (accessed 24 June 2010) (see Part I, page 6)

²² The SVR allows the Scottish Parliament to vary the rate of standard rate Income Tax by +/- 3p in the pound, but not to alter the tax base.

choice on the rate of income tax applying in that region in order to address its revenue shortfall and increase the block grant. The critical factor being that the drop in revenues is sufficiently large to “bite” so the “do nothing” option is unlikely to be sustainable.

Applied to the current Scottish circumstance, this would mean that the default basic rate of income tax in Scotland would be, for example, 10p rather than the UK basic rate of 20p. The corresponding reduction in the block grant paid by the UK Government to the Scottish Parliament, based on current estimates, would then be £3.8 billion⁶. Should the Scottish Parliament elect to harmonise the rate with the rest of the UK, the block grant would be increased accordingly, with any other deviation in the chosen Scottish rate from the UK rate reflected in the block grant.

Such a mechanism would deliver accountability to the devolved administration - it connects a tax base that is very evident to the electorate with the capacity of the devolved administration to provide public services – whilst not necessarily altering the parity of public service provision across regions. In the Scottish context, it may be that the administrative costs of such an arrangement would not differ substantially from those associated with implementing the SVR.²³

It has been argued that adopting this approach was Calman’s “most important move” because it would give “tax room of about £5bn a year to Scotland.”²⁴

The Commission also adopted the IEG’s recommendations and supported devolution of a set of tax bases – Stamp Duty Land Tax; Aggregates Levy; Landfill Tax; and Air Passenger Duty. It was argued that the best taxes to devolve were on things that did not move, and therefore rejected the idea of devolving VAT, Corporation Tax, or excise duties; if a tax base is mobile (and goods and capital are both mobile) then it can relocate for the purposes of avoiding higher taxation. The IEG also noted that:

It is also the case that people are mobile, and thus it might seem that income tax is not a good candidate for devolution. We think there is a strong distinction to be made, in that devolving, for example, Corporation Tax, VAT and excise duties creates opportunities for tax avoidance and potentially harmful competition (notwithstanding our views on the scope for this in practice) leading to the under provision of public services. Income tax, however, is a tax measure that is closely connected with the electorate,

²³ Independent Expert Group (2009) ‘Final Report – the consultation response’ available online at: <http://www.commissiononscottishdevolution.org.uk/uploads/2009-06-17-ieq-consultation-reponse-final.pdf> (accessed 24 June 2010) (see page 19)

²⁴ McLean, I (2010) ‘Calman and Holtham: the public finance of devolution’ available online at: [http://www.nuffield.ox.ac.uk/politics/papers/2010/Calman_and_Holtham_\(2\).pdf](http://www.nuffield.ox.ac.uk/politics/papers/2010/Calman_and_Holtham_(2).pdf) (accessed 24 June 2010) (see page 10) (note: the author was a member of the IEG)

meaning that preferences for particular combinations of taxes and services can be expressed democratically.²⁵

The Calman Commission explained the difference between its recommendations and what is already in place with the Scottish Variable Rate as follows:

In essence, if applied to Scotland, this process would mean that the Scottish Parliament would be substituting income from its devolved tax powers for some of the block grant. In our view, rather than the Scottish Parliament being allowed the power to vary income tax, it should be required to levy income tax and receive the associated revenues. To facilitate this, the UK tax rates would be reduced (as would the block grant) to create the tax room for the Scottish Parliament to exercise this power.

The key feature of this model is that it would require the Scottish Parliament to make a tax decision unless it sets no rate of income tax and bases its budget on considerably reduced revenues. This would represent a very significant step from the current arrangements and we think it would introduce substantial financial accountability to the Scottish Parliament.²⁶

5. What are the considerations for Northern Ireland in relation to these suggested approaches?

According to one commentator:

When the process is complete, it seems likely that the Holtham Commission's final report will stress the equity objectives of fiscal federalism, and recommend a regression-based block grant arrangement. Calman has stressed the efficiency and accountability objectives of fiscal federalism (while nodding to equity in retaining block grant), and has recommended substantial tax devolution to Scotland.²⁷

The two proposed solutions to the perceived funding problem are very different. Understanding why they are different could help to illustrate some of the issues that might be relevant to Northern Ireland should one approach or another be put to the Executive as a proposed way forward.

Fiscal autonomy

²⁵ Independent Expert Group (2009) 'Final Report – the consultation response' available online at: <http://www.commissiononscottishdevolution.org.uk/uploads/2009-06-17-ieg-consultation-reponse-final.pdf> (accessed 24 June 2010) (see page 19)

²⁶ Calman Commission (2009) 'Serving Scotland Better: Scotland and the United Kingdom in the 21 Century' <http://www.commissiononscottishdevolution.org.uk/uploads/2009-06-12-csd-final-report-2009fbookmarked.pdf> (accessed 24 June 2010) (see page 104)

²⁷ McLean, I (2010) 'Calman and Holtham: the public finance of devolution' available online at: [http://www.nuffield.ox.ac.uk/politics/papers/2010/Calman_and_Holtham_\(2\).pdf](http://www.nuffield.ox.ac.uk/politics/papers/2010/Calman_and_Holtham_(2).pdf) (accessed 24 June 2010) (see page 12)

It is worth noting that according to some commentators there is an element of confusion in the language used in fiscal debates:

'fiscal autonomy' clearly has a positive ring. This is one reason why it is used to characterise fundamentally different arrangements, blurring essential distinctions. For emphasis, there is often reference to 'full fiscal autonomy', a condition that is likely to exist only for independent states. For example, an independent Scotland would be in the same position as, for example, Denmark, with no connection to the UK Exchequer, except for indirect ones through European Union (EU) membership.²⁸

It is argued that there are usually two reasons given in support of fiscal autonomy.

- The devolved administrations would be dependent solely on their own resources. For a low need region with a high taxable capacity this would remove the obligation to transfer resources to other jurisdictions creating the opportunity for higher spending and/or lower taxation. As highlighted in section 3 above, Northern Ireland is the *beneficiary* of such transfers rather than the source as it currently lacks self-sufficiency.
- Fiscal autonomy could shrink the public sector. Those who believe that democratic politics leads to an excessively large public sector argue that fiscal autonomy creates an incentive to lower taxation to increase economic activity: this would be accompanied by decreased public expenditure.

A further argument is also made that politicians should be responsible for raising some of the money they spend and that accountability for expenditure trade-offs alone is insufficient. Rather, there should be an explicit trade-off between expenditure and taxes raised. Also, there are issues relating to the independence of devolved administrations:

If regional governments are to function as genuine democratic units, with the power to make free decisions concerning the level and pattern of public services, they will need to have access to some form of tax revenues under their own control. Reliance on fiscal transfers from central government will undermine the ability of regional governments to make their decisions free from central influence.²⁹

Essentially, there is a trade-off between the political attractions of the decision-making responsibility of devolution and accountability for the money that funds the implementation of those decisions. The Calman approach seems to offer more in relation to that accountability. One respondent to the Holtham Commission summarised some of relevant arguments quite succinctly:

²⁸ Heald, D and McLeod, A (2010) 'The Taxation and Borrowing Powers of the UK Devolved administrations' presented to the Political Studies Association's Specialist Group Conference on British and Comparative Territorial Politics in Oxford in January 2010, unpublished.

²⁹ Blow, L, Hall, J and Smith, S (1996) 'Financing Regional Government in Britain' available online at: <http://eprints.ucl.ac.uk/14940/1/14940.pdf> (accessed 24 June 2010) (see page 60)

The inability or unwillingness of the devolved administrations to raise own revenues leads to a limited capacity to govern. These regional governments cannot offer their electorate increased levels of public spending at increased tax rates, nor decreased levels of public spend at decreased tax rates should they choose to do so, or should their electorates demand this policy mix.³⁰

Borrowing powers

With the transfer of tax powers of whatever description, there is also an accompanying transfer of risk. Most revenues are volatile to some extent according to the performance of the economy and many other factors. Instability or unpredictability of revenue could make financial planning difficult for the UK's devolved administrations unless they had the power to borrow when revenue fell in order to repay when revenue subsequently increased. Also there are likely to be forecasting errors with any estimation of future revenue; revenue forecasting is not an exact science.

At present, the borrowing powers of all the devolved administrations are limited and would have to be increased were there to be some tax devolution. But it has been observed that:

obtaining borrowing powers often looks like code for spending more. The obvious, but frequently ignored, point is that borrowing does not allow more expenditure, but rephases it – at a cost [...] The UK Government has legal obligations to comply with the EU Stability & Growth Pact. Borrowing, and debt accumulated by devolved administrations, would count towards the UK figures.³¹

European law

In 2006 the European Court of Justice (ECJ) confirmed that a variation in income tax rate approved by the regional Government of Azores, Portugal was to be classified as state aid. The decision hinged on whether the application of a particular rate in one region of a member state was 'selective' or not.

In the view of the Portuguese, British and Spanish governments however, consideration should be given to the constitutional framework of the member state concerned. They argued that:

a measure that applies to all enterprises within the jurisdiction of an autonomous regional government should be deemed general and therefore would not constitute state aid. The ECJ has shared this position and

³⁰ <http://wales.gov.uk/docs/icffw/publications/091218russellmelletten.pdf> (accessed 24 June 2010) (see paragraph 2.1)

³¹ Heald, D and McLeod, A (2010) 'The Taxation and Borrowing Powers of the UK Devolved administrations' presented to the Political Studies Association's Specialist Group Conference on British and Comparative Territorial Politics in Oxford in January 2010, unpublished.

*declared that a tax rate which applies only in a region within a member state may be considered of a general nature in some instances.*³²

It is held that a regional tax system should be recognised as ‘general’ (and, therefore, not ‘selective’) only when it has been approved by a truly autonomous regional government. This is to be determined through the application of three tests:

*institutional, procedural and economic autonomy. This means that the regional tax regime must be approved by a public body with a considerable degree of autonomy and without the interference of the central government in the approval process and that its financial impact must be borne by the autonomous government, without compensation from the state authorities.*³³

To put it another way, the region must have both the power to adopt the tax measures and bear the cost of doing so. In Northern Ireland it seems likely that the condition for power to set the measure without interference could be met as long as it was legislated for in the Assembly rather than Westminster. To meet the condition for bearing the cost, there would have to be some degree of off-setting against the block grant.

If any devolved or assigned tax were however judged to be selective then they would become subject to state aid rules.

Economic performance

Wales is - relative to Scotland - a poor area. Expressed in terms of Gross Value Added (GVA) per head, Wales’ performance has been between 78 and about 85 (relative to an index where UK = 100) for many years. Scotland, however, has typically been in the mid or upper 90s, and so is an ‘average’ rather than a poor performer.³⁴

Arguably it is therefore predictable that a needs-based system would appeal more to Wales and than it would to Scotland. Table 7 below shows the index of GVA per head from 1999 to 2008. It is immediately apparent that while GVA per head in Northern Ireland has not been quite as low as in Wales, it has been considerably below that in Scotland. Also, in 2007 and 2008, GVA per head in Northern Ireland fell while in Scotland it rose. To put it another way, Northern Ireland became less economically productive relative to Scotland in those years.

³² Armesto, D (2006) ‘ ECJ backs regional tax regimes in the Azores case’ available online at: <http://www.internationaltaxreview.com/?ISS=22569&PUBID=35&Page=10&SID=653518&TYPE=20> (accessed 25 June 2010)

³³ Armesto, D (2006) ‘ ECJ backs regional tax regimes in the Azores case’ available online at: <http://www.internationaltaxreview.com/?ISS=22569&PUBID=35&Page=10&SID=653518&TYPE=20> (accessed 25 June 2010)

³⁴ McLean, I, Lodge, G, and Schumuecker, K (2008) ‘Fair Shares? Barnett and the politics of public expenditure’ available online at: <http://www.ippr.org.uk/members/download.asp?f=%2Fecomm%2Ffiles%2Ffair%5Fshares%2Epdf> (accessed 24 June 2010)

Table 7: Regional GVA per head³⁵

		1999	2000	2001	2002	2003	2004	2005	2006	2007	2008 ⁴
GVA per head:Indices (UK less Extra-Regio=100)											
United Kingdom	IGAW	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
North East	IGAX	78.1	77.8	77.9	77.6	77.8	78.0	78.4	78.1	77.5	77.4
North West	IGAY	88.2	88.0	88.0	87.5	86.9	86.4	86.1	85.5	85.0	85.6
Yorkshire & The Humber	IGAZ	87.4	87.2	87.1	86.9	86.6	86.0	85.1	84.1	83.6	83.3
East Midlands	IGBA	90.2	89.7	89.9	89.7	89.9	89.7	89.2	88.7	88.3	87.9
West Midlands	IGBB	90.7	90.5	90.1	89.1	88.2	87.3	86.5	85.8	85.4	85.1
East of England	IPLL	94.0	93.8	93.8	93.7	94.1	95.0	95.2	95.5	95.6	94.9
London	IPLM	160.7	160.4	159.2	161.0	162.3	163.6	164.7	166.6	168.9	169.5
South East	IPLN	106.7	107.7	108.5	108.3	108.1	107.9	107.5	107.1	106.5	105.7
South West	IPLP	91.9	91.9	92.3	92.2	92.3	92.4	92.0	91.9	91.4	91.5
England	IGBG	102.6	102.6	102.7	102.7	102.7	102.7	102.6	102.6	102.5	102.4
Wales	IGBH	77.4	77.1	77.1	76.7	76.2	75.5	75.7	74.8	74.4	74.3
Scotland	IGBI	94.5	94.1	93.6	94.0	94.2	94.2	95.3	96.1	96.6	97.9
Northern Ireland	IGBJ	79.4	79.8	79.6	79.2	79.2	80.1	80.3	80.0	79.5	78.9

What this suggests is that the route preferred by the Holtham Commission may be rationally more attractive (or perhaps less unattractive) to Northern Ireland than the Calman route.

Tax administration

The Calman proposals present what have been described as “non-trivial” problems.³⁶ The Holtham Commissioners raised these in a meeting with members of the Calman IEG:

It was suggested that there were practical hurdles to be overcome before a variation in Income Tax could be applied to Scotland. As a result, it was unlikely that the Calman recommendations could be fully implemented for some time. In order to introduce Income Tax devolution, the UK needed to move to an address-based tax system. While HM Revenue & Customs and the Department for Work and Pensions should, between them, hold the personal addresses of a large percentage of tax payers in UK, it was asserted that the administrative systems did not currently exist to apply this information to the collection of Income Tax and, moreover, any system would require addresses for all potential taxpayers.³⁷

In relation to this point, the Scotland Office (in consultation with HM Revenue and Customs and HM Treasury) published a paper in November 2009 which considered some of the implications of the proposals to alter the Scottish tax system. The main findings of this work were:

³⁵ Office of National Statistics (2009) ‘Regional GVA December 2009’ available online at: http://www.statistics.gov.uk/downloads/theme_economy/CRC2008ALL.pdf (accessed 24 June 2010)

³⁶ McLean, I (2010) ‘Calman and Holtham: the public finance of devolution’ available online at: [http://www.nuffield.ox.ac.uk/politics/papers/2010/Calman_and_Holtham_\(2\).pdf](http://www.nuffield.ox.ac.uk/politics/papers/2010/Calman_and_Holtham_(2).pdf) (accessed 24 June 2010) (see page 13)

³⁷ Independent Commission for Funding and Finance for Wales, minutes of meeting of 21 July 2009 available online at: <http://wales.gov.uk/docs/icffw/news/091119meetingnotesen.pdf> (accessed 25 June 2010) (see pages 1-2)

- *As part of the unified UK tax system, there is no need for Scottish businesses, individuals or HMRC to divide tax liability between Scotland and the rest of the UK in relation to any UK taxes.*
- *The Scotland Office estimate that **the tax compliance costs for Scottish business could double to more than £1bn** if a separate Scottish tax system was introduced, as would be necessary under fiscal autonomy or separation.*
- *Companies such as retail multiples purchasing, processing and selling goods across both jurisdictions would need to: comply with two different sets of rules for each tax collected and remitted to each administration; and establish the proportions of profits liable for Corporation Tax in each jurisdiction. Potentially, the compliance burden for cross border businesses would be duplicated for each tax.*
- *It is not possible to estimate the costs of creating and operating a separate Scottish Tax system as nothing is known of what taxes would apply and what the operational rules would be. By way of comparison, HMRC's annual administrative costs are c. £4 billion. It is not clear if the ongoing operational costs of a separate system would be radically less than these running costs.*
- *One way of reducing some of the compliance cost to business of fiscal autonomy or separation would be to move away from a PAYE system and require individuals to self assess their own tax bills. This would be abandoning a key feature giving the UK tax system an advantage over many others in the developed world.*
- *The burden of complying with a separate tax system would fall disproportionately on business because, in addition to their own tax liabilities, they are responsible for withholding tax due from remuneration paid to their employees. It is estimated that 65% of Scotland's exports are to the rest of the UK.*
- *No estimates exist of the rates of taxes that might be needed in Scotland under full fiscal autonomy or separation from the rest of the United Kingdom. The response to any divergence in tax rates in Scotland compared to the rest of the UK is not known. Scotland's long term fiscal position, allied to the creation of new administrative costs, suggest that lower taxes are unlikely to be affordable.³⁸*

³⁸ Scotland Office (2009) 'Tax administration and constitutional change in Scotland' available online at: <http://www.scotlandoffice.gov.uk/scotlandoffice/files/Scotland%20Office%20Tax%20Paper%201711.pdf> (accessed 25 June 2010) (see page 1)

Of these points there are a few that merit particular attention in relation to Northern Ireland. Firstly, the assertion that tax compliance costs for businesses could double would be of concern to the private sector.

Secondly, the third bullet point raises an issue that could apply in reverse to Northern Ireland in some circumstances. Business operating in both the Republic of Ireland and in Northern Ireland already have to comply with two sets of rules – as well as two currencies. Depending on what were to be proposed there could potentially be a simplification of north/south cross-border trade. On the other hand, businesses in Northern Ireland that also operate in Great Britain could see their tax compliance complicated by variations in taxation levels across the UK.

The final bullet point about the absence of estimates of the taxation levels that might be required for Scotland may well also apply to Northern Ireland; in the absence of such estimates it is not possible to comment in this paper as to whether lower tax levels might be affordable or not – although the information presented in section 3 might suggest this is unlikely.

Needs assessment

A House of Lords Select Committee on the Barnett Formula reviewed its operation and reported in July 2009.³⁹ It found that a new system should be based on the following principles:

- It should consider both the baseline and any increment in funds;
- It should be fair and seen to be fair;
- It should be comprehensible;
- It should respect territorial autonomy; and
- It should be stable and predictable

And any needs assessment should take these aspects into account:

- The age structure of the population;
- Low income;
- Ill-health and disability; and
- Economic weakness.

This Committee did not suggest a detailed solution in terms of needs assessment but its report did highlight the funding formula models used for distributing funding to local government and health bodies in England.

It has been argued that elsewhere that:

³⁹ Select Committee on the Barnett Formula (2009) '1st Report of Session 2008–09'
<http://www.publications.parliament.uk/pa/ld200809/ldselect/ldbarnett/139/139.pdf> (accessed 25 June 2009)

*the health formulae, delivered by unelected local bodies, work well. The local government formulae, delivered to, and then by, elected local authorities, work badly [...] because the elected politicians at both levels have a powerful incentive to reward people living in some places and punish people living in others.*⁴⁰

Whether that assertion for the cause of difficulties with local government funding is correct or not, it is certainly noticeable that the distribution formula is controversial.⁴¹ One of the controversies, for instance, is related to the way the formula does or does not take account of changing population: it is argued that population increases are not caught and therefore remain unfunded.

Controversy is no doubt a consequence of the observation noted above that prioritisation of needs is inevitably a political matter and so – almost by definition – will lead to disagreements. It perhaps seems unlikely that any needs assessment aimed at distributing funding to the UK's devolved administrations would be able to avoid controversy. As can be seen from Northern Ireland's current reliance on other UK taxpayers as highlighted in section 3 above, the stakes are high.

⁴⁰ McLean, I (2010) 'Calman and Holtham: the public finance of devolution' available online at:

[http://www.nuffield.ox.ac.uk/politics/papers/2010/Calman_and_Holtham_\(2\).pdf](http://www.nuffield.ox.ac.uk/politics/papers/2010/Calman_and_Holtham_(2).pdf) (accessed 24 June 2010) (see page 11)

⁴¹ See, for example, <http://www.londoncouncils.gov.uk/media/current/pressdetail.htm?pk=631> ;

<http://www.lgcplus.com/news/analysis-unsettled-conditions-ahead/358181.article> , or

<http://www.sigoma.gov.uk/sigoma/docs/core/Local%20Government%20Finance%20Settlement%202009-10.pdf>

(accessed 28 June 2010)