

# Calman and Holtham: the public finance of devolution\*

by Iain McLean

[iain.mclean@politics.ox.ac.uk](mailto:iain.mclean@politics.ox.ac.uk)

## Abstract

The ‘Barnett formula’, which governs the transfer of block grant from the UK Treasury to the governments of Scotland, Wales, and Northern Ireland to fund devolved services, is fatally flawed. It bears no relation to relative need. Also, because the devolved administrations do not raise most of the taxation required to fund their services, they have no incentive to be fiscally responsible. The Scottish and Welsh parliaments have each commissioned an official committee to review the situation: the Calman and Holtham committees. Their approaches are described and contrasted. It is shown that the Scottish (Calman) approach corresponds most closely to the Canadian regime for intergovernmental transfers, and the Welsh (Holtham) approach is likely to correspond most closely to the Australian. Implications for the future governance of all parts of the UK, including England, are discussed.

- 
- I was a member of the Independent Expert Group on Finance, Calman Commission; and have twice given evidence to the Holtham Commission. My thanks to fellow IEG members and to the Commissioners and staff of both Commissions. Apart from a number of interviews with politicians and civil servants working on Barnett in the UK and territorial governments, all sources used in this paper are in the public domain. This version addresses comments from the secretariat of both Commissions on an earlier draft but all comments made are my responsibility. Earlier versions were presented to the Departmental Seminar, Department of Economics, Strathclyde University, and the Finance Seminar, School of City and Regional Planning, Cardiff University. Thanks for the helpful comments then received. Thanks also to my co-authors Guy Lodge, Katie Schmuecker, and Alistair McMillan who have collaborated on earlier papers in this area.

## **Calman and Holtham: the public finance of devolution**

### ***The decline and not-quite-fall of the Barnett Formula***

The famous – although much misunderstood - Barnett Formula has governed the distribution of public spending across the United Kingdom since the 1970s. But devolution has provoked a growing and impassioned debate about how public spending is distributed, and politicians, commentators and the public are increasingly asking: who gets what, and is public money distributed fairly?

The Barnett formula is regularly attacked for allegedly over-rewarding Scotland, Wales and Northern Ireland at the expense of England. Territorial finance seems to be one of the key issues driving English dissatisfaction with the devolution settlement and the Union itself. Recent data from the British Social Attitudes Survey suggests that the proportion of people in England that think Scotland receives ‘more than its fair share’ of public spending has risen from one in five in 2000 to one in three in 2007 (Curtice and Seyd 2009, Table 6.12). English commentators perceive that additional funding enables the Scots to enjoy popular policies like free personal care for the elderly, the abolition of prescription charges and university tuition fees.

Within England, the northern regions complain that objectively their needs are greater than those of Scotland, yet they receive less spending per head, while the Greater South East complains that it subsidises everyone else. But to blame the Barnett formula for spending disparities within England is to blame the wrong device: Barnett only covers the distribution of public spending between Scotland, Wales, Northern Ireland based on spending in England – where the latter is treated as a single block. Nonetheless, this has not prevented the idea that the Barnett formula punishes the English regions from entering the public imagination.

In 2009, an *ad hoc* select committee of the House of Lords was created on the motion of Lord Barnett. Its powerful membership included a former Chancellor of the Exchequer and four former territorial Secretaries of State or First Ministers. It, too, roundly condemned Barnett:

A new system which allocates resources to the devolved administrations based on an explicit assessment of their relative needs should be introduced. Those devolved administrations which have greater needs should receive more funding, per head of population, than those with lesser needs. Such a system must above all be simple, clear and comprehensible. It must also be dynamic: able to be kept up to date in order to respond to changing needs across the United Kingdom. (HL 139/2009, Summary)

But not only the English have a problem with Barnett. In Wales an independent commission was established to review whether the funding formula is denying Wales its fair share of the public spending cake and whether it should be replaced. This Independent Commission on Funding and Finance for Wales was set up in summer 2008 as a result of the One Wales agreement drafted by the coalition partners Labour and Plaid Cymru, who form the Government in the National Assembly for Wales elected in 2007. The Commission is chaired by the economist Gerald Holtham. Its terms of reference are 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 Assembly Government to have tax varying powers as well as greater powers to borrow. Source:*

<http://wales.gov.uk/icffw/home/about/faq/?lang=en>, consulted 03.12.09

In Northern Ireland there are concerns about whether the level of spending is keeping pace with need, and the Finance Committee of the Northern Ireland Assembly has urged the Executive to examine the implications of the Barnett Formula and scenarios for reform (Committee for Finance and Personnel 2007). While politicians in the Northern Ireland Assembly have been preoccupied with wrangling about the transfer of security powers, Barnett has been more of an official than a political concern. But senior members of the NI Civil Service have believed since at least 2004 that Barnett is unsuitable for funding services there.

In Scotland a different but related debate has arisen over fiscal autonomy. In 2008, Labour, the Conservatives and the Liberal Democrats, who between them hold a majority of seats in the 2007-11 Scottish Parliament, launched a Commission with backing from the UK Government to review Scottish devolution and make recommendations to improve the financial accountability of the Parliament. This Commission, under the chairmanship of Sir Kenneth Calman, was created in April 2008. It issued an interim report in autumn 2008 and its final report in June 2009. Its terms of reference were:

"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, improve the financial accountability of the Scottish Parliament, and continue to secure the position of Scotland within the United Kingdom." Source: <http://www.commissiononscottishdevolution.org.uk/about/index.php>, consulted 13.12.09

Recognising that one of its chief tasks was the somewhat technical one of reviewing the existing arrangements for taxing and spending in Scotland and making recommendations, the Commission appointed an Independent Expert Group on Finance (IEG) under the chairmanship of Anton Muscatelli, then Principal of Heriot-Watt University (now of Glasgow University). The IEG comprised economists, political scientists, a former Scottish Executive finance chief, and a lawyer. Its secretary was a senior economist at the Scotland Office. It produced four reports, which may be read on the Calman Commission website, and on which I draw for this paper (IEG 2008; 2009a, b, c). The Commission adopted the IEG's proposals.

The minority Scottish Nationalist (SNP) government in Edinburgh initially refused to engage with Calman, preferring to proceed with its own National Conversation. However, it did make a mostly factual submission to Calman in the evidence-gathering period. Its 2007 White Paper on constitutional options discussed whether Scotland should be granted more fiscal powers; its response to Calman lists three

options ranging upwards from Calman to “devolution-max” and independence (Scottish Government 2007, 2009). Both it and the UK government (HM Government 2009) have published reactions to Calman and reacted to one another’s reactions to Calman. These reactions, although sharply disagreeing with each other, tacitly concede that debate has moved on from Barnett. Although HM Government again intones, as it has for twenty years, ‘The government has no plans to review the Barnett formula itself’ (HMG 2009: 4.24), it accepted all bar one of Calman’s fiscal recommendations.

Wendy Alexander, the Labour leader in the Scottish Parliament at the time that Calman was being set up, has argued that fiscal autonomy for Scotland may help defuse the situation south of the border:

A beneficial by-product of strengthening the [financial] accountability of the Parliament through greater autonomy would be to address some of the concerns elsewhere in the UK around relative spending levels. Inevitably a larger assigned or devolved element means the grant element would be smaller and so potentially less contentious (Alexander, 2008).

This sentiment is supported by the British Social Attitudes survey of English opinion, which found that three-quarters of those surveyed agreed with the statement that “now Scotland has its own parliament, it should pay for its services out of taxes collected in Scotland” (Curtice and Seyd 2009, Table 6.13). The upshot, it seems, is that Barnett has no true friends.

In previous work (especially McLean, Lodge and Schmuecker 2008) we set out some core principles that we think should inform how public money should be distributed across the nations and regions of the UK, before exploring how money is currently distributed between the countries of the UK via the Barnett Formula. I do not repeat that work. Rather, this paper first considers fiscal federalism, especially on the “tax” side of tax and spend: until very recently that side has been seriously neglected in UK public policy debate. Then I briefly describe the completed Calman and ongoing Holtham processes. They come to very different conclusions, as would have been inferred from previous analysis including ours. Scotland has done very well out of the block grant; Wales has done badly. Scotland has a more robust tax base than Wales. Therefore Scots rationally prefer fiscal autonomy to needs assessment; the Welsh rationally prefer (so far) reformed needs assessment to fiscal autonomy.

### ***Principles of fiscal federalism for a not-quite-federation***

The principles of fiscal federalism are well established in public economics (Oates 1999; Boadway and Shah 2007). UK discussion has almost exclusively focused on the expenditure side, and within that narrowly on relative needs. Health, education, and local government spending by English subnational governments are controlled by elaborate formulae which are supposed to allocate grant to each territory so that similarly-situated citizens have access to the same standards of service wherever they live. A much more sophisticated (because less gameable) version of this regime is administered by the Commonwealth Grants Commission in Australia ([www.cgc.gov.au](http://www.cgc.gov.au); McLean 2005). Barnett is not needs-related except in the very coarse sense that it is population-based. In equilibrium, block grant under Barnett would converge on to equal spending per capita (EPC) for the four countries of the

UK. This is an obviously inappropriate target; there are therefore many calls for a needs-based substitute.

The magisterial survey by Oates (1999:1120, with two small errors silently corrected) states:

The basic issue is one of aligning responsibilities and fiscal instruments with the proper levels of government. As Alexis de Tocqueville observed more than a century ago, "The federal system was created with the intention of combining the different advantages which result from the magnitude and the littleness of nations" (1945, v. I, p. 163). But to realize these "different advantages," we need to understand which functions and instruments are best centralized and which are best placed in the sphere of decentralized levels of government. This is the subject matter of fiscal federalism.

The list of functions that sit at the top level of government (Tocqueville's "magnitude") does not vary much across states. For the UK, the main reserved functions include defence, foreign relations and macroeconomic management. There would be serious diseconomies of scale were any of those to be devolved. However, the most expensive reserved functions by far are social protection and debt interest. There is no *a priori* reason why either of these must sit at the top level<sup>1</sup>. For social protection, the core argument, newer than Tocqueville, is that social protection relates to the state's (implicit) guarantee of social citizenship: that citizenship implies equal rights to pensions or unemployment insurance wherever in the state the citizen lives. However, UK citizens probably feel at least as strongly that health (a devolved function) should be socially guaranteed. Why do health and social protection not sit at the same level of government in the UK? Calman took the concept of social citizenship to imply a broad parity of public service provision in the UK, but it is also true that a national social security system acts as an automatic stabiliser in the event of an economic downturn disproportionately affecting one part of a state, such as one particularly dependent on banking services.

What about "littleness"? All parties in the UK say they are in favour of localism; few ever make serious moves in that direction. Public economists would say that the characteristics of different territories are different; therefore their citizens are best placed to decide service priorities at local level. The Highland region might rationally prefer, at the margin, ferry subsidies to multicultural education (except Gaelic education); East London boroughs the reverse (except for Gaelic).

But fiscal federalism is as much about tax bases ('resources' in the parochial English debate) as about relative needs or different tastes. The fundamental point is that some tax bases are more mobile than others. Capital is highly mobile; labour less so; land not at all. With the advent of online trading, much expenditure is also 'mobile' in the sense that a trader can locate at almost zero cost in the lowest-tax jurisdiction. It is not practicable then for expenditure tax to vary according to where the customer lives.

---

<sup>1</sup> Local authority debt is decentralised – but most of it is to HM Treasury which is simply passing on Gilts. There is however a strong argument of economy of scale in debt. William Pitt the younger used that to win the Napoleonic wars. The UK could borrow more cheaply than France.

This ought to structure discussions of devolved and reserved tax bases; but I am aware of very little such discussion in the UK until the Calman Report discussed below.

Whatever its tax bases, a government at any level ought to have an incentive to nurture them. A government which controls capital taxes ought to encourage capital to settle and grow on its patch; a government which controls property taxes ought to take steps to increase the value of property in its patch.

### ***Calman and Holtham: the political context***

The pure theory of fiscal federalism was not, however, the motive for creating either the Calman or the Holtham commission. In previous work (notably McLean and McMillan 2005), my co-authors and I have ascribed the politics of UK devolution to the differentially credible threats posed by different regions of the UK to the central state. Ireland (and now Northern Ireland) poses a credible threat of public disorder. Scotland poses a credible threat of secession. London also poses a credible threat of public disorder: usually on a smaller scale than that in (Northern) Ireland, but more threatening and conspicuous to the state which is largely located in London. The last of these claims has been challenged. The onus is on the challenger then to explain why public expenditure in London is anomalously high. The richest region in the UK, it has not the lowest but one of the highest figures for public expenditure per head (McLean, Lodge and Schmuecker 2008). Part (but given the size of London, surely not much) of this is down to the capital city effect which also sees anomalously high spend per head in Canberra, Ottawa, and Washington DC.

The politics of credible threats and territorial public spending in the UK goes back to 1888, when Unionist Chancellor George Goschen devised his eponymous formula as part of government attempts to “kill [Irish] Home Rule by kindness”. They failed to kill Irish Home Rule, but the Goschen Formula continued to protect public spending in Scotland. As Scotland’s relative population declined in the 20<sup>th</sup> century, so its public spending per head became more and more anomalously high. When Northern Ireland was created in the bitter sectarian politics of 1920, the credibility of its threat to public order was immediately obvious; hence killing by kindness in Ireland restarted, but with a different set of beneficiaries.

The so-called Barnett formula (actually predating Joel Barnett’s time as a Treasury Minister) was HM Treasury’s attempt to reduce the overspending which they believed took place in Scotland and Northern Ireland. The reason that in equilibrium Barnett would converge on to EPC is that HM Treasury designed it to do so. Treasury officials intended that, long before that had happened, a cry would have gone up for readjustment on the basis of relative needs. The Treasury itself coordinated a now-notorious Needs Assessment (HMT 1979), which the Scottish Office bitterly resisted. In such efforts, which continued until devolution, Scottish finance officials could depend on backing from Scottish Ministers.

Through all this, Wales remained the weakling of devolution. It possessed fewer credible threats than any of Scotland, London, and Northern Ireland, as gruesomely revealed in the aftermath to the Aberfan disaster of 1966 (McLean and Johnes 2000).

The scheme that underlies the Scotland Act 1998 was drafted in Scotland by various civil society organisations under the previous Conservative government. It therefore

does well what its drafters wanted to see done well; and badly what did not interest them. It built on the existing administrative devolution to Scotland. (Almost all the services now run by the Scottish government were run by the Scottish Office before devolution.) The two weakest points of the Act were therefore representation and finance: exemplified by the West Lothian Question (discussed extensively elsewhere but not in this paper) and the Barnett Formula<sup>2</sup>. The Government of Wales Act 1998 was worse thought out (and had to be modified in 2006); while the Northern Irish devolution legislation came from a different quarter entirely. Therefore Barnett remained undisturbed for the first 8 years of devolution. After the 2007 devolved elections, however, none of the three devolved territories had a government of the same complexion as the UK Government. Until 2007, any public questioning of Barnett by Scottish Labour politicians could be seen as disloyal to their UK counterparts. The 2007 election removed this constraint. The prime mover in setting up Calman was therefore Wendy Alexander, who was Labour leader in the Scottish Parliament during 2007-08, and a politician with excellent links to UK Government ministers. With a minority nationalist government in power at Holyrood, it was in the common interest of Labour, Conservative, and Liberal Democrat politicians to support the wide-ranging review of the working of devolution in Scotland which they commissioned.

Rhodri Morgan, First Minister of Wales until 2009, was more detached from London Labour than Alexander; and closer to being an open sceptic on Barnett. He and his advisers were aware that Barnett did Wales no favours, as first revealed long ago by the 1979 Needs Assessment. However as real public expenditure in Wales (as in the rest of the UK) was increasing annually after 1999, there was no need to pick a fight over Barnett. Therefore a formal review of Barnett in Wales began only with the coalition agreement under which Plaid Cymru joined with Labour to form the coalition government of the 2007-11 National Assembly. It was under that agreement that the Holtham Commission was created.

The two commissions had similar cores but different penumbræ. The Calman Commission was a gallery of Scotland's great and good, and its remit was wide – to review the operation of devolution across the whole range of policy and institutions, including the relationship between the two Parliaments. However, people close to the creation of Calman confirmed that it was always intended that the main action should be its review of the fiscal relationship between Scotland and the UK government. Accordingly, as noted above, the Commission created the academic Independent Expert Group (IEG) chaired by Anton Muscatelli, to do the heavy analytic lifting.

---

<sup>2</sup> “The principle of equalisation will continue. This means resources will be pooled on a UK basis and distributed on the basis of relative need. The establishing Act will embody the principle of equalisation - which has provided a stable, long-term foundation for government expenditure in Scotland for many years, receives the support of all the UK parties, and has served Scotland and the UK well. Thus, Scotland will continue to be guaranteed her fair share of UK resources, as of right. The current formula for the calculation of government expenditure in Scotland - the Barnett/Goschen formula - will continue to be used as the basis for the allocation of Scotland's fair share of UK resources. We recognise that any formula will need to be jointly reviewed from time to time. In time such discussions will undoubtedly lead to a greater transparency in, and understanding of, the economic situation across the different parts of the UK.” From *Report of the Scottish Constitutional Convention* 1995.

The Holtham Commission is more narrowly focused on finance and funding, and its expertise lies with the Commissioners themselves – two economists both with an academic background, and a German public administration academic.

### ***The Calman report; Scottish and UK government reactions***

Although Calman had a wide remit, this section considers only its recommendations in public finance. It devolved its detailed thinking to the IEG, which produced four reports in 2008/9. The most important of these were its first report and its report on oil and gas in the second round.

The IEG's first report opens by setting out some principles of fiscal federalism, and the advantages and disadvantages of a unitary taxation system (Table 1).

[Table 1 about here]

A devolved tax system must satisfy equity, autonomy, and efficiency objectives; however, these were not wholly compatible. If equity were the prime consideration, the system should measure need and ensure that most resources went to places and people where the need was greatest. If autonomy and/or efficiency were deemed primary, the focus should be on increasing the tax powers of, and improving the incentives facing, the Scottish Parliament.

The report went on to discuss tax assignment (that is, the apportionment to a sub-national territory of receipts from a given tax base) and tax devolution (that is, devolution to a sub-national territory not only of tax receipts but of the tax base and tax rate, with the authority to change either or both). It pointed out that Scotland already had partial devolution of income tax. The Scottish Variable Rate (SVR) allows the Scottish Parliament to vary the rate of standard-rate Income Tax by  $\pm 3p$  in the pound. It was authorised by referendum in 1998. The Scottish Parliament has no power to alter the base of income tax. It has never applied the SVR.

In autumn 2008, members of the IEG facilitated the visits to Scotland of François Vaillancourt, a fiscal federalism specialist from the Université de Montréal, and Alan Morris, Chair of the Australian Commonwealth Grants Commission. They gave evidence at a session on the Commission and the IEG. The upshot is revealed in one of the later IEG reports (IEG 2009c):

#### ***Question 33.***

*Are there any ways in which the Scottish Parliament could be required to make a tax decision, so that its revenue would be affected if it did not?*

**12.1** 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 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.

**12.2** 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 billion<sup>6</sup>. 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.

**12.3** 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.

The IEG argued that, in accordance with the principles of fiscal federalism, the best taxes to devolve to the Scottish Parliament were taxes on things that don't move. It therefore rejected, as did the Commission, the idea of devolving VAT, Corporation Tax, or excise duties. North Sea oil and gas does not move until it is extracted. Since the 1970s, the SNP has argued that "It's Scotland's oil". Its tax-and-spend proposals have always assumed that in an independent Scotland, the vast majority of North Sea tax receipts would accrue to Scotland. The IEG's report on the taxation of North Sea oil (IEG 2009b), however, argued that offshore oil was an unsuitable tax base for devolution:

**10.4** The assignment of a Scottish share of these revenues would have major implications for the funding of the Scottish budget. It would expose the Scottish Parliament to significant revenue variations, given the inherent volatility of oil and gas taxation revenues. Oil and gas taxation revenues from the UKCS [UK Continental Shelf] will also diminish over time given the finite nature of the resource. Substantive borrowing and investment powers could enable these revenue variations to be mitigated. For example, investments in an oil fund above the level to maintain the nation's capital stock could be made when prices were high....

**10.6** The assignment of a Scottish share of UK oil taxation revenues might be expected to have major implications for the grant from the UK Government which currently forms the basis for the Scottish Government's budget. The grant could clearly be reduced, and a formula would need to be designed which did so in an equitable manner.

The lead author of this report was the acknowledged leading expert on these matters, Professor Alex Kemp of the University of Aberdeen. Professor Kemp is also a member of the Scottish Government's Council of Economic Advisers. The Scottish Government frequently cites his other work as proof that an independent Scottish government could not only thrive on North Sea revenues but could and should create an oil fund on Norwegian lines (see, e.g., Scottish Government 2009, Box 3 and paragraphs 3.43 to 3.46). That the Scottish Government apparently intends to spend its oil receipts and save them at the same time is not Professor Kemp's fault. I merely note that its interpretation of his work seems at variance with IEG 2009b, of which he was the lead author.

The Calman Commission adopted the IEG's recommendations. Specifically, it supported devolution to Scotland of a set of tax bases that do not move (Stamp Duty

Land Tax; Aggregates Levy; Landfill Tax; and Air Passenger Duty). However, it did not develop a subtle hint thrown out by IEG 2009c, para. 7.8:

we do note that local taxation is already devolved, and this currently applies to property.

This was intended to hint that if the Scottish Government wished to make a stronger tax effort, it could alter the rates and base of Council Tax and Uniform Business Rate, already under its control and much larger in yield (about £3.65 bn) than the list of small taxes proposed for devolution.

However, Calman's most important move was to adopt the "Vaillancourt plan" of cutting the level of income tax chargeable in Scotland by 10p in the pound and requiring the Scottish Parliament to set a tax rate. This would give tax room of about £5 bn a year to Scotland. If it set that rate at 10p, it would be taxing at the same level and spending at the same level as in the last year before the change. Or it could decide to tax more and spend more (say by setting a rate of 11p); or tax less and spend less (say by setting a rate of 9 p). Unlike with the SVR, these rates would affect the higher rate as well as the standard rate. And

3.176 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. (Calman 2009)

By substituting devolved income for about half of the block grant, such a regime might draw the sting from Barnett as predicted by Alexander (2008). HM Government (2009) accepts all of Calman's financial recommendations except on devolving Air Passenger Duty. It promises to legislate (after the 2010 General Election) to give effect to them. The Conservative and Liberal Democrat Scottish spokesmen have also endorsed the general principle of Calman; the SNP has not.<sup>3</sup>

### ***The Holtham interim report***

In my monograph *The Fiscal Crisis of the United Kingdom* (McLean 2005), I set out two alternative routes away from Barnett, a Canadian road and an Australian road. Calman received evidence from the chair of the (Australian) Commonwealth Grants Commission, and from one of Canada's two leading public finance economists (the other, Robin Boadway, was a corresponding member of the IEG). It then took the Canadian road. It eschewed fiscal models built on reformed needs assessments. It has a Canadian emphasis on encouraging tax effort at subnational levels of government, rather than an Australian emphasis on ensuring that equally situated citizens are

---

<sup>3</sup> Speeches by David Mundell MP, Alistair Carmichael MP and Stewart Hosie MP at Reform Scotland symposium on Calman, Westminster, 04.02.2010.

entitled to equal public services, assuming governments in all territories were equally efficient and had similar policy priorities.

At the time of writing, the signs are that Holtham will take the Australian road. In its First Report (ICFFW 2009a), the Holtham Commission, like the Calman IEG, leant on the literature of fiscal federalism to describe the principles of equity, efficiency and accountability. However, unlike Calman, it then focussed primarily on equity. It showed, like all previous studies of the matter, that Barnett performs poorly in Wales on equity grounds. As its long-term aim is convergence, it cannot possibly be the right equity formula for Wales, given that Wales unlike Scotland is a poor region of the UK.

Holtham concluded (ICFFW 2009a):

3.9 We believe that Barnett must ultimately be superseded by a needs-based formula. No doubt that will need to be accompanied by an adjustment mechanism since the formula may imply substantial changes to block grants and it would be both disruptive and politically difficult to introduce those rapidly. In order for a revised system to be durable, it would need to be seen to be equitable to all parties. Any new needs-based funding model should therefore be jointly agreed by Ministers from both the UK Government and all the devolved administrations concerned.

Such a needs-based model would look quite like the Australian regime.

[Table 2 about here]

The UK government, acting as the government of England, already applies formula funding to most of the services that are devolved outside England. Like some other academic analysts, Holtham analysed the likely outcome for Wales in the event that it were treated as a tenth standard region of England, and the English spending formulae applied in Wales. The result (Table 2) shows that Wales would get slightly more than it gets at present under Barnett (114/100 Wales/England, compared to 112/100 under Barnett). However, this sum would not converge. There would be no ‘Barnett squeeze’. Such a needs-based procedure would therefore deliver more equity than would continuing with Barnett.

But Holtham has given the subject a further twist (ICFFW 2009b). The Commission notes that needs-based formulae already govern the allocations of grant to most devolved functions in England, as well as in Scotland and Wales. Health, education, and so on are delivered by subnational units in England – local authorities, health authorities, and individual schools. Each of these receives a block grant that is calculated on the basis of relative needs. The needs formulae in health have a history that goes back to health minister David Owen’s overriding his officials and insisting on a RAWP (Resource Allocation Working Party) in 1976. The needs formula for local government services including education has evolved over decades. In McLean (2005, chapters 6 and 7), I argue that the health formulae, delivered by unelected local bodies, work well. The local government formulae, delivered to, and then by, elected local authorities, work badly (I argued) because the elected politicians at both levels have a powerful incentive to reward people living in some places and punish people

living in others. How might one devise a territorial needs formula that was relatively simple and immune from political interference?

The Holtham Commission argue that most of the variance in expenditure per head on devolved services is captured in a regression model whose independent variables are a few simple indicators derived from Census or other non-manipulable data (Table 3)

[Table 3 about here]

To set the relative weightings of the predictors is a political matter, which the Holtham Commission declines to do. Rather, it infers them by finding the model that best fits the actual block grant to the top-level authority areas in the UK: i.e., English county, unitary, and London council areas, and the unitary Scottish and Welsh local authority areas<sup>45</sup>. That model explains 96% of the variance in the actual block grant per head among the 160-odd areas in the model (Adjusted  $R^2 = 0.962$ ). It also suggests (and here is the political dynamite) that 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 than Scotland, not less, as at present. That the regression model produces essentially the same result as the Commission's earlier application of the English formulae to Scotland and Wales means that the two methods validate one another.

Within four days, the first Scottish reaction to ICFFW 2009b appeared (Bell 2009). Professor David Bell, a member of the Calman IEG, calculated that 'At current spending levels, this would mean a cut of around £4.5bn in Scotland's annual grant from Westminster.... Of course, in a world of fiscal autonomy, it might be possible to make up the shortfall through tax increases. Unfortunately, based on the latest GERS<sup>6</sup> data, this would necessitate increasing the total income tax take by more than a third.'

Although ICFFW 2009b does not mention Australia, the regression method used is similar to the methods used by the Commonwealth Grants Commission. The motives are the same: to make the indicators in the model that determines block grant immune from gaming or manipulation by elected politicians.

### ***Will one size fit all?***

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

---

<sup>4</sup> It rejected Calman's suggestion of devolving air passenger duty as being contrary to EU state aid rules

<sup>5</sup> Grant for local government services goes directly to local authorities. Grant for health services goes to unelected NHS bodies which are typically smaller than a county or London borough council area. ICFFW 2009b does not explain how it, or its consultants, have aggregated grant to counties, boroughs, etc.

<sup>6</sup> *Government Expenditure and Revenue in Scotland*, a National Statistics publication produced annually by the Scottish Government. Latest at <http://www.scotland.gov.uk/Topics/Statistics/Browse/Economy/GERS>, accessed 22.03.10

block grant), and has recommended substantial tax devolution to Scotland. In a word, these are Australian and Canadian solutions respectively. Why are they so different? Could they be reconciled?

They are different because Wales and Scotland are different. Wales is a poor area, whose GDP per head relative to UK=100, has been between about 78 and about 85 for many years. Scotland is an average-GDP area, with relative GDP per head typically in the mid or upper 90s (McLean, Lodge and Schmuecker 2008). It was therefore predictable that the National Assembly for Wales would most like a block grant based on a needs assessment; while the Scottish Parliament would like that least of all the available alternatives, as it would for sure lead to a sharp cut in block grant per head to Scotland. Although the UK Government response to Calman promises to retain some block grant, the fact that it 'has no plans to review the Barnett formula' seems to rule out the sort of needs assessment recommended by Holtham.

There are subtler differences. The Holtham Commission have produced a striking map (Table 4).

[Table 4 about here]

Table 4 shows that the Scotland/England border is thinly populated; the England/Wales border is thickly populated. Almost the entire population of Wales lives within 50 miles of the English border. This has multiple implications. Relatively few people can nip over from Cornhill-on Tweed to Coldstream to take advantage of the more expensively funded services in Scotland; but millions of people can move quickly between South Wales and Bristol, between Mid Wales and Wolverhampton, or between North Wales and Liverpool. There are stark disparities between spending per head in (especially the North-East of) England and Scotland, but few people actually have a chance to shop for services. The Wales/England border is much more permeable. For instance, acute hospital services for much of Powys have traditionally been provided in Shrewsbury and Oswestry.

The map also has implications for tax devolution. As Calman said, subnational governments should not in general tax mobile tax bases. Table 4 shows that this would be especially difficult if Wales gained the power to tax mobile tax bases. Activities would move just a few miles either way across the border to take advantage of the more favourable tax regime, with zero or net negative benefit to the UK.

Devolution of income tax also presents some non-trivial problems, which Calman did not discuss, but which the Holtham Commissioners raised at a meeting with members of the Calman IEG and others (ICFFW 2009d):

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.

To this powerful point, the Calman IEG members present could only reply that the UK would already need to move to an address-based system if the SVR were ever to be implemented; and the SVR has been enshrined in statute since 1999, with a concordat in place that if the Scottish Government decided to introduce it, HM Revenue and Customs would be ready(ish).<sup>7</sup> The Calman (Vaillancourt) recommendation would not involve anything that was not already implied by the existence of the SVR.

The Scottish and Welsh recommendations could be reconciled if Scotland gains more tax devolution than Wales, but if a needs-based grant system is applied to both countries. Scotland would predictably lose grant, but could recoup lost ground by making more tax effort. George Osborne, Shadow Chancellor of the Exchequer, has made interesting comments on a recent visit to Wales, suggesting that in office the Conservatives would explore a needs assessment for the countries of the UK. The chair of the Holtham Commission promptly sent him the Commission's calculations (Barry 2010). Unless Scotland becomes independent, and/or English regions gain some devolution, UK devolution seems fated to remain both asymmetric and messy.

---

<sup>7</sup> HM Revenue & Customs (HMRC) are already obliged to maintain a list of Scottish taxpayers though its data quality needs to be improved. Only employers can fill the gap caused by taxpayers whose address HMRC does not have, and they have no particular incentive to keep their information up to date.

## References

- Alexander, W. 2008. 'Change is what we do', speech available at <http://www.wendyalexander.co.uk/speeches/change-is-what-we-do/>
- Barry, Sion (2010), "'Barnett replacement" working paper is sent to Tories', *Western Mail* 27 February. At <http://www.walesonline.co.uk/business-in-wales/business-news/2010/02/27/barnett-replacement-working-paper-is-sent-to-tories-91466-25924155/>, accessed 22.03.10.
- Bell, D.N.F. (2009). 'End of the Barnett Formula?', *Scotsman*, 8 December.
- Boadway, R. and Shah A. ed. 2007. *Intergovernmental Fiscal Transfers: Principles and Practice*. Washington DC: The World Bank
- Calman, Sir Kenneth (chair). 2009 *Serving Scotland Better: Scotland and the United Kingdom in the 21st Century*. Final Report – June 2009. At <http://www.commissiononscottishdevolution.org.uk/uploads/2009-06-12-csd-final-report-2009fb bookmarked.pdf>
- Committee for Finance and Personnel, Northern Ireland Assembly 2007. *Report on the Executive's Draft Budget 2008-2011*. At <http://www.niassembly.gov.uk/finance/2007mandate/excreport.htm>
- Curtice, J. and Seyd, B. (ed.) 2009. *Has Devolution Worked? The verdict from policy makers and the public*. Manchester: Manchester University Press.
- HM Government 2009. *Scotland's Future in the United Kingdom: building on ten years of Scottish devolution*. Cm 7738. Norwich: TSO
- HM Treasury 1979. *Needs Assessment – Report*. London: HMT.
- House of Lords *ad hoc* Select Committee on the Barnett Formula. *1<sup>st</sup> Report of Session 2008-09: The Barnett formula*. HL 139
- Independent Expert Group (IEG) 2008. *First Evidence from the Independent Expert Group to the Commission on Scottish Devolution*. Edinburgh: Heriot-Watt University.
- IEG 2009a. *Should Scottish Ministers be Able to Borrow?* Edinburgh: Heriot-Watt University.
- IEG 2009b *Natural Resource Taxation and Scottish Devolution*. Edinburgh: Heriot-Watt University.
- IEG 2009c *Final Report – The Consultation Response*. Edinburgh: Heriot-Watt University.
- Independent Commission on Funding & Finance for Wales (ICFFW). 2009a. *First report: Funding devolved government in Wales: Barnett & beyond*. Cardiff: ICFFW. At <http://wales.gov.uk/docs/icffw/report/090708barnettfullen.pdf>
- ICFFW 2009b. *Working paper: Replacing Barnett with a needs-based formula*. Cardiff: ICFFW. At <http://wales.gov.uk/docs/icffw/news/091204needsworkingpaperen.pdf>.
- ICFFW 2009c. *Socio-economic indicators: Wales, Scotland and England*. Cardiff: ICFFW. At <http://wales.gov.uk/docs/icffw/news/091119socioeconomicen.pdf>.
- ICFFW 2009d. Minutes of meeting of 21 July 2009. At <http://wales.gov.uk/docs/icffw/news/091119meetingnotesen.pdf>
- McLean, I. and Johnes, M. 2000. *Aberfan: government and disasters*. Cardiff: Welsh Academic Press.
- McLean, I. 2005. *The Fiscal Crisis of the United Kingdom*. Basingstoke: Palgrave.
- McLean, I. and McMillan, A. 2005. *State of the Union: unionism and the alternatives in the United Kingdom since 1707*. Oxford: Oxford University Press.

McLean, I, Lodge, G. and Schmuecker, K. 2008. *Fair shares? Barnett and the politics of public expenditure*. London/Newcastle: ippr/ippr north

Oates, W.E. 1999. 'An Essay on Fiscal federalism', *Journal of Economic Literature*, 37(3):1120-49.

Scottish Government 2007. *Choosing Scotland's Future: A national conversation*. Edinburgh: Scottish Government.

Scottish Government 2009. *Your Scotland Your Voice: a National Conversation*. Edinburgh: Scottish Government.

Tocqueville, Alexis de. 1945. *Democracy in America*. NY: Vintage Books Random House: first published 1838

Table 1. **Advantages and Disadvantages of a Unitary System**

**Advantages**

- 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.

**Disadvantages**

- 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

Source: IEG 2008, Part I, Table 4.1

Table 2. Applying English funding criteria to Wales: approach taken in main devolved spending areas and results

Spending area	Size of English budget 2010-11	Percentage share of total comparable English budget	Approach taken	Welsh relative need (England = 100)
Health	£108 billion	46	1. Needs based formula in existence, applied directly to Wales	114
Children, Schools & Families, Of which: <i>Schools and other DCSF programmes</i>	£60 billion	25		103
<i>16-18 Further Education</i>	£51 billion	21	1. <i>Old schools element of local government formula applied to Wales</i>	102
	£7 billion	3	3. <i>Relative numbers of 16-18 year olds in state funded education used as best available proxy</i>	106
<i>Sure Start</i>	£2 billion	1	2. <i>Unpublished needs based formula, applied indirectly</i>	114
Local Government	£25 billion	10	1. Needs based formula in existence, applied directly to Wales	132
Higher Education	£8 billion	3	3. Relative student numbers per head used as best available proxy	117
Economic development (Regional Development Agencies)	£2 billion	1	4. No published formula in use in England, spending per head on RDA in the North East of England taken as best available proxy	223
Housing: Supporting People	£2 billion	1	1. Needs based formula in existence, applied directly to Wales	145
Other areas	£33 billion	14	5. Unable to assign relative need, assumed equivalent to weighted average of spending areas for which weights have been assigned	114
<b>Total</b>	<b>£237 billion</b>	<b>100</b>		<b>114</b>

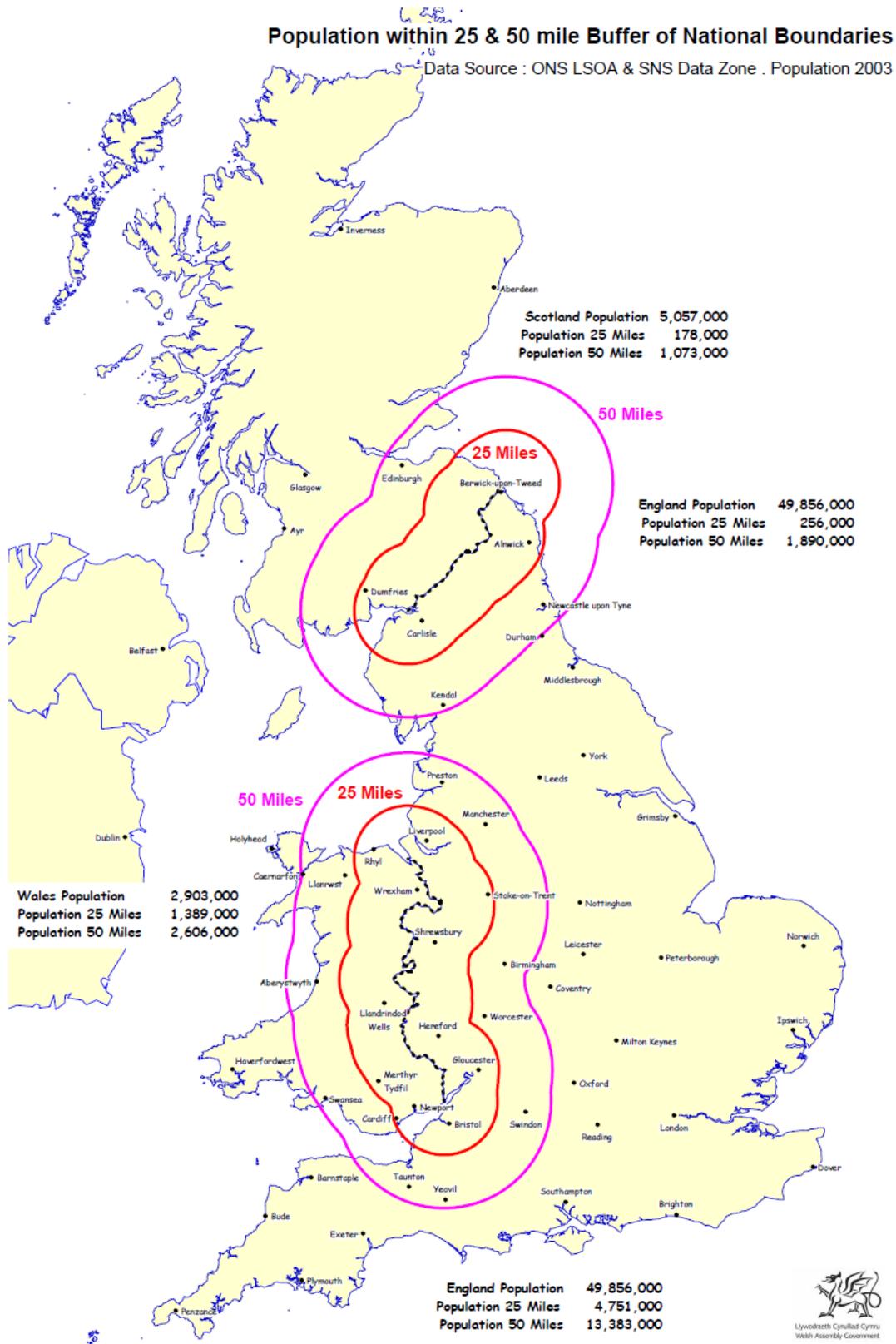
Source ICFFW 2009a, Table 4.1.

Table 3. Modelling relative need in England, Wales, and Scotland: predictors. Source: ICFFW 2009b.

	<b>Need indicator</b>	<b>Description of variable</b>	<b>Source</b>
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

Source: ICFFW 2009b, Table 1.

Table 4. Population within 25 and 50 miles of Scotland/Wales borders (Source: ICFFW 2009c)



© Welsh Assembly Government 2009. All rights reserved. Welsh Assembly Government. Licence Number: 100017916  
 wiffrwyf y Goron 2009. Cedwir pob hawl. Llywodraeth Cynulliad Cymru. Rhif trwydded 100017916

079.09-10 Produced by Cartographics, Statistical Directorate, Welsh Assembly Government  
 Cynhyrwyd gan Cartograffeg, Y Gyfarwyddiaeth Ystadegol, Llywodraeth Cynulliad Cymru