

# Financing Options for Devolved Government in the UK

James Gallagher and Daniel Hinze\*

This study provides a comprehensive overview of the financing options for devolved government in the UK. Starting with a discussion of the present situation, the consequences and the possible future of the Barnett formula, the key economic and political principles for devolution finance are examined and then applied to possible financing options. The conclusion draws together the main points of the analysis and comments on the alternatives for funding the devolved administrations.

While currently there appears to be considerable cross-party support for the Barnett system, it continues to be a contentious arrangement, with some observers even talking of a “fiscal crisis” (McLean (2005)). The paper therefore reviews the strengths and weaknesses of the present system, together with suggestions for possible changes.

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\* School of Law, University of Glasgow.

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## INTRODUCTION

Devised as a temporary, simple and administratively expedient measure in 1978 to avoid yearly arguments over the allocation of resources to Scotland, Wales and Northern Ireland, the so-called Barnett formula (or, more accurately, the Block and formula arrangement) has been determining funding allocations to the countries of the UK for a quarter of a century. Given the simplistic – and “not strictly rational”<sup>1</sup> - approach embodied in the formula, it has come under criticism from many quarters. On the one hand, the allocations under the Barnett formula are attacked for giving Scotland and Northern Ireland too many financial resources compared to some of the poorer English regions. On the other hand, the so-called Barnett squeeze is anticipated to reduce expenditure per head for the devolved administrations to the UK average in the long run, leading to claims that the devolved administrations will be underfunded, given their greater needs (engendered by lower population density, health inequalities, etc.).

But there is another, more fundamental, issue with the present system of devolution finance: the devolved administrations do not raise their own income. Scotland has the power to vary the basic rate of Income Tax (the “Tartan tax”) but it has not been used and no party proposes to do so. Local taxation is devolved, but is used in support of local council spending. Some commentators argue that this state of affairs reduces the devolved administrations’ fiscal responsibility, unduly limits the set of powers a parliament should legitimately possess and restricts the scope for devolved administrations to influence economic outcomes.<sup>2</sup> As Oates (1999, p.1120) points out: “The basic point [of decentralisation] is one of aligning responsibilities and fiscal instruments with the proper levels of government.”

This paper starts with a discussion of the present funding arrangement, its strengths, its weaknesses and possible pressures that will be brought to bear on it. After presenting the key principles of multi-level government finance, financing options for sub-central authorities are analysed. The aim is to present viable and efficient options for a funding system, including the options for appropriate revenue-raising powers for the devolved administrations, within a stable UK public finance framework.

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<sup>1</sup> In the words of Lord Barnett in his speech to the House of Lords on 7 November 2001 (Hansard column 226). The formula is irrational in that Barnett-consequential allocations bear no relation to the actual spending needs or an equalisation of resources of the devolved administrations.

<sup>2</sup> See, for example Midwinter and McVicar (1996) or Comford (1996).

## BARNETT – PAST AND PRESENT

The basic principles for the current system of devolution finance have been in place since the mid-1970s. The Barnett formula was used for the first time to determine additions to the total of the Scottish Office budget in 1979-80; it was introduced for Wales and Northern Ireland two years later. At the time of the introduction of the Barnett formula, Government also introduced the so-called “Scottish block”, which gave the Secretary of State for Scotland the freedom to allocate funds within this overall funding envelope without having to consult with Treasury on the specific allocation.<sup>3</sup>

Formula-based funding to the countries of the UK has a long history. In the 1888 budget, Chancellor Lord Goschen gave the first block grants to the administrations of Scotland and Ireland. These were based on the “general contribution of [each] country to the Exchequer”.<sup>4</sup> The funding was allocated according to the ‘Goschen proportions’ of 80:11:9 for England and Wales, Scotland, and Ireland. As McLean (2005, p.48) points out, the Irish revenue contribution of 5 per cent was significantly smaller than its funding share of 9 per cent: in formula funding Goschen found “a device for quiet redistribution: enough to alleviate grievances in the periphery but not to provoke resentment at the centre”.

While the ‘Goschen proportions’ applied to the *whole* budget, the Barnett formula only applies to *additions to* the budget. The formula-derived ‘Barnett consequentials’ are added to previous budget allocations to give total funds available to Scotland, Wales, and Northern Ireland.<sup>5</sup>

The additions to the assigned budgets<sup>6</sup> are determined by a population-based share of the increase or decrease in the comparable budgets, generally for England (the “baseline”). The principle is that a change in expenditure in England (or, in some areas, England and Wales) on a service which is devolved, results in a change in the devolved budget that is proportionate to its population share and the relative level of service provision. For example, an increase in the Transport Department’s DEL by £100 million will lead to an increase in the funding for Wales by £3.54 million ( $£100 \text{ million} \times 60.0\% \text{ (comparability factor)} \times 5.9\%$  (Welsh population as a percentage of the English population)). The comparability factor reflects the extent to which DoT spending is comparable between England and, in this case, Wales.<sup>7</sup> It is lower than 100 because sub-programme expenditure on, for example, the Strategic Rail Authority is disregarded in the funding allocation since the services provided by the Authority also cover Wales. For Scotland the ‘Barnett consequential’ would be £8.75 million (comparability factor of 86.6% and population share of 10.1%).<sup>8</sup>

Public spending in the areas of the devolved administrations is relatively high, but not all of this is comes out of the budgets of these administrations. In 2003-04, each Scottish citizen

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<sup>3</sup> This continues to be the case: the budget allocation is not hypothecated, i.e., the devolved administrations have full autonomy over their spending decisions, regardless of the departmental origin of the Barnett consequentials.

<sup>4</sup> Hansard 26.3.1888, col. 301, cited in McLean (2005, p.48).

<sup>5</sup> For an example see HM Treasury’s “*Statement of Funding Policy*” (4<sup>th</sup> edition 2004, Annex B).

<sup>6</sup> The Barnett formula applies to the major part of the Departmental Expenditure Limit (DEL) but not to Annually Managed Expenditure (AME).

<sup>7</sup> The comparability factors are detailed in HM Treasury’s “*Statement of Funding Policy*” (4<sup>th</sup> edition 2004, Annex C).

<sup>8</sup> For a more detailed description of the history and the implementation of the Barnett formula see, for example, Edmonds (2001) or Heald and McLeod (2005).

benefited from about 19 per cent more spending on identifiable services compared to the average UK citizen, Welsh identifiable per capita spending exceeded the UK average by 12 per cent and the Northern Irish by 29 per cent (see table 1). Identifiable expenditure is that part of expenditure on public services that can be identified as having been incurred to the benefit of a particular region or country of the UK; the data is collected as part of Treasury’s annual *Public Expenditure Statistical Analyses* (PESA) publication. In particular, it includes health and education spending, as well as social benefits to the residents of a region. As such, it includes large amounts that are *not part of* the Barnett allocation to the devolved administrations, but it is the most comparable source of data for overall spending in these areas.

**Table 1 Identifiable expenditure on services by country, 2003-04**

	Total		Per head	
	£ million	percentage of UK total	£	relative to UK (UK = 100)
England	296,131	80.7%	5,940	96.4
Scotland	37,152	10.1%	7,346	119.2
Wales	20,277	5.5%	6,901	112.0
Northern Ireland	13,527	3.7%	7,945	128.9
UK	367,086	100.0%	6,164	100.0

Source: Public Expenditure Statistical Analyses 2005, Tables 8.1, 8.2.

## 1 Convergence in Per Capita Spending – the Barnett ‘Squeeze’

Per capita spending in Scotland<sup>9</sup> has been significantly above the UK average over the last decades (see chart 1), although the consistent application of the Barnett formula should have led to a convergence of per capita spending on expenditure items covered by the formula (the so-called ‘Barnett squeeze’).<sup>10</sup> The Barnett squeeze should have occurred because the formula *allocates only* the comparable *per capita increases* in public spending across the UK: as the cumulative sum of these increases (which are, barring different comparability factors, the same for each resident) becomes ever larger, differences in the initial “base” grant become less relevant and per capita spending equalises.<sup>11</sup>

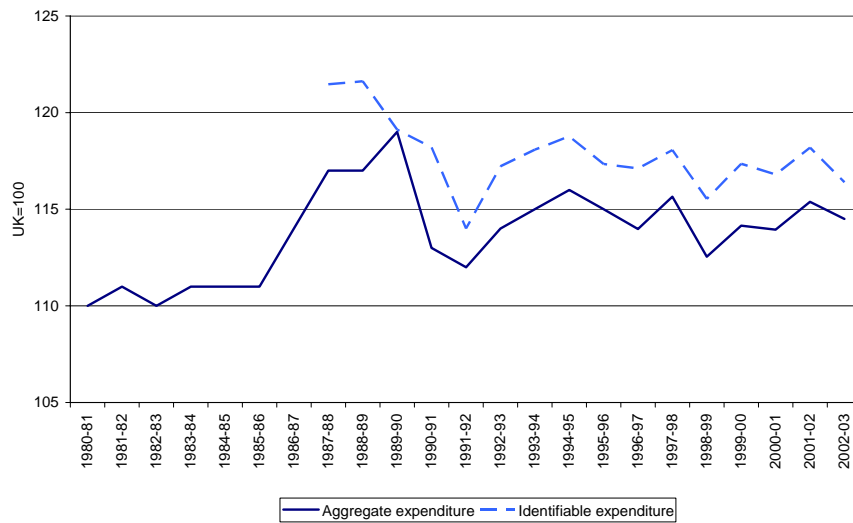
Chart 1 displays on the face of it little evidence for convergence. It shows Scottish identifiable and aggregate per capita expenditure in relation to the UK average; but both cover significantly more expenditure items than are included in the Barnett allocation. The aggregate expenditure estimate includes the share of UK-wide spending from which Scottish residents benefit – mostly apportioned by population share. The largest item of non-identifiable spending that is apportioned in this way is defence spending.

<sup>9</sup> Scotland is taken as an example here because the most comprehensive set of data is available for it, with the annual *Government Expenditure and Revenue in Scotland (GERS)* publication.

<sup>10</sup> For further discussion of the distribution of expenditure across the UK see Midwinter (2004).

<sup>11</sup> Mitchell (2002, p.6) states that the formula was introduced *with the intention* of bringing about convergence of per capita expenditure across the UK. As Midwinter (2004, p.501) points out, there is no public document or ministerial statement to confirm this intent, although it has later been interpreted as a convergence formula (e.g. by Andrew Smith MP, Chief Secretary to the Treasury on 19.07.2001 (*Hansard Commons*, col. 425), quoted in McLean and McMillan (2003, p.11)).

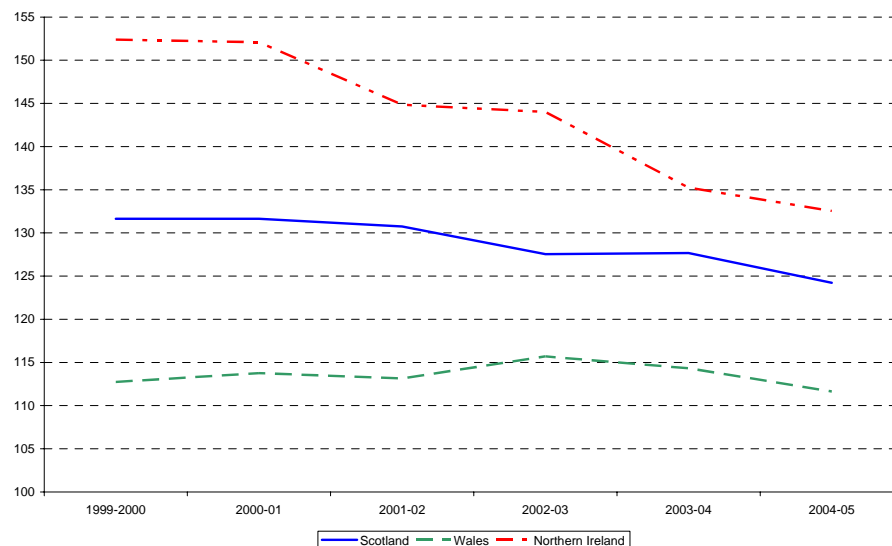
**Chart 1 Scottish per capita expenditure on services relative to the UK**



Source: GERS 2002-03

Midwinter (2004, p.508) notes that there has not been a consistent pattern of convergence on English spending levels, with “evidence of *convergence* in the case of Northern Ireland; *divergence* in the case of Wales; and *stability* in the case of Scotland”. Heald and McLeod (2005) lay out the difficulties in tracking the numerical operation of the Barnett formula post devolution, showing that the data do not allow precise estimates of convergence. Additionally, in the case of Scotland, the decline in population counteracts per capita convergence, as the funding baseline is not adjusted downwards for population reductions.<sup>12</sup>

**Chart 2 Per capita identifiable expenditure on services (excluding social protection and agriculture; England = 100)**



Source: PESA 2005, own calculations.

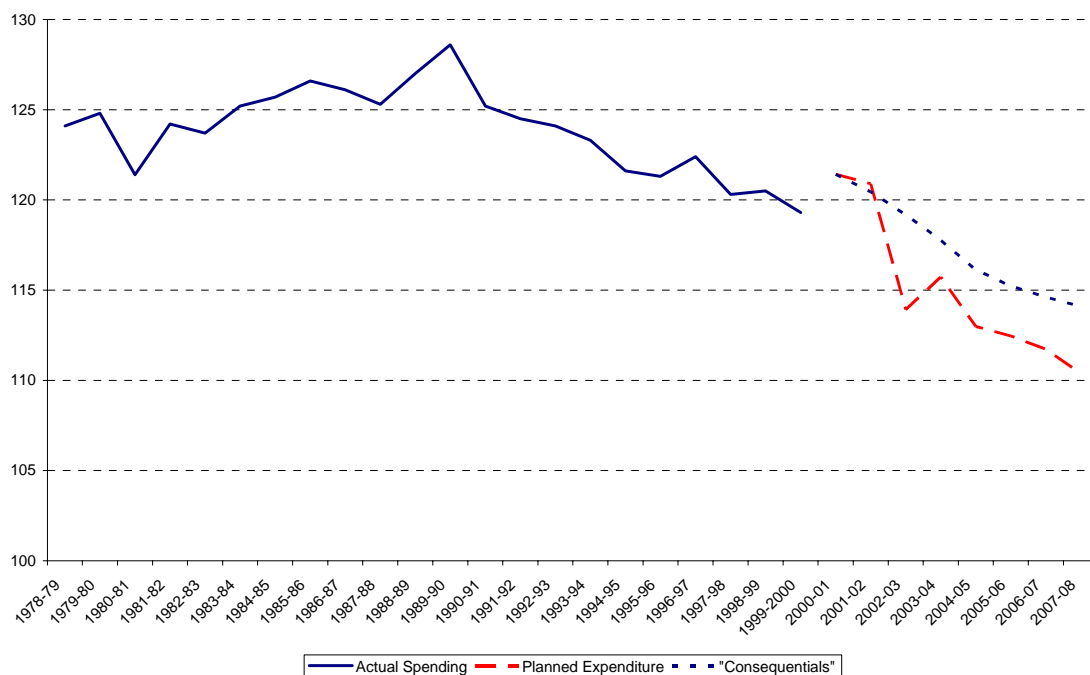
<sup>12</sup> Cuthbert (2001) demonstrates this effect: The larger the difference between population growth in Scotland and England and the lower expenditure growth, the higher the value of relative per capita expenditure to which Scotland is converging.

It is important to note that the ‘Barnett squeeze’ only applies to the assigned budgets. Spending within Annually Managed Expenditure (AME), like job seekers allowance and other social protection programmes or most of the agricultural support, is not affected by the formula and accounts for a large portion of the absolute difference in identifiable per capita spending.

Using identifiable expenditure without social protection and agriculture spending as a proxy for the devolved administrations’ assigned budgets, chart 2 shows how Northern Ireland appears to converge quite rapidly to English expenditure levels; Scotland is on a slight downward trend, while Wales holds approximately stable. Though these numbers only reflect imperfectly the Barnett-induced spending consequential they give a rough impression of the convergence trends in the three devolved administrations. What this means, of course, is that increases deriving from Barnett ‘consequential’ will always represent a smaller percentage rise for all the devolved administrations’ budgets, representing a management and budgetary challenge for them.

Strictly speaking, convergence as a concept is only applied appropriately to aggregate devolved expenditure, rather than programme spend since detailed spending plans in the devolved administrations are determined by political priorities and not the “departmental” consequential. Lacking comprehensive data on aggregate consequential, however, one can illustrate the possibly dramatic impact of convergence if one looks at comparable programme spending at a greater level of detail.

**Chart 3 Per capita expenditure on the NHS in Scotland (England = 100)**



Sources: Scottish Executive data, SR 2000, 2002, 2004 (Scotland and UK; the most recent plans have been chosen where expenditure plans overlap); own estimates of “Consequential”.

For example, comparing Scottish and English expenditure plans for the NHS over the last three Spending Reviews, the theoretical “Consequential” – which would effectively assume that the NHS spending consequential from the UK Spending Review are fully used for Scottish NHS expenditure - show a decrease in per capita expenditure by over seven percentage points in seven years. Although the estimate of the consequential is only approximate, it looks as if the effect of the Scottish Executive’s budgeting decisions was in

practice close to applying the consequentials in full. Some of the gap between theoretical consequentials and planned expenditure can be explained by the fact that some health-related expenditure in Scotland is disbursed by local authorities rather than the NHS. Comparing spending on the NHS over a longer period, one finds that a trend of per capita spending convergence becomes apparent from the beginning of the 1990s when population proportions were first updated and the Barnett formula applied more rigorously.<sup>13</sup> This convergence further accelerated from the end of the 1990s when the UK Government significantly increased spending growth. These recent developments indicate the pressures that convergence brings to bear on the devolved administrations' budgets as a whole.

## **2 Strengths and Weaknesses of the Barnett Funding System**

The Barnett-based system represents an internationally *unique solution* to intergovernmental transfers and the devolution of fiscal powers: all the revenue at the country level is determined wholly externally *and* linked to national expenditure while power over local expenditure is fully devolved. The setup keeps decisions over fiscal aggregates and stabilisation policy entirely in the hands of central government, while giving the devolved administrations unparalleled freedom to decide over their allocations within a stable overall budget envelope. This situation compares favourably with the position of the German Länder, for example, who are *assigned* parts of tax revenue, giving them spending flexibility at the cost of substantial revenue risk without being able to change rates individually. The Australian states, on the other hand, are given substantial grants but about two fifths of these are tied to specific purposes and conditions; again, in marked contrast to Barnett.

The high degree of resource dependency, however, engenders *great potential for conflict* between the devolved administrations and central government. So far this has been avoided because of the cooperative relationship between the devolved administrations and Westminster; however, given the substantial real growth in public spending over the period, conflict over budgeting might have been surprising. Investigating inter-institutional relations in the UK, the House of Lords (2002, p.15, §24) has warned that the current relationship between the devolved administration and central government are characterised by too high a degree of informality and too heavy reliance on goodwill. The report therefore recommends the introduction of formal mechanisms to facilitate relations, particularly when governments of different political persuasions have to deal with each other (p.16, §29).

Arguably, a formalised method of interaction and conflict resolution between the different levels of government is especially important when it comes to funding decisions. While the principles of Barnett funding are set down in the *Statement of Funding Policy*, there is little information publicly available about the actual Barnett consequentials. Furthermore, the extent of formula bypass (if any) is ultimately determined by the UK Treasury with no official recourse by the devolved administrations.<sup>14</sup> Even when there is little substantive

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<sup>13</sup> In the preceding period, the effect of the convergence mechanism remained limited because under volume accounting the Barnett consequential was applied to the real increase, which was far smaller than the nominal increase (for which an inflation allowance was granted). The move to cash budgeting brought about greater convergence pressure but initially the UK's budgeting process allowed for an automatic uplift in the third year of the spending plans for *all* departments, which meant effectively that the Barnett consequential applied only to the part of spending that exceeded the uplift.

<sup>14</sup> The House of Lords (2002, p.31, §102) therefore recommends that where discrete disputes arise, which cannot be resolved between Treasury and the devolved administrations, they should be referred to an independent body - that has yet to be constituted - which then makes a recommendation to Cabinet for final resolution.

formula bypass, “the complexities of the position effectively confer on the UK government a great deal of discretion over the operation of the system: notably, discretion over inter-Review additions; and over classification questions. This will leave UK governments open to the charge of manipulation, a possibility exacerbated by the general confusion in political and media circles over the operation of the system.” (Heald and McLeod, 2005, pp. 512-513)

The Barnett formula continues to attract support<sup>15</sup> and has proved to be remarkably resilient to change.<sup>16</sup> This is explained by the fact that it provides a pragmatic and stable arrangement with predictable funding allocations and considerable autonomy for the devolved administrations whose alternatives are bound to be more complex and are likely to lead to protracted negotiations and inter-institutional conflict.

Several developments could undermine the current consensus. Firstly, the resource allocation to the devolved administrations could be limited to such an extent that they would be willing to gamble on the outcome of a needs assessment or a change in the financing regime.

Secondly, greater fiscal powers could be demanded as a matter of principle, for example, when the political majorities in the devolved administrations change. As a part of the bedding down and maturing of devolution in the countries of the UK, national assemblies and parliaments might want to take on tax-raising powers that are more commensurate with their powers and responsibilities in primary legislation. Balancing the spending and revenue powers – at least partially – would be justified as encouraging greater responsibility in the budgetary process as it would introduce a further dimension of choice and make explicit the trade-off between taxation and public services.

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<sup>15</sup> Midwinter (2002, p.563) characterises the Barnett formula as a “simple, transparent and objective approach”. This view was also expressed by the then Scottish Finance Minister, Jack McConnell (2000, p.65) who sees the debate around the Barnett formula as distorted and quite pointless: “This controversy deflects efforts away from the much more worthwhile areas of public debate like how to improve efficiency in public spending [...]” He asserts (p.67) that “historically, Scotland was judged to have relatively higher spending needs than other parts of the UK and successive Governments have concluded, on the basis of a range of evidence, that this remains the case”. Furthermore, since one of the main criteria, which drive public expenditure was population, the Barnett formula provided for a fair share of increases in public expenditure. He points out that the Barnett “squeeze” is a misnomer since “what is actually happening is that English public spending levels are slowly converging upwards towards the Scottish figure”. “[... U]ltimately the distribution of resources across the UK and between political programmes is always, rightly, a matter for political judgement. [...] Barnett never has been and never will be about relative spending needs.” (p.68)

<sup>16</sup> Although, for example, the introduction of updated population proportions in the 1990s shows the capacity for adjustments to the way the formula is implemented in practice.



## PRINCIPLES FOR FINANCING DEVOLVED GOVERNMENT

The present situation in the UK is characterised by a variety of financing arrangements at all levels, which – on the whole – reflect a unitary system of government, where power is ceded from the central administration to lower levels of government, rather than a federal solution where the centre takes on only those functions that cannot effectively be fulfilled by state and local governments.

While this may seem like a rather artificial distinction of only theoretical interest it does have important practical implications. For example, the predominant use of grant financing in the UK (from the centre to the devolved administrations and then further down to the local councils) would not be acceptable in those federal states where the centre derives its legitimacy from lower levels of government rather than the converse, such as Germany or Canada.

The UK devolution settlement has the effect of reserving those functions to central government that would not be executed efficiently or equitably by lower levels of government,<sup>17</sup> most importantly, macroeconomic stabilisation, redistribution policies and social transfers, insurance functions (unemployment, incapacity),<sup>18</sup> foreign policy and defence.

One argument that is being advanced in favour of devolved government is that it can tailor public services to the particular preferences of the regional population and that it gives rise to greater policy experimentation, better long-run solutions and thus greater welfare (unless it reduces economies of scale in centralised service provision). When looking for workable solutions to devolution finance, however, one should bear in mind that the impetus for devolution was not the desire for economic betterment but for greater political self-determination and participation.<sup>19</sup>

The viability and success of a devolved system primarily depends on public acceptance that the UK Government is the right “unit of social cohesion” with responsibility for the system of national solidarity, that all levels of government are seen to be legitimate and powers are shared appropriately, and that the extent of regional transfers is perceived to be fair.

The system of UK grant finance involves the explicit (through the Formula Spending Shares of the councils) or implicit (for the devolved administrations) adherence to a UK-wide standard for spending on services. Transfers to councils from the UK Government and the devolved administrations are made by reference to assessed need, which is defined in relation to central policy aims and largely limited by the centrally determined budget allocation. Through the Barnett formula, the devolved administrations receive additional funding in direct proportion to spending increases by the UK Government – which tends to argue that

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<sup>17</sup> The Scottish devolution white paper *Scotland's Parliament* (Scottish Office 1997b, §3.2) says: “There are many matters which can be more effectively and beneficially handled on a United Kingdom basis. By preserving the integrity of the UK, the Union secures for its people participation in an economic unit which benefits business and provides access to wider markets and investment and increases prosperity for all.”

<sup>18</sup> The health service is not reserved, although it is an insurance-equivalent system that applies UK wide. The system includes a strong transfer element, given that the “premia”, i.e., taxes and national insurance contributions, are income- rather than risk-based.

<sup>19</sup> Vito Tanzi (2000) hypothesises “that decentralisation is a superior good, the demand for which is likely to grow with per capita income” (p.1) and that the “need for decentralisation may grow with the size of government” (p.2).

the underlying presumption for such a process is that the devolved administrations' policies mirror central policies, even in their budget implications.<sup>20</sup>

Clearly, there is scope for deviation from the central standard but only in so far as local own resources allow or central grants are generous enough – unless, of course, the level of provision is chosen lower than the central standard. However, there remains a tension between councils and, *a fortiori*, devolved administrations as independent entities that are democratically accountable to their respective electorates and the *external* setting of standards. Arguably both autonomy and democratic accountability are compromised when central government standards determine devolved decision-making.

The funding solution crucially depends on the distribution of powers and competencies between the different levels of government as they have been defined in the devolution settlement. The following sections set out the main principles for devolved government finance in order to provide criteria for judging possible funding alternatives. It is important to bear in mind that pursuit of some criteria (e.g., funding stability) may impair the attainment of others (like accountability). The present funding arrangement, for example, is characterised by great stability but has weak fiscal accountability of the devolved administrations.

## 1 Equity

Implicit in the way devolution has been implemented and the Barnett formula has been applied in practice is the central government's aim of equitable treatment of the UK's countries. The 1979 *Needs Assessment Study* states that

*[2.9] [i]t is a long-established principle that all areas of the United Kingdom are entitled to broadly the same level of public services and that the expenditure on them should be allocated according to their relative needs.*  
(HM Treasury, 1979, p.4)<sup>21</sup>

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<sup>20</sup> Admittedly, no "standards" are directly imposed on devolved administrations through the block grant system since the grant is not hypothecated. However, through the Barnett formula, funding allocations and thereby devolved decision-making are directly linked to UK policy decisions. Indeed the Barnett formula assumes that there are similar services provided by the public sector in each part of the UK, so that, for example, the fact that water and sewerage services are provided in England by private companies and publicly in Scotland means that borrowing by the public body Scottish Water, a charge on the Scottish Block, is not supported by consequentials from similar investment in England. Radically different methods of funding healthcare, for example, might have similar consequences and would call into question the whole basis of the system.

<sup>21</sup> Elsewhere, the equalisation of living conditions is enshrined in the constitution; for example, in Germany (the German Basic Law, Article 72(2) gives the federal government legislative powers to achieve equivalent living conditions across Germany, Articles 106 and 107 set out the arrangements for funding equalisation). The Canadian Constitution Act of 1982 (Part III) commits the Parliament and the provincial legislatures to

- (a) *promoting equal opportunities for the well-being of Canadians;*
- (b) *furthering economic development to reduce disparity in opportunities; and*
- (c) *providing essential public services of reasonable quality to all Canadians.*

as well as the

*[...] principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.*

This equalisation principle calls for horizontal equity (equal treatment of equals) by affirming each area's entitlement to "broadly the same level of public services". Additionally, it provides for vertical equity (giving priority to areas that suffer disadvantages) by demanding that expenditure take account of the needs of a particular area. Given the disparities in need and tax-generating capacity between different regions, this implies a redistribution of funds from richer to poorer areas.

Ultimately, it is people to whom the social disparities apply and not the localities in which they live. Social protection programmes provide immediate income support for neediest individuals and promote horizontal equity. Equality in, for example, education and health outcomes is achieved through policies at all levels of government, which have to be funded accordingly. Area-level funding is thus justified in terms of the equalisation objectives pursued in these policy areas, although it does not prevent possible individually inequitable uses of funds.

**Table 2: Per capita identifiable spending on services in 2003-04 (UK=100)**

	Health	Education and training	Social protection	Other	<b>Total</b>	<i>Total (excluding Social Protection)</i>
England	97.6	98.2	97.1	92.3	<b>96.4</b>	95.8
Scotland	116.0	106.9	112.7	144.1	<b>119.2</b>	123.7
Wales	107.2	101.5	114.5	119.6	<b>112.0</b>	110.1
Northern Ireland	108.9	128.2	121.7	162.1	<b>128.9</b>	134.0
<i>Memo: shares of total identifiable spending in the UK</i>	20.4%	16.7%	41.4%	21.6%	<b>100.0%</b>	58.6%

Source: Public Expenditure Statistical Analyses 2005, Tables 8.5a to 8.10b, own calculations.

As shown in table 2, per capita identifiable expenditure<sup>22</sup> on different programmes is quite disparate in the four countries of the UK. The final column excludes the direct payments to individuals that are not relevant to the budgets of the devolved administrations and gives a very approximate estimate of the budget relativities in the countries. The high per capita spending on education in Northern Ireland is explicable in terms of the larger number of children in the school system while the "other" spending category includes transport which contributes to the relatively high per capita spend in Scotland.

Although it can be argued that Treasury does indeed take resource requirements into account – particularly if it allocates resources other than via the Barnett formula as in AME – the funding system itself is not based on an explicit assessment of need. In the absence of other data, total per capita spending (excluding social security) may give a rough impression of how central government must view the relative spending needs of the UK countries. It could be argued that an assessment of needs would provide a more transparent, and arguably more objective, basis for the equitable resourcing of the devolved administrations. Options for a needs assessment are discussed at length in the section on grant finance below.

<sup>22</sup> Identifiable spending is that part of public expenditure that can be assigned to a region or country of the UK. About 81 per cent of Total Managed Expenditure is identifiable.

## 2 Autonomy within the Union

As Blow et al. (1996, p.100) point out: “[F]inancing questions cannot be considered independently of the purpose that regional government is intended to serve. The role envisaged for regional governments will determine both the scale of the resources they require and the extent to which they, themselves, should exercise control over the level of resources they receive.” In other words, the financial arrangements should reflect the status and degree of autonomy of the body financed.

Presently, the devolved administrations are largely autonomous in their spending decisions. Treasury does not apply grant earmarking, or grant matching (i.e., the provision of central grants to match local expenditure full or in part) in order to direct regional spending towards central policy objectives.<sup>23</sup> As mentioned above, this degree of sub-central spending autonomy is internationally without parallel and, in principle, affords the devolved administrations the opportunity to set spending priorities fully independently. This aspect of the Barnett system is largely taken for granted by those involved in the operation of the UK’s devolution financing system (debate has tended to concentrate on the equity of relative spending levels and, for Scotland, the question of taxation). The spending autonomy allowed is, however, a remarkable feature of the system. It has its roots in the flexibility allowed to the territorial departments under administrative devolution, but that was constrained by Cabinet’s collective responsibility. It now allows the devolved administrations a degree of spending autonomy that sub-national governments in many other nations would welcome.

Lacking (or not wishing to use) any substantial tax powers or the ability to issue debt, however, the devolved administrations have to accept the externally determined funding envelope. Given the generous supply of funds in the past, this has not impaired severely the devolved administrations’ budget autonomy. With a possible fiscal tightening Scotland, Wales and Northern Ireland may find their options to be more limited in the future.

Greater tax powers would enhance the devolved administrations’ fiscal self-sufficiency and enhance their autonomy in so far as they could choose to set the overall level of spending. At the moment, for example, the devolved administrations do not benefit from reducing spending as the savings would have to be handed back to the centre. In the implementation of greater fiscal powers, care should be taken to avoid an overlap of competencies at different levels of government, which would lead to duplication of work, ingrained institutional conflict, and limit the autonomy of the devolved administrations. If substantially greater taxation powers were granted, there would be a strong argument for a proportionate increase in borrowing powers, at least to smooth the revenue cash flow so that the UK government was not bearing all the revenue risk. The sharing of taxes/tax assignment is not a solution that materially increases autonomy, if decisions about rates and the rate structure continue to be made by central government alone.

The possible range of funding options is limited by the exigencies of the historical, political and economic union of the UK constituent countries that create a need to consider the cross-UK implications of differential tax policies and other funding mechanisms.

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<sup>23</sup> So far, Treasury has not ringfenced the Barnett consequential from UK capital spending either, although doing so may help it meet the “Golden Rule” if the devolved administrations were to devote disproportionately large funds to current rather than capital spending. One minor exception has been the additional funds, above the Barnett formula, allocated to Wales to cover receipts from the EU for Objective 1 funding, which the devolved administration matches from within the Welsh Block.

### 3 Accountability

Increasing fiscal accountability is often cited as a reason for conferring greater powers of taxation to sub-central authorities. To consolidate the decision over the benefit of greater spending and the cost of greater taxation in the hands of the appropriate authorities would achieve greater transparency of the trade-offs involved and establish clear responsibilities and it would help regional voters identify the *marginal* benefit from extra services versus the extra costs of provision (see Blow et al., 1996, p. 106). Greater accountability can thus lead to greater efficiency in the use of funds.

It is desirable that taxation and marginal spending decisions be commensurate. Where regional spending deviates from the central government “standard” it is appropriate that the *differential* spending that benefits only local citizens should be borne by them. Firstly, it is a matter of fairness that higher spending that is not a consequence of applying a common standard to an area of greater need or deprivation, but the result of local political decisions, should be financed locally. Secondly, taking spending decisions without the duty to raise the requisite funds through taxation offers the opportunity for irresponsibility.

A possible mixed system of a central equalisation grant element and a devolved tax component needs to be defined carefully in order to promote fiscal accountability. The grant needs to take into consideration the resource base and may not compensate for lower tax-raising efforts. The tax base to be devolved needs to be large enough to allow the respective administrations to pursue distinct policies and the taxes need to be ‘perceptible’<sup>24</sup> for the electorate to be aware of the costs involved.

The system of local government finance, based on a mechanism that aims to promote accountability and equity by combining a needs-based grant and a resource equalisation element with own revenue powers, serves as an example of how difficult it is to achieve an equitable allocation of funds and generate greater fiscal accountability at the local level. If resources don’t match spending needs very closely, “over-resourced” local authorities have the opportunity to offer additional services at no local cost in terms of higher council taxes, while “under-resourced” councils are forced to increase council taxes in order to provide a standard level of service. This problem is compounded where increases in the grant allocations are volatile, or deviate greatly from the changes in the costs of provision. In this case, changes in council taxes have nothing to do with local decisions “at the margin” but are brought about by central budget policy, severing the crucial link between local taxation and spending decisions.

### 4 Economic Efficiency

As mentioned above, an economic rationale offered for decentralisation is that local political decision-making promotes allocative efficiency by matching public services with local tastes.<sup>25</sup> Additionally, the matching of benefits from this local expenditure with local funding would make politicians and the electorate aware of “the true tax burden of [...] public spending, and so raise the efficiency in the use of public money” (MacDonald and Hallwood, 2004, p.12). Greater accountability thus raises efficiency as it provides information about the trade-offs involved and gives the incentive for responsible decision-making.

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<sup>24</sup> Layfield (1976, p.191, §§40, 41) stresses this point.

<sup>25</sup> Bell and Christie (2002, p.125) are sceptical of the validity of this argument in practice: “While Scots may have a strong national identity, it is not clear that their *fiscal* preferences are significantly different from those in other parts of the UK.” They point to the importance of ensuring the “*long-run effectiveness within a stable political framework*” (p.124) of any system with greater fiscal autonomy.

Furthermore, the differential setting of policies (especially taxes) can incentivise private sector investment and growth: so the devolution of tax powers might be used to foster economic development – although there is no gain across the UK if these powers are used for competitive intra-UK tax reductions. At the same time, lower levels of government have a greater incentive to implement growth-promoting policies if they see a benefit in the form of higher revenues.<sup>26</sup>

Given these positive incentive effects, one would expect that greater fiscal decentralisation generally promotes growth. However, the empirical evidence is not entirely supportive of this expectation.<sup>27</sup> The economic effects of decentralisation are far too contingent on the entire institutional framework of a specific country to be able to draw hard and fast conclusions.<sup>28</sup>

## 5 Macroeconomic Stability

Greater decentralisation of tax powers and devolved deficit spending might run counter to macroeconomic stabilisation efforts at the UK level as Treasury partly loses control over fiscal aggregates. Thus, from a Treasury perspective, there are good reasons to resist the calls for greater fiscal autonomy. Giving the devolved administrations the power to issue debt makes control over a key policy instrument far more difficult, but solely transferring tax powers might give rise to pro-cyclical spending patterns as spending varies with tax revenue.<sup>29</sup>

Treasury would rightly be concerned if the transfer of tax and borrowing powers were to lead to irresponsible and unsustainable fiscal policies in the devolved administrations, given that, ultimately, central government could not allow any devolved administration to go bankrupt and would have to bear the cost of failed fiscal policies in the countries of the UK. However, a judicious choice of tax powers combined with the right borrowing safeguards (e.g. Treasury-determined debt allocation, requirement for budget balance over the economic cycle, stabilisation grant, or others) should ensure fiscal discipline.<sup>30</sup>

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<sup>26</sup> This is particularly the case at the council level, where decision-makers will find it easier to veto controversial development projects if there is no countervailing benefit (e.g. higher revenue from non-domestic rates) to incurring voters' wrath.

<sup>27</sup> For some cross-country studies see, for example, Davoodi and Zou (1998), Woller and Phillips (1998), Martinez-Vasquez and McNab (2001), or Thießen (2003). Thießen shows that a "medium" level of fiscal decentralisation is possibly the best option – both too low and too high levels of decentralisation are associated with lower growth rates. However, according to Thießen's study, the subnational revenue share as an indicator of fiscal decentralisation has a very small and not statistically significant influence on long-term growth.

<sup>28</sup> Cuthbert and Cuthbert (2002), for example, propose that Scotland's 'chronic' economic underperformance "is intimately bound up with Scotland being part of the UK monetary union" (p.90) and short of leaving this union and gaining control over interest and exchange rates they argue that "direct action to reduce key rates is likely to be essential if Scotland, or any chronically disadvantaged area within a monetary union, is to break out of relative decline". (p.94)

<sup>29</sup> There would be a case for devolved stabilisation policies if the economic cycles between the countries of the UK differed markedly. In a monetary union like the UK where individual countries cannot respond to asymmetric macroeconomic shocks through monetary policy, there is scope for "fine-tuning" through fiscal policies. However, given the close integration of the UK economies it may be better to leave macroeconomic policy to the centre, even if the economic cycles are not perfectly correlated.

<sup>30</sup> Drummond and Mansoor (2002) find that good governance (through the use of incentives, rules and coordination among levels of government) is the primary determinant of successful macroeconomic management in a system with devolved fiscal powers.

## **6 Stability and Flexibility of Budget Planning**

Political choices government programmes ideally should not be driven from year to year by grant or tax revenue volatility. At present, the Barnett-based system, in conjunction with spending reviews that span three years, gives decision-makers in the devolved administrations considerable, indeed remarkable, planning security. Over the last years, Government has put in place measures to raise the stability and flexibility of the budget planning system. Apart from the biennial Spending Review that produces longer planning horizons, end-year flexibility in the budget allows for surpluses and shortfalls to be carried over into future years and avoid wasteful end-year spending sprees or inopportune saving efforts. This represents effective financial management within the UK government, and through the Barnett system this has applied first to the territorial departments, and now to the devolved administrations. It is another aspect of the system easily taken for granted.

Stability and reliability in funding is not only necessary for effective planning by the public sector and its private sector partners, it is also a requirement for a mature devolution settlement in which funding allocations are not set arbitrarily but are predictable and determined in a transparent manner. The provision of stability to lower levels of government also means that central government presently bears all the revenue risk. Any transfer of revenue powers will impair funding stability to some extent.

## **7 Transparency and Objectivity**

The funding arrangement should provide for maximum possible transparency so that the parties concerned can base their judgements on objective data. The present arrangement falls far short of creating transparency. Recognising these shortcomings, the House of Lords (2002, p.30, §93) recommends that:

- (a) information about changes to public spending for England should be made available in a manner that relates directly to the categories attracting consequential payments under the Barnett formula; and*
- (b) the statistics collected and made available by HM Treasury to the devolved administrations be reviewed so as to ensure the all the information needed by the devolved administrations is available to them.*

These recommendations spring from the supposition that an objective and extensive source of information is the basis for rational political decision-making and that the devolved administrations are presently somewhat excluded from central government information flows, at least when it comes to funding allocations. Any future arrangement needs to take heed of the House of Lords' recommendations in order to provide the appropriate information to devolved administrations and the electorate.

## OPTIONS FOR MULTI-LEVEL FINANCE

The finance principles laid out in the previous section help in evaluating the options for devolution finance and the trade-offs each of the possible alternatives involve. There is no “optimal” balance in the pursuit of the different principles outlined above. The extent of fiscal powersharing is fundamentally a political decision that needs to weigh up the demands of regional political autonomy against central fiscal powers and the resulting benefits and costs. Given the strong unitary tradition of the UK it is perhaps no surprise that the Barnett system has found support for such a long time, despite the criticism that has been heaped upon it.

The present settlement is characterised by a high level of stability, which reflects the history of the UK as a unitary state and which is very helpful to effective public expenditure planning in the devolved administrations. It also allows for a remarkable degree of spending autonomy. The relative opacity of the present system is not necessary and could be changed, though it might lead to some additional administrative costs of collecting and disseminating the relevant information. Given the lack of a comprehensive assessment of needs it is also unclear in how far Barnett provides for equitable expenditure shares – although needs-related funding is clearly an aim. It is, however, striking that the convergence so long asserted as a feature of Barnett has since devolution begun to take effect, so that spending on devolved services is now seems closer to the levels of relative “need” assessed in 1978 than they were at that time. The fiscal and macroeconomic stability of the Barnett system are bought at the price of limiting the devolved administrations’ fiscal powers to the expenditure side (with the exception of Scotland’s ‘Tartan tax’) and result in reduced fiscal accountability. The question is whether, as a natural progression of devolution, central control will be ceded and sub-central revenue raising powers be brought into some balance with the considerable devolved spending powers.

An obvious alternative to Barnett would be the introduction of an explicit assessment of needs and corresponding transfer payments. While a mechanistic formula cannot replace political judgement, a comprehensive assessment might give a clearer idea of the relative needs of the different countries and enhance equity in expenditure across the UK. The following section discusses the conceptual and practical challenges in assessing needs and deriving transfer allocations, looking at some relevant examples.

Even if central transfers were derived in a more objective fashion, however, needs-based grant finance does not solve the problem of accountability. The introduction of a mixed system of central grant with a significant tax component can create greater accountability ‘at the margin’ while maintaining a degree of cross-country equity in the provision of services. The penultimate section considers the taxes available and the best candidates for devolution.

A move to greater devolution of fiscal powers would reduce the stability of the system to some extent. Revenue streams to the devolved administrations would become less predictable and macroeconomic stabilisation policies might then be more difficult to pursue with tax powers divided between centre and “periphery”. In the most radical case of full fiscal autonomy, i.e., the complete transfer of tax powers without any grant support, the link between centre and periphery is severed and neither stability nor equity objectives are pursued on a UK-wide basis - the countries are essentially independent in relation to devolved matters and fully accountable for their budget decisions on them.

Any funding solution has to navigate the fundamental tensions between stability, equity and accountability. This issue will be taken up again in the conclusion, where the options for a



new devolution funding settlement are discussed in the light of the alternatives for transfer payments and tax powers.

## GRANT FINANCE

The principles for financing the devolved administrations are set out in the *Statement of Funding Policy* (HM Treasury (2004)). It states that

*[11.3] [s]ubstantial revisions to this Statement of Funding Policy would need to be preceded by a study of relative spending needs across the United Kingdom. The detailed arrangements for such a study would need to be decided at the time, but the Treasury would fully consult the Secretaries of State and devolved administrations on the arrangements.*<sup>31</sup> (p.29)

Seeing that any reform of the financing system thus will be preceded by a needs assessment exercise, this section first discusses the challenges involved in identifying and assessing the relative needs of the countries of the UK, then looks at examples of needs-based transfer finance and finally discusses the options for a future grant funding solution.

### 1 Assessing Need

The concept of “need” is not easily defined and even more difficult to apply in a practical context. Need is determined in relation to the services provided publicly and public policies pursued. The first question that arises from this is whether need should then be measured by service demand (for example, in the case of education: number of pupils), output (educational attainment), or outcomes (for example, youth employment)?

A second problem arising - once some characteristic is identified that is agreed to represent need - is the choice of the appropriate indicator. For example, is ethnicity a good indicator of need or is it preferable to use indicators like fluency in English to identify greater funding needs that might arise in a more heterogeneous population? Each indicator will map the needs characteristic in a different way and lead to a different assessment.

A third problem with the assessment of needs is the extent to which certain outcomes are the result of choice and in how far these should be taken into regard when identifying need. For example, should Welsh or Scottish bilingualism be seen as a choice or should the promotion of Welsh and Gaelic be seen as a need worthy of extra funding? Another, more controversial, example relates to health spending. The relative ill health of the Scottish population has brought about greater per capita spending than the UK average. Of course, it is clear that relatively high mortality and morbidity are (at least in substantial part) related to life style differences, and it is a nice question whether, as a matter of principle, such differences – which may be a matter of choice – should lead to resource transfers.<sup>32</sup>

McLean (2005, p.152) points out that “needs are what philosophers call ‘essentially contested’, such that no agreement on what constitutes need is possible”. In practice, methodological choices define needs and determine funding allocations. The following sections provide different examples of needs assessments to give a flavour of the complexity of the process and the extent to which subjective judgement has to be exercised.

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<sup>31</sup> The House of Lords (2002, p.32, §106) is conscious that carrying out this assessment would involve considerable tension between the devolved administrations and that impartiality will be of prime importance. Therefore it recommends (§107) that a needs assessment should be carried out by an independent and impartial body, that should reflect the views of all parts of the UK.

<sup>32</sup> Effectively, the “bad risks” would have to contribute higher premia (taxes) for national health insurance, meaning that Scottish citizens would have to pay for their costly health choices.

## 2 The 1979 Needs Assessment

In autumn 1976 it was agreed that an interdepartmental Needs Assessment Study – the first of its kind - be conducted for the four countries of the UK in order to collect information on their *relative* expenditure needs, i.e. the amounts of money needed to pursue the same policies<sup>33</sup> in different parts of the UK.

The final version of this needs assessment exercise was published in December 1979. The exercise covered the six main programmes, which were to be devolved under the Scotland and Wales Act 1978: Health and personal social services, education (excluding universities), housing, other environmental services, roads and transport (excluding railways), and law, order and protective services (excluding police).

The relative expenditure needs were assessed, using what the study called “objective” factors, by which it meant indicators *not* under direct control of the spending authority (e.g. children of school age, levels of car ownership, etc.), although some “subjective” factors (e.g. bilingualism) were also recorded.

For each of the six programmes a set of indicators was chosen to calculate the volume of services needed in each of the countries and then expressed relative to the English “standard”. The needs assessment took a relatively simple form, with a limited number of indicators per spending programme. Given the methodological and theoretical difficulties with establishing relative needs, the balance was struck in favour of intelligibility rather than sophistication.

The study concluded that Scotland required per capita spending that was 16 per cent higher than in England. The gap for Wales measured 9 per cent and 31 per cent in Northern Ireland. Actual per capita expenditure on the six programmes analysed in the study differed from the assessed needs. In 1977-78 per capita expenditure was 22 per cent higher in Scotland than in England, 6 per cent higher in Wales and 35 per cent in Northern Ireland. Edmonds (2001, p.5) comes to the conclusion that “[i]f the relative need of the regions were similar to that in [the] exercise carried out in 1979 the result would be an immediate and substantial fall in provision for all three territories”.

One important dispute arose over the measurement and relative importance of morbidity in assessing health needs. In the absence of hard morbidity measures, Standardised Mortality Ratios (SMRs) were used as a proxy indicator. Given that there is no reliable evidence about the precise numerical relationship between SMRs and morbidity-related health need, the majority view that a one-to-one relationship (i.e., one per cent extra mortality implies one per cent greater health need) should be adopted was challenged by the representatives of the Scottish Office, who suggested that a gearing of up to 3:1 might more adequately reflect differences in need.<sup>34</sup> The Scottish proposal would have raised the health needs indicator for Scotland and Northern Ireland by up to 20 percentage points relative to England, which would have considerable implications, given the size of the health budget.

Because the 1979 assessment did not have any practical consequences, its results were not discussed controversially. Its significance lies in the fact that it might quite possibly provide the basis for a future exercise.

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<sup>33</sup> The report does not clarify whether the relative spending needs refer to policy outcomes (like lower levels of social deprivation, or morbidity of the population) or to the provision of public goods (like number of hospitals). In the event, the choice of needs indicators was a mix of both.

<sup>34</sup> See HM Treasury (1979/80) *Needs Assessment Study: Programme Reports*, Volume I, Part II, pp.9, 10.

### 3 Other Examples of Needs-based Grant Finance

#### 3.1 English Local Government Grant Distribution<sup>35</sup>

An English council's *Formula Grant* is principally determined by the so-called *Formula Spending Share* (FSS).<sup>36</sup> The FSS allocates the overall grant available according to the authorities' relative needs and circumstances – with an adjustment for the councils' different tax-raising capabilities. There are separate formulae for each of the major services, as expenditure in each of the seven funding blocks (and sub-blocks) is influenced by a disparate set of factors. The seven blocks are "Education", "Personal Social Services", "Police", "Fire", "Highway Maintenance", "Environmental, Protective and Cultural Services", and "Capital Financing".

Each formula allocates the same *Basic Amount* per client (for example, primary school pupils) to each local authority. *Deprivation Top-Ups*, *Area Cost Top-Ups*, and *Other Top-Ups* allow for additional cost pressures brought about, for example, by social deprivation, local economic conditions, and rural sparsity.

There have been ongoing consultations by the Office of the Deputy Prime Minister to improve the local authority funding system. The recent move from Standard Spending Assessments to Formula Spending Shares is part of this improvement process.<sup>37</sup> It is an acknowledgement of the widespread dissatisfaction with the system. A DETR-commissioned survey by Davis and Lopata (1999) found that for an overwhelming majority of local authorities the system was hard to understand and nearly half of respondents of a telephone survey of local authority managers said that the spending assessment led to unfair outcomes. Only 15 per cent of authorities were satisfied with the system overall; the two most commonly cited reasons for low satisfaction with the system were that it was too complex, and the lack of resources it produced.

In an effort to compare local authority grant formulas across the UK, David King et al. (2005) applied the FSS approach to Scottish education spending and found that according to this approach Scotland would need about 3 per cent more per pupil than England; although they caution that the English approach may underestimate Scotland's needs, given that it does not adjust sufficiently for population sparsity. The spending on education in Scotland, distributed by the Grant Aided Expenditure (GAE) approach that is actually applied there, it is shown to be 7 per cent more generous than the FSS.

King et al. also find that there is only a modest correlation between relative education needs of the different authorities as assessed by the FSS and the GAE approaches, leading them to assert that there may be serious shortcomings in at least one approach. However, rather than showing methodological shortcomings, it might be argued that this discrepancy in assessed needs is grounded in a different understanding of need and the educational outcomes pursued. It points to the fundamental problem that there is not an objective yardstick whereby needs could be measured: needs and their assessment are a matter of interpretation and political judgement.

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<sup>35</sup> The information on the funding system is derived from ODPM (2005). England as the largest country is taken as an example here; the arrangements in Scotland, Wales and Northern Ireland are similar.

<sup>36</sup> The formula grant distribution system replaced the old system, based on Standard Spending Assessments in 2003-04.

<sup>37</sup> For a discussion of the options for improvements that were developed, see ODPM (2002).

Of course, local authorities also raise substantial and varying amounts in local taxation. So the *Formula Grant* allocation includes a resource-equalisation element that takes into account the differing council tax capacity of the local authorities. After each council's total assumed spending is determined through the FSS, the assumed council tax revenue for the year is subtracted. This revenue is calculated as the product of each authority's council tax base (the number of band D-equivalent properties) and the assumed national level of council tax. Authorities with a larger tax base thus receive comparatively less grant support, regardless of how much revenue they actually raise.

In England, council tax accounts for about a quarter of local authorities' resources; the rest is provided through Government grants (of all kinds) and redistributed business rates (together known as *Aggregate External Finance - AEF*). The largest component of AEF is the *Formula Grant*, which is made up of the Revenue Support Grant, business rates and the Police Grant. Additionally, councils receive unconditional specific formula grants which are distributed outside the main formula and ring-fenced grants that usually support services and initiatives of national priority. "Excellent" authorities are generally rewarded in the funding settlement by receiving unconditional, rather than earmarked grants.

The Government guarantees a minimum 'floor grant' increase in Formula Grant.<sup>38</sup> After the notional Formula Grant is determined as the difference between the Formula Spending Share and the assumed council tax revenue, authorities with an allocation below the floor receive additional funds. These funds are provided by scaling back the allocation to authorities whose grant increases are greater than the floor. This process is known as "floor damping".

Central government has considerable influence over local authorities' budgets. It has the power to 'cap' or limit the budget requirement for each council. In 2004-05 it capped spending (and thereby council tax increases) in 14 authorities. In priority areas like Schools it 'asks' that the full increase in Schools FSS be passed on to councils' Schools Budget. In previous years the increase in Schools FSS was greater than the whole increase in Formula Grant for some authorities, implying cuts in other spending blocks. In order to prevent this situation from arising, the overall grant increase is now at least equal to the increase in Schools FSS.

Since the overall amount of the grant is fixed, increases in benefits to one authority necessarily reduce the funds available for others. The funding arrangements are discussed in detail between local and central government representatives, but these discussions rarely result in a universally agreed solution.

As McLean (2005, p.148) notes, "the process [of measuring local authorities' spending needs] is intensely political. It is much more political than the process of setting grants to health authorities, because local authorities are elected and health authorities are not. Governments want to reward their favourite local authorities or their favourite voters."

Looking at how the grants are used, the expenditure patterns of local authorities in England, Scotland and Wales show interesting differences. For example, a key factor explaining higher Scottish expenditure levels than in England was found to be "the fact that the Local Authorities in Scotland are responsible for a higher proportion of the population than is the case south of the border. This is due to the high number of English pupils educated in grant maintained schools and the independent sector." (Scottish Office, 1997a, part III, §21). The findings of the Scottish Office study imply that an adequate distribution of grants becomes

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<sup>38</sup> With separate floors for each funding block, and for the Education FSS even sub-block floors.

more difficult to achieve through a funding formula the greater the structural differences between the funded authorities.

What is striking about the system of local government finance – and this is equally true of similar but slightly less elaborate arrangements in Scotland and Wales – is the great complexity of grant allocation to achieve aims (equity, accountability, appropriate local autonomy, stability, etc) that are similar to those for the financing of devolution. This is coupled with, in England at least, low levels of satisfaction with the system. The contrast with the simplicity of Barnett is marked.

### **3.2 English Health Finance Allocation – Weighted Capitation Formula<sup>39</sup>**

The Advisory Committee on Resource Allocation (ACRA) advises the Secretary of State for Health on the distribution of resources across primary and secondary care to ensure that these fully reflect local population need and operate as fairly as possible. Members include academics, NHS managers and GPs. The ACRA-led needs assessment informs the spending decisions by the Secretary of State. The grant will reflect wider considerations to do with the government’s overall health strategy.

The target for the resource finance allocation for the English primary care trusts (PCTs) is determined by the so-called “weighted capitation formula”. The formula covers five components of the resource allocation to primary care trusts: hospital and community health services (HCHS), prescribing (the drugs bill), general medical services (cash-limited and non-cash-limited) and the costs of dealing with HIV/AIDS.

Resources to the HCHS are allocated “on the basis of the size of population, weighted (or adjusted) according to two basic criteria:

**need** - adjustments [are] made to reflect perceived geographical differences in the need for healthcare;

**cost** - unavoidable geographical differences in the cost of providing services.” (Department of Health (2003), §11, p.9)

The objective is “to secure equal opportunity of access to healthcare for people at equal risk”. (Department of Health (2003), §10, p.8)

Age is seen as the major determining factor in the allocation of funds. For each of the components an age/cost curve is derived. Further, non-age-related “additional needs” are also taken into consideration (for example, adjustments for circulatory, musculo-skeletal and psychiatric morbidity). To take into consideration differing geographical costs a “market forces factor” (MFF) accounts for variations in labour markets, land and building costs.<sup>40</sup>

The weighted capitation targets are then derived by combining the needs and cost information for each component with the “PCT-relevant” population data (which reconciles registered GP patients with ONS population data). Including other adjustments (for rough sleepers and people with English language difficulties), a composite target is derived for each PCT. Comparing these targets with the actual allocation gives the “distance from target” (DFT) which *informs* the allocation of extra resources to PCTs that are under target.<sup>41</sup>

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<sup>39</sup> Again, England is taken as an example.

<sup>40</sup> The devolved administrations have implemented similar procedures with slight differences. Scotland, for example, does not use a Market Force Factor but adjusts for “rurality”.

<sup>41</sup> For a simplified worked example see Department of Health (2003, Appendix 12, p.74).

A far smaller fund for HCHS “operational” capital expenditure is allocated on the basis of depreciation charges and “strategic” capital expenditure through the Strategic Health Authorities is allocated on the basis of a capitation formula.

Primary Care Trusts (PCTs) receive 75 per cent of grant funding, but they are individually too small to have the capacity for making long-term planning decisions; therefore the twenty-eight Strategic Health Authorities, which replaced the district health authorities in 2002, have to fulfil this role. The direct funding of relatively small local units is aimed at promoting a ‘primary-care-led’ NHS where PCTs procure necessary health care services from other providers (hospitals, private contractors).

Pollock (2004, p.25) points to the problems that arise from this: “[...] significant downloading of risk to onto relatively small ‘risk pools’ – the pool of people who share the risk of becoming ill. If a PCT happens to have an unusually high proportion of patients who need very expensive drugs, some of these patients may have to do without, or other services will have to be reduced”. In principle, the capitation formula should reflect such differences in funding needs. However, the smaller the individual units are the greater will be demand volatility.

The details of the funding formula for health authorities are indeed very intricate – and this complexity is multiplied when it comes to determining needs for a whole range of policy areas, as the example of funding to the Australian States shows.

### **3.3 Australian Commonwealth Grant Allocation**

The Australian government provides grants to the States in the forms of specific purpose payments (SPPs) (also called ‘tied grants’) and general purpose payments (GPPs) (‘untied grants’). SPPs are payments for purposes such as health and education, on terms and conditions that the central government specifies. On the other hand, the States have full autonomy in the spending of the GPPs. The main component of GPPs is Goods and Services Tax (GST) revenue. This is distributed among the states on the basis of the calculations by the Commonwealth Grants Commission (CGC).

“The Commission’s role is to advise the Australian Government on ‘per capita relativities’ which can be used to distribute the Goods and Services Tax (GST) revenue and Health Care Grants (HCGs) among the States. The distribution of GST revenue and HCGs is intended to ensure all States have the same financial capacity to provide services to their populations. The Commission has no role in determining the amount to be distributed.” (CGC 2005a, p.1)<sup>42</sup>

The Commission’s advice is based on the principle of horizontal fiscal equalisation which states that:

*State governments should receive funding from the pool of goods and services tax revenue and health care grants such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard.*  
(CGC 2005a, p.4)

In order to determine the funding needed, the Commission measures the costs of providing services of an average standard to the states’ population (relative costs of services) and the relative revenue-raising capacity of each state.

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<sup>42</sup> In 2003–04, GST revenue and HCGs were 43 per cent of total state budget revenues (70 per cent of the total funds provided to the States by the Australian Government).

Relative costs are influenced by “use disabilities” and “cost disabilities” that are outside the states’ control. These two “disabilities” correspond to the “need” and “cost” elements in the English health capitation formula, although they are not separated as neatly by the Grants Commission. Disabilities include the socio-demographic composition (like age, sex, aboriginality, income), economic environment (as far as it affects public service provision), administrative and service delivery scale (to take account of economies of scale in service provision), input costs, as well as a number of geographical indicators (urbanisation, population dispersion, isolation).<sup>43</sup>

For each of the expense components examined (like pre-schools under the Education heading) the most relevant disabilities are considered in order to determine “standardised expenses” for each state or territory.<sup>44</sup> Each state’s per capita expenditure needs are determined as the difference between this standardised expense and the standard expense (the Australian *average* position).

To account for differences in revenue collection, standardised revenue - that revenue that would accrue if the same taxes and charges were collected at the same rates with the same level of efficiency - is calculated for each state and compared to standard or average state revenue.

The Governments of New South Wales, Victoria and Western Australia, who receive less GST revenue than their population share – thus effectively becoming ‘donor’ states - commissioned a “Review of Commonwealth-State Funding” in 2001 to support their claim that the present funding arrangements were disadvantaging them.

In its submission to the review, the New South Wales (NSW) Treasury criticises the conceptual underpinning of horizontal fiscal equalisation, as practiced by the Commonwealth Grants Commission. The fundamental concern is that the system focuses on the equalisation of fiscal capacities between states rather than individual equity.

The NSW Treasury also takes issue with the Grants Commission’s process of assessing needs as overly complex and unwieldy; thus undermining confidence in the outcomes generated. It calls for a reduced scope of the Commission’s professional judgement, providing more certainty, transparency and better supported outcomes. It sees the system undermined by the lack of a guarantee that the outcomes achieved in the individual states will address the equity issues identified as warranting subsidies. Furthermore, the grant system creates economic inefficiency by giving the wrong (purely grant-maximising) incentives to state governments and discouraging inter-state migration of labour to more productive workplaces.

According to NSW Treasury a “neutral” starting point would be to return GST revenue to each state based on its contribution to this revenue source – which, as a ‘donor’ state, would clearly benefit NSW. Where there is need for a degree of intergovernmental transfers, it should be justified with reference to demonstrable and credible needs for fiscal support. The goal of achieving interpersonal equity should best be pursued directly by the Commonwealth.

The Australian model might inspire a possible solution for the UK, with its central assessment that explicitly takes into consideration of revenue as well as need. It is striking that this assessment is undertaken by an independent referee – presumably prompted by the recognition of a possible bias of an assessment by the central executive and the difficult bargaining situation between Commonwealth and the States. Also noteworthy is the extent to

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<sup>43</sup> See CGC (2005b) Volume I, section 3.

<sup>44</sup> For the assessment results for pre-school education see CGC (2005b) Volume III, p.56-68.



which tied grants (SPPs) are used to implement Commonwealth policies. Accounting for about two fifths of the grant total, they are disbursed for specific policy purposes and are subject to individual agreements between Commonwealth and State Governments, stipulating terms and conditions to the grants. SPPs are also taken into consideration by the Grants Commission and score against GPPs. Again, the autonomy afforded by the Barnett system compares favourably to the Australian funding scheme.

#### **4 Needs-based Grant Finance in the UK: Issues**

It is clear that a system with substantial central transfers and some needs justification will continue to determine spending in the devolved administrations in the foreseeable future. In the light of the material above, we now look at the issues that have to be addressed if an explicit assessment of need were to be implemented.

The 1979 needs assessment exercise defined needs relative to the policies of the time. It does not specify, however, whether these needs refer to government output or policy outcomes. Especially with a multi-tier structure of government, it is arguably better that needs should be defined in terms of outcomes (e.g., educational attainment of the population) rather than outputs (e.g., number of hours taught) – otherwise it would not be possible to account for country-specific modes of policy delivery.

Relative needs might then be defined in terms of the difference between a standard outcome sought and the actual situation in the countries of the UK. As the report on the Needs Assessment Study points out (§3.7), however, there were few explicit standards laid down in 1979 - though those might have meant input standards as we might now call them - and this continues to be the case. This is not surprising as, firstly, there is a lack of statistical data to analyse the situation in more detail; and secondly, it is near impossible to draw clear links between provision and outcomes as specific government outputs often address multiple outcomes and specific outcomes are generally pursued using a multitude of government outputs.

The requirement to describe needs in relation to UK government policy for England (or some other common standard) means that it is essential to share an understanding of the role of the public sector across the UK. Different approaches to public policy are based on different perceptions of need and appropriate service delivery. If the role of the public sector were defined *radically* differently, needs could not be identified in a meaningful common way across the UK. For example, private provision of water and sewerage services in England means that investment in improved facilities there generates no public spending consequentials for the corresponding publicly run services in Scotland, whose borrowing is financed from the Scottish Block.

Even if a common needs standard can be agreed there is a further obstacle to finding a commonly agreed grant allocation: cost allowances for the provision of services will be determined by the assumptions on the method of delivery, which might differ significantly between different authorities, as they seek to find more efficient ways of delivering public services. This notwithstanding, a standard of delivery has to be established as well in order to arrive at a definite budget allocation.

If there is to be another needs assessment exercise across the UK, the outcome will depend on whether the English regions are represented at the negotiating table or not and in how far Treasury manages to retain its professional leadership. The devolved administrations would be well advised to direct its analytical capacity to this question well in advance of any assessment being undertaken in order to understand the relative importance of all needs measures for the determination of their funding allocation. While, for example, rural sparsity

may not be a problem in large parts of England, it is a concern especially for Scotland; ethnic diversity, on the other hand, has some impact in the devolved administrations but will be seen as a very important measure of need in significant parts of England. There are good reasons for using both indicators in an assessment of needs, but the relative weighting will skew the funding distribution in favour either of the devolved administrations or of England.

There is no objective way of agglomerating the data on the different needs indicators. It involves the weighting of radically different types of characteristics in a summary statistic that can only ever *attempt* faithfully to represent the true extent of the underlying needs. Since the needs assessment is of immediate importance for the resulting grant, any such evaluation is fraught with political controversy.

It appears useful at this point to re-examine the principles for devolution finance in the context of grant-funding in the UK.

*a. Equity of Regional Resource Distribution*

In so far as population characteristics determine needs-based grant funding, it might be said that *needs are well-defined if every authority is indifferent between losing any of its residents and accepting any other residents from other authorities in their place*. If this were not the case, the grant that results from a change in the composition of the resident population is apparently different from the costs imposed on the authority, contradicting the principle that needs and the resultant grant should be in line. Unfortunately, there is no mechanism to reveal authorities' preferences and every authority will downplay the benefits to itself and pretend that it would very much like to accept certain residents from other authorities because the needs assessment was supposedly weighed in their favour. In the absence of forced relocations no authority could ever be tested on the veracity of its assertions.<sup>45</sup>

A needs assessment establishes relative spending needs in relation to "standard" UK policy (outputs or outcomes). Seeing that the spending standard is prescribed by UK policy, grant funding from the centre seems to be a logical consequence. However, genuinely needs-based funding has yet to be implemented in the UK.<sup>46</sup> As the 1979 study showed, there were significant differences between the needs indices and the actual funding allocations.

In case the UK funding system is reviewed, the arguments advanced by New South Wales in favour of reducing the extent of interstate redistribution of resources, will possibly be repeated by the English 'contributor' regions citing the unequal distribution of funds across the UK. 'Contributor' regions to any funding system have an obvious incentive to question its fairness and if grant funding is used to support different spending patterns, according to different political priorities, a further argument is available to them.

The most radical proposal, as put forward by FitzGerald and Garnaut (2002, p.194) for General Purpose Payments (GPPs)<sup>47</sup> in their review of Australian financial relations, would be to allocate a lump sum for the minimum cost of government per country and distribute the remainder equally per capita, which would represent a significant simplification compared to

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<sup>45</sup> For a general discussion of formula funding of public services see Smith (2003).

<sup>46</sup> The House of Lords (2002, p.32, §105) envisages that any future funding alternative incorporates periodic needs assessments with formula adjustments between assessments. The grant would remain non-hypothecated. While rejecting full fiscal autonomy, the report does not comment on the desirability or extent of any additional fiscal powers.

<sup>47</sup> GPPs do not include spending on the "Health and Aged Care Program", nor on the "Education and Training Program".

a needs-based system. At the same time, such a solution would conflict with vertical equity objectives. Because of its size, England would find it much easier to allocate its funding to support disadvantaged regions, while Scotland, Wales and Northern Ireland would almost certainly receive too few funds to address their greater needs as, for example, regards health inequalities or population sparsity.

Contributor regions would possibly opt to define fairness as an equal distribution of expenditure or resources. A proper assessment of need is the only way to demonstrate the differential disadvantages of the four countries and thus make a convincing case for vertical equity.

English regional hopes of significantly changing the distribution of funds across the UK by a replacement of the Barnett formula have to be tempered by budgetary reality. Looking at the actual distribution of resources one finds that, for example, an equalisation of per capita expenditure would not bring a substantial change in the funds available for the English regions. In 2003-04, the total amount by which per capita expenditure in Scotland, Wales and Northern Ireland exceeded the UK average was £7.5 billion. This number excludes spending on social protection which is mostly entitlement-based and represents a central government obligation. Transferring all these funds to England would raise available per capita funds by £151 (or 4.3 per cent of per capita expenditure, excluding social security) – although these funds would only be available after a difficult adjustment process. Scotland, Wales and Northern Ireland are simply not large enough in relation to England for the redistribution of funds to have an immediate and substantial impact in England.

The countries (and regions) are likely to take very different positions on the definition of needs and the best ways to pursue equity across the UK. Putting the needs assessment into the hands of an independent referee could make it considerably easier to find a compromise solution.

#### *b. Autonomy*

It has already been noted that the Barnett arrangements allow for substantial autonomy. Historically, this is a consequence of the inheritance from the pre-devolution arrangements. But arguably such levels of autonomy are entirely appropriate for both a Parliament and an Assembly with primary and secondary legislative powers. Certainly that was the clear intention of the UK Parliament in creating bodies which were vehicles for the expression of national identity, and not agents of central government delivering services with limited operational autonomy.

Unconditional or block grants give the sub-central government full autonomy over its spending decisions, while conditional (earmarked, hypothecated) grants limit the devolved authorities' autonomy and make the sub-central institutions into executive organs of the central authority if the spending is too narrowly prescribed. Matching grants give an incentive for spending funds in a prescribed way but leave it up to the recipient to take advantage of the matching funds available – although the grant-giving authority can structure the conditions in such a way that the recipient has little choice but to accept unless it wanted to do without, possibly essential, funds.<sup>48</sup>

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<sup>48</sup> This method of 'moral suasion' is extensively used by the US federal government to make state governments implement its policies.

The problem is to achieve congruence between grants and needs, as the “contributor regions” would demand, while giving devolved administrations discretionary policy authority and safeguarding their autonomy.

*c. Accountability*

With grant funding there will always be a disparity in the accountability for spending and the corresponding revenue decisions. The centre is responsible for raising funds that are spent (semi-) autonomously at the sub-central level. The population may find this acceptable, as it provides for stability in the funding of the devolved administrations, which would be compromised by giving them power over their own resources – however, the populations in the contributing regions will take a slightly dimmer view of the virtues of funding stability and may stress the importance of fiscal responsibility.

If one is willing to accept greater funding instability, then a case can be made for a greater own-resource component for the devolved administrations to fund their policy choices or support the choices of their populations: It would substantially enhance accountability for marginal spending at the sub-central level beyond the, essentially devolved, tax powers like council taxes and non-domestic rates. Furthermore, the independence of devolved policy-making may arguably be compromised by relying exclusively on a central funding allocation. The scope for own resources and the accountability they might bring is discussed in the next section. Even with an own revenue component, however, grant funding can limit accountability if the allocation is very unstable - necessitating compensating tax changes - and no clear relationship between tax decisions and service provision can be established.

*d. Stability and Flexibility of Funding*

In order to provide for stability one could introduce the previous year’s grant as a floor for the following year, as the local government funding systems do. If there were any discrepancies between the grant allocation and the needs assessment these would converge over time, as the amply funded regions would experience below-average funding growth, rather than having to go through a sudden downward adjustment in their grant. To further attenuate the adjustment pressure, one could additionally introduce a growth guarantee that is linked to overall growth in the central budget (for example, at least a quarter of the growth rate of the central budget).

The stability of funding is necessary to enable a stable planning platform for public services. The example of health funding makes clear that it is important to allocate funds in a way that allows for volatility in public demand in order to be able to provide a sufficient and stable flow of public services. The smaller the unit funded, the greater the risk of unforeseen demand shifts.

The criticism of the restrictive input controls imposed for the Special Purpose Grants from the Australian Government to the States also underlines the need to provide funds in a way that gives the sub-central authorities the flexibility to “pursue their objectives efficiently” and be able to take account of “changing demographic, economic and social characteristics”. (FitzGerald and Garnaut, 2002, p.72)

*e. Objectivity, Transparency and Legitimacy of Process*

The discussion above underlines the need to provide a transparent, if necessarily not fully “objective”, assessment of need that can be understood by political decision-makers and the electorate and thus be scrutinised in a democratic process. The Australian procedure has been criticised as being overly intricate; Denmark and Sweden, on the other hand, have opted for less complex data sources and techniques in the interest of transparency and

comprehensibility. Both countries separate the grant distribution and equalization process. General grants are distributed on an equal per capita basis in the case of Sweden and in proportion to the sub-central authorities' share of the total tax base in the case of Denmark. The general grant determines the size of the aggregate level of funding. The equalization of resources, costs and needs then involves the redistribution of the individual funds and has no net effect at the national level. This procedure is felt to increase transparency and clarify the debate. In Sweden, "delegations" of academics or local politicians review the grant distribution methodology and provide their recommendations to the Ministry of Finance, which produces a report for public consultation. This report includes amendments by central government and its recommendations are usually enacted unchanged by Parliament.<sup>49</sup>

If there are to be regular needs assessments, there is a strong case for establishing an independent body, like the Australian Grants Commission, charged with assessing funding needs and proposing grant distributions.<sup>50</sup> Given that "need" is a contested concept, which cannot be defined according to some unequivocal benchmark, establishing the standards for its assessment is bound to be a complicated process, all the more if all the interested parties were locked into fractious negotiations. An independent body might greatly facilitate the establishment of needs indicators and the assessment methodology.

Heald (2003, p.90) categorically rules out the Treasury or the Cabinet Office as bodies preparing a needs assessment: "The legacy of centralised government renders these bodies unsuitable for making the judgements necessary to sustain equalisation in a decentralised polity. The results of exercises under their control would lack legitimacy."

Already in 1973, the Royal Commission on the Constitution (p. 205, §672) made a similar point when it proposed the setting up of a "small and carefully selected regional exchequer board" to "fix the standards by which regional services would be measured, and would decide how these standards should be costed from region to region."

Funding formulas would have to be reviewed regularly, with the work of the advisory commission being scrutinised by central government and the devolved administrations. It can be argued that the formula calculation should be as simple as possible – with complexity only introduced if a material change in the funding allocation can be demonstrated. While a more comprehensive and complex might improve "objectivity", it introduces the possibility of greater arbitrariness and makes the results of the assessment far more difficult to judge. The needs assessment should be seen as a solid guidepost for the grant decision rather than replacing the political decision of the final grant allocation. In doing so, the grant commission could produce a "funding band", defined by minimum standards at the lower end, indicating average spending as a guideline, and superior quality of provision at the upper end.

## **5 Options for a new Grant-based Funding Solution**

There are several processes by which transfer payments could be allocated. At the one extreme would be an entirely formula-based system, like a strict application of the Barnett formula, at the other would be a process of negotiation whereby the relevant authorities come to a collective decision. The formula - or negotiation - might deal with the whole grant or it might exclusively apply to the funding increment. Finally, the assessment of needs might take a central role in the determination of transfers – or none at all.

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<sup>49</sup> see: DETR, 2000, Annex B, pp.52-54.

<sup>50</sup> Smith (2003, p.317) gives some historical examples of how funding formulas have been skewed to fit political purposes.

McLean (2005, pp.151-159) proposes to institute a joint ministerial council to decide on the allocation of funds - either upon the recommendation of an independent commission that assesses needs, or without any reference to an explicit needs assessment. In order to alleviate the problem of an unequal distribution of bargaining power in the council McLean proposes a unanimity requirement that is backed up by an inverse GDP default rule, in case no compromise can be reached.

The default rule would allocate spending increments by the inverse of per capita GDP, thus allocating the greatest spending growth to the poorest regions. Essentially, GDP is used as a surrogate for needs. Apart from the fact that inverse GDP is not an entirely satisfactory proxy for needs, with this procedure the default rule might easily become the norm as it will prove to be difficult to find a compromise that would be better than the inverse GDP default for all areas.

A similar solution would be the institution of a body to undertake needs assessments on whose basis a ministerial decision is made – however, without unanimity requirement or default rule. It is important that the commission undertaking the needs assessment commands legitimacy and professional authority, lest its conclusions be called into question by those who feel themselves disadvantaged by its recommendations, undermining public confidence in the funding settlement. Therefore it is important that the commission be independent but also consult intensively with the devolved and central administrations on the construction of the needs index (and its updating over time).

To provide for stability in budgeting and planning – one of the main advantages of the Barnett formula - it would be preferable to use the needs assessment to derive funding increments for the devolved areas, rather than applying it to the whole funding block. This would also mitigate possible conflict between the negotiators in the ministerial council as it lowers the stakes considerably. If the need indices stayed constant over time this procedure would imply a long-run convergence of the per capita funding allocation to the relative needs index.

If the devolved administrations were to receive greater tax powers the grant would have to be adjusted for their resource capacities and the system would have to include some provision for revenue volatility. Given that, for example, the income tax share of each of the devolved administrations is significantly smaller than their population share, the grant would have to be amended to provide greater resources to areas with lower income tax bases.

Revenue volatility could be addressed in two ways. Firstly, the centre could guarantee income streams based on estimates of future tax revenues. While this would not compensate for possible shortfalls in income, it would introduce a “resource floor” and greatly aid budget planning in the devolved administrations. Secondly, there would possibly need to be established a facility to smooth revenue streams in order to achieve income stability. Again, central government could provide an automatic stabilisation payment determined by the difference between the “standard” resource capacity of the authority and actual revenue, which would be repaid in times of above-average tax revenues. Alternatively, the devolved administrations could be given the power to raise debts to smooth volatile income streams.

As mentioned before, any solution that gives the devolved administrations borrowing powers introduces a moral hazard; central government will not be able to avoid having to guarantee the debts of the devolved administration. Freed of the ultimate responsibility for its debts an administration might then follow a course that is not fiscally sound. Government will therefore insist on narrowly prescribed powers that limit the extent of deficit finance.

## TAX REVENUE

Having examined the options for grant finance, this section now moves on to discuss alternatives for autonomous sources of revenue. Of course, grant and tax finance are not mutually exclusive and a future funding solution may combine both.

The introduction of tax powers for the devolved administrations should be based on four main principles:

1. The devolved tax should be as simple and efficient to administer as possible (for taxpayers and the receiving authority);
2. The tax system should give the right economic incentives and be fair to taxpayers. The devolution of taxes should not introduce perverse incentives but, where possible, enhance the economic efficiency of the system;
3. Their introduction should raise fiscal responsibility/accountability – which implies that they have to be substantial enough to bear the strain of differential spending decisions; and
4. Taxes should be “perceptible”, i.e., the electorate should be aware of the tax decision and clear about the impact a change in taxes will have in order to achieve accountability.

The efficient administration will help creating public acceptance or even support for a change in the tax system, a simple system helps in reducing compliance costs and limiting avoidance and fraud. Greater accountability is the primary political argument for giving devolved administrations more fiscal powers, and providing the right economic incentives is the touchstone of an efficient tax system. One cannot define objectively the fairness of taxes; it touches on people’s ability to pay and also the benefit they derive from the public services provided. The tax base should be broad enough to establish the link between taxpayer and public services.

Apart from being a source of revenue, taxes provide the opportunity for implementing macroeconomic and distributive policies. Indeed, one argument often advanced in favour of greater tax decentralisation is the opportunity for sub-central authorities to foster growth by lowering tax rates (*and* possibly reducing the size of the public sector). Many studies find a connection between lower tax burden and higher economic growth (e.g. Engen and Skinner (1996) for the US). Many of these studies analyse the impact of lower tax rates on economic behaviour (labour supply, investment demand, consumption demand, etc.) while largely neglecting the implications of lower resource availability for the public sector. We should expect lower taxes to have a stimulating effect on private-sector activity; however, countries with low overall tax revenues and government activity do not necessarily produce higher growth rates.

**Table 3: Size of the public sector, subnational share of revenue and growth rates**

	Total tax revenue as percentage of GDP (2002)	State and local tax revenue as percentage share of total tax revenues (2002)	Annual growth rate of real GDP (average 1998-2003, in per cent)
Australia	31.5	18.3	3.3
Canada	33.9	44.0	3.6
Germany	36.0	28.8	1.1
Japan	25.8	26.0	1.1
Sweden	50.2	32.1	2.7
<b>United Kingdom</b>	<b>35.8</b>	<b>4.5</b>	<b>2.6</b>
United States	26.4	33.8	2.8

Sources: OECD Revenue Statistics 2004 (tables A, E); OECD national accounts.

Looking at the large variation of growth rates in table 3, which appears to bear no relation to the importance of the public sector (measured by the ratio of public revenue to GDP), it would seem that what matters is the appropriateness of public institutions to provide the right environment<sup>51</sup> for promoting productivity and competitiveness in the private sector, quite independently of the overall size of the public sector. It might therefore be overly optimistic to envisage devolved tax powers as in itself the primary solution for generating greater growth.

Tax policy plays a central role in the redistribution of income. For example, higher-rate income taxpayers, who account for 12 per cent of taxpayers, shoulder 53 per cent of the income tax burden (see table 5). There are good grounds to leave distributive policies in the hands of the central authority rather than transferring them to the devolved administrations. A fair distribution of income should be achieved at the level of the union, where the national system of solidarity is administered, ensuring the equitable treatment of all citizens. That is the basis of the UK social security system.

The UK has one of the most centralised tax systems in the world and relies primarily on grant finance as a means of providing revenue to sub-central levels of government.<sup>52</sup> Decentralisation of taxation control can range from autonomy, where the sub-central authority may define the tax base and set tax rates independently, to a tax-sharing solution where tax revenue is assigned to the different levels of government with the power to set tax base and rates reserved to central government.

Devolved authorities have little to gain from moving from grant finance to a system of tax assignment<sup>53</sup> with central rate setting - apart from greater revenue risk – unless the assigned revenue were to be greater than the grant, which is unlikely.<sup>54</sup> Appropriate tax-setting powers

<sup>51</sup> It is arguable that, for example, social cohesion is an important environmental factor which influences - amongst other things - citizens' outlook, risk-taking attitudes and motivation.

<sup>52</sup> One should be cautious in the interpretation of the local tax share as representing a measure of fiscal autonomy; in many countries tax revenues are shared between different levels of government with the central government retaining responsibility for setting rates and tax bases. For international comparisons of fiscal arrangements countries see Darby et al. (2002, 2003), Ebel and Yilmaz (2002) or Joumard and Kongsrud (2003).

<sup>53</sup> Whereby sub-central authorities are assigned a share of total tax revenue.

<sup>54</sup> Possible gains could be made, however, if tax sharing gave the devolved administration an incentive to promote economic growth in order to raise revenue.



are indispensable for achieving greater fiscal accountability at a sub-central level. At the same time, the devolution of taxation can give rise to a host of problems: legal and illegal tax avoidance where tax differentials between regions arise, with negative effects on the availability of funds and economic efficiency; tax competition; greater complexity of the system; and possibly higher costs of tax collection. Devolved powers to define tax bases and tax thresholds can considerably complicate the system.

Tax avoidance occurs when a mobile tax base shifts to regions with the lowest rates. The pursuit of this tax base, in turn, may lead to tax competition between authorities and a further diversion of income, profits and trade. The tendency towards tax avoidance is counterbalanced where tax payers see the connection between tax burden and the benefits in terms of a better quality of public services.

When the same tax base is shared, sub-central decisions interfere with central government policy, or vice versa. For example, the progressivity of the tax schedule may be changed as sub-central authorities, without responsibility for distribution policy, may not take into regard the distributional impact of their decisions.

The problems outlined above limit the desirable extent of the devolution of tax powers within the UK. The following sections will look at the main taxes and the possibilities for granting sub-central government greater revenue powers.

## 1 UK Tax System and Revenues

Adam (2004) provides an overview of the UK tax system. Table 4 shows UK tax revenues by source and their relative importance.

**Table 4: UK Government Revenue, 2005-06 (projections)**

Source	2005-06 (£ billion)	As a percentage of total current revenue
Income tax (gross of tax credits)	138.1	28.4
National Insurance Contributions	82.6	17.0
Value added tax	76.3	15.7
Fuel duties	24.6	5.1
Tobacco duties	8.4	1.7
Alcohol duties	8.2	1.7
Betting and gaming duties	1.4	0.3
Air passenger duty	1.0	0.2
Vehicle excise duties	5.1	1.0
Insurance premium tax	2.6	0.5
Landfill tax	0.7	0.1
Climate change levy	0.8	0.2
Aggregates levy	0.3	0.1
Customs duties and levies	2.2	0.5
Corporation tax	43.7	9.0
Petroleum revenue tax	1.5	0.3
Capital gains tax	3.0	0.6
Inheritance tax	3.4	0.7
Stamp duties	9.7	2.0
Business rates	19.4	4.0
Council tax	20.9	4.3
Other taxes and royalties	12.4	2.5
Interest and dividends	4.9	1.0
Tax credits, accrual adjustments, other receipts and adjustments	15.5	3.2
<b>Current receipts</b>	<b>486.7</b>	<b>100.0</b>
<i>Memo: North Sea revenues<sup>1</sup></i>	<i>7.1</i>	<i>1.5</i>

Source: Budget 2005 (table C8, p.250).

Note: **1** Consists of North Sea corporation tax, petroleum revenue tax and royalties.

On the basis of administrative efficiency, amounts raised, stability and predictability of yield, Blow, Hall and Smith (1996, p.114) proposed that there are “three candidates for a regional tax, [namely] income tax, VAT (or, more generally, a sales tax) and a regional assignment of the national non-domestic rate (‘business rates’)”. Non-domestic rates have since been devolved. The following sections will look at the main contenders for contributing to devolved revenues, at the economic and administrative (in)efficiencies further fiscal devolution would produce and possible yield and revenue risk.

## 2 Income Tax

Muscatelli (2001, p.34) sees personal income taxation as “the most promising form of devolved taxation”. As it makes up 28% of total tax revenue and is linked to individuals it is a source of revenue that is both substantial enough and provides the connection between tax burden and individual benefit at the local level.<sup>55</sup> Furthermore, it is highly predictable.

### *a. Economic and administrative efficiency*

The introduction of a devolved income tax element is made difficult by two main factors:

- the UK PAYE (pay as you earn) system of collecting tax revenue from labour income is employer-based rather than relying on residence-based records of individual taxpayers; and
- for many taxpayers there is no information available on total income as, for example interest income is taxed at source.

Moving towards a devolved income tax would require administrative adjustments, especially the inclusion of domicile information in HM Revenue and Customs records and the PAYE system. A simple solution would be to require employers to collect this information for PAYE (proof of residence provided by the employee through a council tax slip or equivalent council confirmation). This, of course, would have to include a provision for self-employed taxpayers who are not included in the PAYE system. Where taxpayers do not fill in tax returns, it will not be possible to distribute all taxes on non-employment income to the regions, unless the deductions at source are also attributed by residence of the taxpayer.

Different income tax liabilities may lead to some migration, especially in border regions, as taxpayers seek out areas with a lower tax burden – although higher taxes may also entail immigration despite the greater burden, if they pay for an attractive array of public services.

As the most radical option, income taxes (and national insurance contributions) could be fully devolved – allowances, bands and rates – essentially introducing separate income tax systems in Scotland, Wales, Northern Ireland, and England. This would entail setting up three additional tax authorities to administer the new system (or an equivalent reorganisation within HMRC) and raise the cost of tax administration. In principle, child and working tax credits could continue to be determined at the national level, as they are not directly linked to income taxes; the introduction of different allowances and starting rates can then be used to vary disposable income at the bottom of the range in line with regional distributional objectives.

However, given that those taxpayers who are liable to pay only the starting rate contribute less than one per cent to total income tax revenue and that social tax credits are calibrated to support the most vulnerable within the present system, the devolution of personal allowances, the starting rate band, and the starting rate would seem to cause far too severe disruption and administrative cost than is justified in terms of additional devolved revenue.

This leaves three parameters as serious contenders for devolution: basic rates, higher rates and the basic-rate limit/higher-rate threshold. If we accept the premise that distribution policies should be the preserve of central government and that income taxes are the major instrument to implement those policies, then the devolution of income tax thresholds appears

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<sup>55</sup> For a readable, if in parts somewhat dated discussion of options for local income tax in the UK, see Kay and Smith (1988).

questionable. However, it is unavoidable that the progressiveness of the tax structure would be modified if the devolved authorities changed basic or higher rates individually.

To avoid extreme changes in the tax distribution, one could envisage limiting the extent of permissible variation to a specified band – as is presently the case with the Scottish Parliament’s power to vary the basic rate by up to three pence in the pound. Raising (lowering) basic rates is a regressive (progressive) tax measure, as higher rate taxpayers contribute additional funds only up to the basic-rate limit and continue to pay the same tax for income above the higher-rate threshold.

A straightforward solution to avoid major changes to the distribution of disposable income would be a regional percentage surcharge on the individual tax burden.<sup>56</sup> This would imply that the greater part of the additional revenue would be reaped from higher-rate payers. As Heald and Geaughan (1997, p.344) point out, however, this might lead to higher-rate payers leaving high-tax areas.

*b. Yield and Revenue Risk*

Using HM Revenue and Customs data, one can estimate how tax yields would be distributed amongst taxpayers for changes in the basic rate and a regional surcharge (the surcharge of 2.75 per cent is chosen to approximately equalise total revenue for the two alternatives).

**Table 5: UK income on earnings - tax distribution and yield, 2005-06 (projections)**

Group of taxpayers <sup>1</sup>	Number, 000s (per cent of total)	Tax liability on earnings, £m (per cent of total)	Yield from 1 percentage point increase in basic rate, £m (per cent of total)	Yield from 2.75 per cent surcharge on individual tax liabilities, £m (per cent of total)
Starting-rate	4,310 (14.1%)	345 (0.3%)	-	10 (0.3%)
Basic-rate	22,600 (74.1%)	57,630 (46.6%)	2,410 (70.2%)	1,590 (46.6%)
Higher-rate	3,560 (11.7%)	65,830 (53.2%)	1,020 (29.8%)	1,810 (53.2%)
<b>Total</b>	<b>30,500 (100%)</b>	<b>123,800<sup>2</sup> (100%)</b>	<b>3,430<sup>3</sup> (100%)</b>	<b>3,410 (100%)</b>

Sources: HM Revenue and Customs, *Income Tax Statistics and Distributions* (tables 2.1, 2.6), [http://www.hmrc.gov.uk/stats/income\\_tax/menu.htm](http://www.hmrc.gov.uk/stats/income_tax/menu.htm); own estimates on yields.

Notes: **1** By taxpayers’ maximal marginal rate. - **2** Including taxes on savings income and dividends would increase total tax liability by 8 per cent (9.9 billion). – **3** This corresponds to the 3.4 billion estimate reported in HM Treasury’s *Tax ready reckoner* (PBR 2004, associated documents).

As opposed to the increase of the basic rate, the surcharge would raise the burden for the taxpayers who exclusively pay the starting rate (but only by about £2 and 8 pence per average taxpayer per year). The regressive nature of an increase in the basic rate translates into differing yields for the countries of the UK. England has a greater share of tax yield from higher-rate payers than its overall tax share. The additional amount raised in England from an increase in the basic rate is actually smaller than for the 2.75% surcharge, while total UK yield is slightly higher. The increase in the basic rate yields relatively more in Scotland, Wales and Northern Ireland because a greater burden is shouldered by basic-rate taxpayers. While 11 percent of taxpayers paid higher rates in England in 2002-03, only 8.7 percent did so in Scotland, 6.1 percent in Wales and 7.0 percent in Northern Ireland.

<sup>56</sup> It is not entirely possible to avoid changing the distributional impact of a regional tax; this proposal would raise the progressiveness of the present system to some extent (or lower it if the surcharge were to be negative, i.e., a rebate). However, the basic distributional decisions on thresholds and rates still lie entirely with central government. Such a system could also be amended relatively easily to allow for a local income tax element.

**Table 6: Country yield from income tax on earnings, 2005-06 (estimates)**

Country	Yield from 1 percentage point increase in basic rate, £m (per head of population; UK = 100)	Yield from 2.75 per cent surcharge on individual tax liabilities, £m (per head of population; UK = 100)
England	2,950 (103)	2,990 (105)
Scotland	270 (93)	250 (87)
Wales	140 (83)	110 (65)
Northern Ireland	70 (71)	60 (62)
<b>UK</b>	<b>3,430 (100)</b>	<b>3,410 (100)</b>

Source for estimates: as in table 5 and HM Revenue and Customs, *Income Tax Statistics and Distributions* (table 3.11, 2002-03) [http://www.hmrc.gov.uk/stats/income\\_tax/menu.htm](http://www.hmrc.gov.uk/stats/income_tax/menu.htm); using country tax revenue for 2002-03 (by rough income tax band and total tax) to estimate country shares.

The concern that possibly highly mobile higher-rate taxpayers will leave areas that put a disproportionate burden on them is not to be underrated. Furthermore, as Heald and Geaghan (1997, p.344) note, “[t]he higher rate tax revenue goes into the United Kingdom pool of resources from which [...] the assigned [...] budget [is drawn]”, thus already contributing to the cross-country redistribution of income. Despite its implications for the progressiveness of the tax system, the basic rate of income tax therefore appears to be the central lever for the devolution of tax powers.

The powers that are presently devolved to the Scottish Parliament could be extended to elsewhere in the UK and modified to provide a more substantial tax source. For example, power over a quarter to half of basic-rate revenue could be transferred directly to the devolved administrations, essentially giving them between 5.5 and 11 percentage points of the basic rate of 22 percent, with the power to increase the rate by up to 3 or 4 percentage points (or reduce their portion to zero). Handing over a share of income tax revenue - and the corresponding rates - to the devolved administrations would make the trade-off between taxes and expenditure more evident for politicians and the electorate, which should promote greater accountability.

As the data in table 7 shows, the devolution of half of basic-rate receipts would account for more than an eighth of the Scottish and Welsh block grant and about ten per cent in the case of Northern Ireland.

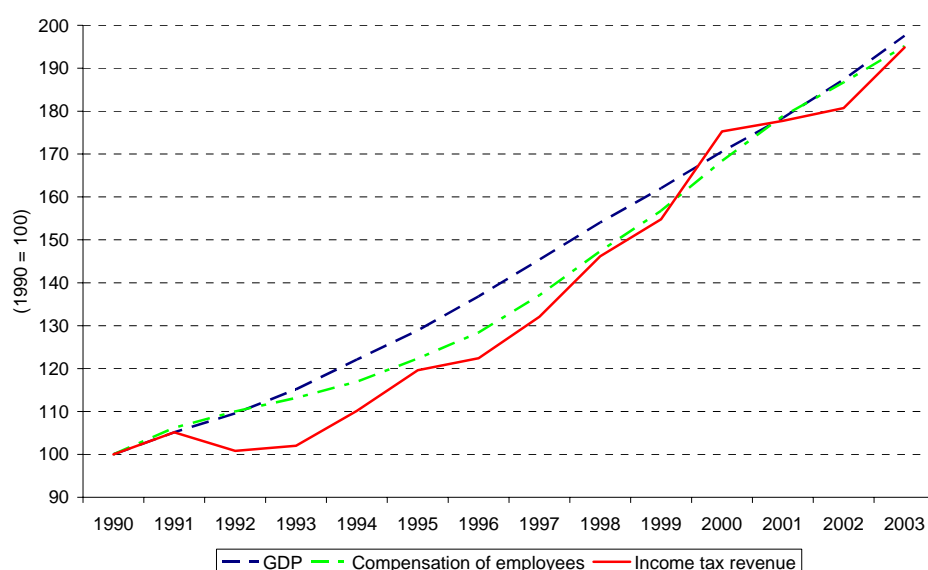
**Table 7: Income tax yield and Block funding by country, 2005-06 (estimates)**

Country	Yield from devolving 11 percentage points of the basic rate, £bn	Departmental Expenditure Limits of the devolved administrations, £bn (SR 2004)
Scotland	3.0	22.8
Wales	1.5	11.8
Northern Ireland	0.7	7.4

Sources: as table 6 and Spending Review 2004 (chapter 23, p. 179)

The main revenue risk with this source of tax is connected to the uncertainties of the economic cycle. Revenues should follow earnings (and GDP) closely. It can be seen from chart 4, however, that this was not the case. In the past, changes by the UK Government to the tax system introduced far greater revenue volatility.

**Chart 4 Nominal GDP, Compensation of employees and Income tax revenue in the UK**



Sources: OECD national accounts and HM Revenue and Customs, *Income Tax Statistics and Distributions* (table 2.4), [http://www.hmrc.gov.uk/stats/income\\_tax/menu.htm](http://www.hmrc.gov.uk/stats/income_tax/menu.htm).

### 3 VAT, Sales Tax and other Indirect Taxes

Given the substantial amounts raised through Value Added Tax (15 per cent of total tax revenue) and the fact it is more broadly spread across the population than income tax, it would seem that a local VAT rates or a retail sales tax could be a good source for devolved revenue.<sup>57</sup>

A devolved Value Added Tax would be complex to administer both for businesses and the tax authorities. VAT deductions on inputs would vary by supplier and large businesses with plants across the UK can nominally shift the bulk of value added to low-VAT areas, through the adjustment of intra-business transfer pricing. Most of these problems can be avoided if the tax were only imposed on final sales to consumers (possibly as a surcharge or rebate on the basic VAT rate).

**Table 8: Yield from a 1 per cent increase in VAT (2005-06)**

Country	Yield, £m (per head of population; UK = 100)
England	3,790 (102)
Scotland	350 (93)
Wales	190 (86)
Northern Ireland	110 (86)
<b>UK</b>	<b>4,450 (100)</b>

Sources: UK yield of 1 percent increase in reduced and standard rates (5% and 17.5%) from HM Treasury's *Tax ready reckoner* (PBR 2004, associated documents; [http://www.hm-treasury.gov.uk/media/8F5/9F/pbr04tax\\_ready\\_182.pdf](http://www.hm-treasury.gov.uk/media/8F5/9F/pbr04tax_ready_182.pdf)). Country yields attributed according to their shares of total household expenditure, derived from ONS, *Family Spending: A report on the 2003-04 Expenditure and Food Survey* (table A35) [http://www.statistics.gov.uk/downloads/theme\\_social/Family\\_Spending\\_2003-04/FamilySpending2003-04.pdf](http://www.statistics.gov.uk/downloads/theme_social/Family_Spending_2003-04/FamilySpending2003-04.pdf).

<sup>57</sup> Hall and Smith (1995) provide a detailed assessment of the feasibility of local sales taxation in the UK.

The imposition of differential sales taxes (or VAT) will lead to change in the geographical pattern of consumer spending and economically inefficient sales tourism (at the moment, consumers from the south of the UK already purchase considerable amounts of alcohol in France). The same holds true for other indirect taxes.<sup>58</sup>

When the travel cost of buying in a low-tax area exceeds the tax savings, tax differentials will not have a greatly detrimental impact. But if the tax differentials have to be kept small to avoid the displacement of local consumption, the tax cannot achieve the aim of serving as a truly autonomous source of revenue.

Given the geographical proximity of the countries of the UK and their economic interconnectedness only small variations in indirect taxes would be possible, raising little extra revenue but imposing additional administrative complexities that would not seem to be justified. Furthermore, the lowering of VAT rates below the EU-wide floor of 15 per cent would require derogation from the European Union.<sup>59</sup>

#### **4 Taxes on Real Estate**

Taxes on real estate are the most appropriate sources of revenue for devolved or local government, as the tax base is immobile and they therefore create the least economic disincentive effects. Council tax on private property is in the hands of local authorities and the power to set non-domestic rates on commercial properties has been given to the devolved administrations and should be regarded as part of the devolution funding package.<sup>60</sup> The third UK tax on property, namely stamp duty, is another clear candidate as a devolved or local revenue source.

Since the devolved administrations give Revenue Support Grants to their local authorities, and their budget is thus affected by local tax revenue, a discussion on these taxes is included here. Furthermore, the design of the different tax systems could also be modified by the devolved administrations to improve the efficiency of the system and adjust it to their particular circumstances.

##### *a. Council tax*

Council tax represents 4.3 per cent of total UK tax revenue. It accounts for about a fifth of the funds available to local authorities, the rest being made up of Revenue Support and special government grants. The main criticism of council tax has been levelled at its regressive nature: that the eight council tax bands do not allow for sufficient differentiation of the tax burden between poorer and richer occupiers and second (or third) properties are taxed at lower rates. This perceived unfairness is one major factor for some to call for the abolition of the council tax and its replacement by a local income tax.

However, this does not seem to be a good enough reason to abolish a tax that creates an immediate link between residency and tax burden for local services. While the council tax may not be felt to be sufficiently progressive, the system has a number of flexibilities which have not been exercised. Firstly, all properties (occupied, second homes, or unoccupied)

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<sup>58</sup> For example, the aggregates levy had to be lowered in Northern Ireland because supply from south of the border displaced local production.

<sup>59</sup> This would entail unanimous agreement by the member states and set a precedent that would run counter to EU-wide harmonisation efforts.

<sup>60</sup> Northern Ireland operates a slightly different system from the rest of the UK. It has regional domestic and non-domestic rates and locally varying district rates. Regional rate revenue supports expenditure by Northern Ireland Government departments.

could be made liable to council tax at the full rate as a standard; councils already have the option of charging full council tax on second homes. Secondly, a greater differentiation of council tax bands or rates directly proportional to the value of the property would make the system more progressive. And finally, property revaluations would have to be undertaken on a regular basis to keep in step with regional price changes. The reluctance to adjust property values by administrations across the UK reflects the political difficulty of re-banding properties, given that the difference in relative values has grown considerably over the years and that there will be a significant number of people living in booming areas who will be subject to significantly higher council taxes. If tax revenue is held constant there will be a similar number of people with lower liabilities who, however, are unlikely counterbalance the political pressure from the “losers” of the revaluation. A regular revaluation would circumvent the adjustment problems that get more severe the longer the re-banding is postponed.

The council tax provides a measure of flexibility to local authorities that should possibly not be reduced by transferring council tax powers to the devolved administrations, which - through the grants they provide - already have considerable influence over the rates that councils set: Where the support grant is insufficient to meet greater expenditure, local authorities have little choice but to raise council tax rates. From 1997-98 to 2002-03 the growth in council tax revenue was significantly higher than the rate of inflation. Over the course of these five years English council tax revenue rose by 46 per cent, while total grant income rose by just 34 per cent (Revenue Support Grant by 7 per cent and business rate revenue by 38 per cent).<sup>61</sup>

Table 9 shows the increase in the average council tax (Band D) for England, Wales and Scotland over the course of eight years; the Northern Irish domestic rates are not shown as they are not fully comparable. The data demonstrates marked differences in growth rates which point to significant differences in the grants supplied to the local authorities.

**Table 9: Council taxes**

Country	Average Council Tax (Band D) 2004-05, £	Increase in Average Council Tax (Band D) 1996-97 to 2004-05
England	1,167	80.7%
Scotland	1,053	48.7%
Wales	887	92.0%

Sources: ODPM (Statistical Release 23 March 2005, Table 5; <http://www.local.odpm.gov.uk/finance/ctax/data/starel.pdf>); National Assembly for Wales (<http://www.wales.gov.uk/keypubstatisticsforwalesfigures/content/local-gov/tax.htm>); Scottish Executive (Local Government Finance Statistics 2003-04, Table S3; <http://www.scotland.gov.uk/Resource/Doc/933/0009479.xls>)

There is a clear tension between local councils and the grant-giving authority. Councils will portray higher expenditure and higher council taxes as engendered by greater demand for their services, market forces, higher standards in service provision demanded by the superior authorities and a general undersupply of grant income. The grant-giving authority will demand greater efficiency in service provision in order to keep council tax increases under control. As possible pressure from higher council taxes falls predominantly on local politicians there will be a tendency to limit increases in central grants - until the council tax burden is felt to have become so onerous as to necessitate a rebalancing of grant and council tax income.

<sup>61</sup> From: Local Government Financial Statistics England No.15 (2004, table 2.1a, p.35).



The devolved administrations also have to take into consideration in how far council taxes change in comparison with England, as Treasury will make balancing adjustments to the Block grant if the costs of the council tax benefit subsidy change at a disproportionate rate relative to England, in order to prevent excessive council tax increases that would raise benefit subsidies at the expense of Treasury (HM Treasury, 2004, p.17, §5.3). The figures above show that, in relation to Scotland, the opposite has happened.

*b. Non-domestic rates*

Non-domestic rates income accounts for 4.0 per cent of total tax revenue. Presently, the respective governments have committed themselves to limiting the growth in rate income to the retail price index, holding real non-domestic revenue constant. The situation of business rate payers thus compares favourably with domestic council taxpayers, whose tax burden has risen faster than retail prices.

As opposed to council taxes, local authorities do not keep the rate income raised in their territory. Instead, that revenue is pooled and then shared out between the local authorities. This obviates the need to adjust local grant finance for different abilities to raise business rates. The rates are, in effect, a devolved source of revenue – even if they are consequently redistributed to local authorities by population share. The problem with pooling rate income is that it reduces the incentive for councils to attract businesses to the area. Having centralised rate setting powers to unify and simplify the system, however, re-localising this power and giving councils a greater incentive to be business friendly might not be a desirable solution<sup>62</sup> - this may be achieved by other schemes.

Property taxes are highly perceptible and the discussions surrounding council tax and non-domestic rate burdens in England and the devolved administrations demonstrate the difficulty for any administration to set above-average rates, lest it be accused of burdening its citizens disproportionately.

*c. Stamp Duty Land Tax*

Stamp duties are levied on the transfers of land and property in proportion to the transaction value. The duty is progressive (with rates ranging from 1 to 4 per cent<sup>63</sup>) and exempts transfers of up to £120,000 in value.<sup>64</sup> The tax has the effect of inhibiting transactions, which is not desirable economically – although recent experience suggests that the tax does not seem to greatly undermine the vibrancy of the UK housing market.

Like council tax and non-domestic rates, this tax could easily be devolved to local or regional authorities. Giving local authorities the power to set stamp duty rates would enable them to mitigate local housing price booms by raising rates and support the housing market in deprived areas with lower rates. However, it would be difficult to include these revenues in the Revenue Support Grant calculation, since one cannot easily establish “assumed” stamp

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<sup>62</sup> A relocation is opposed by the business community, which fears that local authorities would shift some of the tax burden from council taxpayers to non-voting businesses (ODPM 2004, p.37, §4.5). Even without relocation one could establish a statutory link between council tax and non-domestic rates to prevent this perceptibility problem and distribute changes in the local tax burden more evenly between local citizens and businesses.

<sup>63</sup> As Muellbauer (2004, pp.15, 16) points out: “[...] for the commercial sector, largely subject to the maximum rate of 4 percent, much energy has gone into avoidance e.g., by moving partners to transactions offshore. Switching to a simple 2 percent flat rate or a tapered system with a 2 percent maximum for the commercial sector, would likely result in only a moderate revenue loss [...]”

<sup>64</sup> Different rules apply to non-residential properties and disadvantaged areas.

duty revenue as with council tax: it will not only depend on the value of houses traded (and relative values between local authorities may quickly change because of different rates of house price inflation) but also on the number of transactions in each authority area.

Given revenue volatility and uneven local spread of stamp duty income, the most pragmatic solution would be to devolve stamp duties to the countries of the UK. Where administratively feasible, differential rates could be introduced for each of the council areas. The devolved administrations could also change the system to introduce stamp duty rates that only apply at the margin, which would not only avoid the “bunching” of property values at the rate thresholds but also prevent tax avoidance through side payments.

## **5 Taxes on Wealth**

Devolving the taxation of financial wealth and returns from investments (capital gains tax, inheritance tax, stamp duty reserve tax) would produce undesirable capital flows inside the UK towards low-tax areas and amplify tax avoidance and fraud. Through council tax and non-domestic rates the holding of property assets is already taxed. The only tax source that is not fully realised, devolved or not, are windfall capital gains on the granting of building permission on empty land. Muellbauer (2004, p.20) points to the difficulties with raising such a tax, ranging from the possible withholding of land in the hope of a future change in the tax regime, to the trading of land with expected planning approval in order to realise the gains before permission is actually granted and thus keep tax liability to a minimum.

## **6 Corporation Tax**

With 9.0 per cent of total tax income, corporation tax is the fourth-largest source of public revenue (after income tax, national insurance contributions, and VAT). No tax is paid on profits below £10,000; the average tax rises to the reduced rate of 19 per cent when profits reach £50,000 and stay at 19 per cent for profits up to £300,000. Above that threshold the average tax rises again and reaches 30 per cent for profits of £1.5 million and over.

Given the large scope for legal tax avoidance if rates differed within the UK, by shifting profits to low-tax areas, the devolution of corporation tax does not seem to be advisable. However, the reduced rate may be a possible candidate for devolution. The reduced rate only applies to smaller concerns with less scope for manipulating the geographical incidence of their profits. All companies with a profit greater than £300,000 would be taxed according to the UK tax schedule, with taxes accruing to HM Treasury. While this would imply a step in the tax liability when company profits exceed the reduced-rate threshold it would keep the system relatively simple with small companies taxed according to their regional rates and larger companies according to UK rates.

For small business owners there is scope to avoid taxes by incorporating their business and shifting the owner’s income from personal income to profit, wherever the corporation tax rate is lower than the marginal rate of income tax the owner would have to pay. In its 2005 Budget, the UK Government underlined that it believed that the choice of legal form should be made for commercial reasons and not for tax avoidance purposes. The clearest solution to the problem would be to apply income tax to distributed profits (with an adjustment for already paid corporation tax), so that the incentive to shift between personal income and profits for tax avoidance purposes is lost. It bears pointing out that this problem will have to be solved in any event and is in no significant way exacerbated by devolving the reduced rate.

Revenues from corporation tax are relatively volatile and small companies contribute about 25 per cent to the corporation tax total.

**Table 10: Small companies' gross payments on corporation tax, 2004-05 (provisional)**

Country	Total yield from reduced rate, £m (per head of population; UK = 100)
England	7,060 (102)
Scotland	670 (96)
Wales	320 (79)
Northern Ireland	190 (81)
<b>UK (excl. extra regio)</b>	<b>8,230 (100)</b>

Source: HM Revenue and Customs, *Income Tax Statistics and Distributions* (table 11.1) [http://www.hmrc.gov.uk/stats/income\\_tax/menu.htm](http://www.hmrc.gov.uk/stats/income_tax/menu.htm); country shares distributed according to their (ex regio) GVA share (ONS Regional Accounts).

Table 10 provides a rough estimate of corporation tax revenues that might accrue to the UK countries if revenue from reduced-rate paying businesses were devolved.

## 7 Taxation of Oil

Given the importance of oil revenues in the political debate in Scotland, it is appropriate to also discuss the possible merits of their devolution. Public revenues from the extraction of oil in the North Sea derive from three sources: petroleum revenue tax (PRT), corporation tax, and a supplementary charge. All of these taxes are applied to some measure of profit.

The PRT of 50 per cent only applies to profits generated by oil fields approved before March 1993 and counts as a deductible expense for both corporation tax and the supplementary charge. Corporation tax applies in the same way as elsewhere, only that it is ring-fenced, i.e., a company's oil field profits cannot be offset against losses it may sustain in other parts of its operation. The supplementary charge was introduced in the 2002 budget to replace licence royalties and levies an additional 10 per cent tax on profits from all fields.

There are a couple of problems with devolving oil revenue. Firstly, production has reached its peak and is now on a declining path. Profits and revenues may not decline to the same extent as output if oil prices keep on increasing. In the medium term, however, taxes on oil profits will become an ever smaller source of revenue. Additionally, considerable, tax-allowable decommissioning costs will eat into petroleum revenue in the future<sup>65</sup> (see Kemp and Stephen (2004)). Furthermore, the volatility of oil prices makes taxes from the production of oil equally volatile and therefore inappropriate as a dependable source of fiscal revenue.

Finally, it is unclear how the revenue would be divided up between Scotland and the rest of the UK. While the majority of fields would probably fall into Scottish "territory", it is open to discussion how the area would be demarcated in practice. Heald (1990, p.5) reckoned that "the most powerful reason for denying to a devolved Scottish Parliament access to oil revenues has always been that it is symbolically important to stress that such windfall tax revenues should accrue to the United Kingdom as a whole, irrespective of whether they are generated off the coast of Scotland or of Cornwall".

Heald's analysis may still hold to some extent; however, the *most powerful* reason for not devolving oil revenues may now arguably be that the declining revenue from oil profits is just too small and too volatile to make a substantial and dependable contribution to the Scottish Executive's funds.

<sup>65</sup> As noted in Muscatelli (2001, p.36).

## **8 Other Revenue, User Charges, and new Sources of Revenue**

Further revenues that could be raised locally or regionally include congestion charges, road user charges, tourist and hotel taxes. These and other possible fees, charges and taxes can be useful policy instruments for the local and devolved authorities. However, the revenue that could be raised from them individually is too low to make a substantial contribution to local and regional budgets.

## **9 Taxation Options**

Reviewing the previous discussion, one will find that there are several serious contenders for devolution. The devolution of income tax would be a reasonably practical means of transferring a substantial amount of tax revenue to the devolved administrations. It is a perceptible source of tax and would be able to raise fiscal accountability 'at the margin'.

Devolving VAT or the introduction of a regional sales tax would equally provide a good source of income: it is clearly perceptible and would be able to raise accountability. Due to the close economic integration and geographical proximity of the countries of the UK, rate differentials between them may only be small in order to prevent 'sales tourism' and other inefficient tax avoidance measures. The tax would also be expensive to administer. On administrative and economic efficiency grounds many will therefore remain sceptical of devolving VAT or sales taxes.

The small business corporation tax would provide substantial revenue – however, it is not perceived by many taxpayers as a burden and therefore could be a politically more easily exploited source of revenue, lowering fiscal accountability. On the other hand, reducing this tax can be used to attract small companies and generate greater economic activity, which would counteract the perceptibility problem.

Stamp duty land tax could be devolved. Because revenues can differ drastically between localities, it is probably best pooled on a country level. Like other fees and user charges it is not a major source of revenue and possibly has some use as a policy instrument, with rates rising in buoyant markets to dampen house price inflation.

Any devolution of tax powers would have to be reflected in the grant formula in order to take account of the amount of devolved tax revenue. As in the local government finance formulae, the assumed income calculated on the devolved tax base would be deducted from the central grant in order to put all countries on the same footing.

One central aspect of local government funding has to be avoided in any future financing solution for the devolved administrations: Changes in funding should not be erratic so that the tax element has to be used to compensate for funding swings rather than truly discretionary expenditure. Given that any proposed funding system should provide the devolved administrations with funds that are in proportion to UK expenditure, the problem is somewhat mitigated. However, to ensure that fiscal accountability through taxation at the margin actually works, the funding grant (and its growth) should be stable and predictable.

## CONCLUSION

This paper has reviewed the funding of sub-national government in the United Kingdom, the strengths and weaknesses of the present arrangements, based on the Barnett formula, and the scope for developing or changing them.

### *The remarkable durability of Barnett*

The Barnett formula has grown from a convenient administrative arrangement for setting a departmental budget to an extraordinarily durable mechanism that underpins the UK's new constitutional arrangements. It is not hard to see how this has come about, and why the system shows such persistence. Compared to other mechanism for financing sub-national government, it gives the devolved administrations a remarkable degree of autonomy. This has been particularly valuable during the formative years of the Scottish Parliament and Welsh Assembly. It also leaves macroeconomic management issues firmly in the control of central government.

Together with the stability and predictability it allows in the financing of public services, this is an advantage easily taken for granted. It is, of course, the policy of the UK government that in devolved matters the administrations should exercise discretion and be allowed flexibility, and clearly this is the aspiration of politicians on Edinburgh, Cardiff and indeed Belfast. The lack of transparency in the system is something of a criticism but could be cured at the price of some administrative effort.

### *The Question of Need*

Debate often centres on whether the levels of funding which have been provided under the system are equitable, especially compared with the English regions. Successive governments, and now devolved administrations, have argued that the higher per capita spend is justified by reference to higher need in the territories compared to England as a whole. What constitutes need and how to measure it are highly argued concepts, and no wholly objective measure exists. The work that was done inside government in 1978 arrived at one assessment of relative need; actual spend was, however, never linked to it, and the other UK countries all have both higher assessed need, and higher spending, than England.

Since then relative need may have changed somewhat, but perhaps more importantly, relative spending level have converged as a result of the Barnett mechanism. There was marked convergence in recent years as the formula has been applied strictly and public spending has risen substantially: in effect, English spending levels have "caught up" to a substantial degree with, for example, the Scottish. It is hard to identify this in overall public spending numbers, for a variety of reasons. But an analysis of Scottish health spending relative to England (which may be taken as a microcosm for the whole Budget, as increases in Scottish health spending have been similar to health consequentials) show a substantial degree of convergence.

Through the Barnett formula, convergence in relative spending levels has to occur, unless there is considerable formula bypass. At the moment, however, the devolved administrations have little to gain from changing a system that still provides substantial funds and gives them a free hand in their expenditure decisions. Whether further convergence takes place depends on the growth in public spending (which is slowing) and, of course, on relative population levels. If Scotland's relative population continues to shrink, *per capita* spend will remain above English levels even as the growth of total spending is markedly less than in England.

### *Re-assessing need and implementing changes*

The position of the UK government is that the first step to finding any new funding solution is a cross-UK needs assessment (as in the *Statement of Funding Policy* (2004, §11.3)). Despite its highly technical character, this would, be anything but a purely technical exercise - the definition of “needs” is to considerable extent a value judgement, as is the relative importance of the different types of needs. Furthermore, the needs assessed and the grant allocation that flows from the assessment is inevitably determined in relation to UK “standard” policy. Political disagreements over policy objectives will translate into different interpretations of needs.

In order to minimise institutional conflict and ensure the legitimacy of the process, it would be advisable to institute an independent advisory board, akin to the Australian Commonwealth Grants Commission, to undertake the consultation for the assessment and derive the needs-based formula. Given the criticism of the local government funding system and the Australian grant formula, and the fact that government ministers bear ultimate responsibility for the allocation of funds, it stands to argue that the tension between simplicity of the formula and perceived objectivity of the assessment should be solved in favour of transparency in order to promote political accountability. The assessment can only ever be a guide for the allocation of money, and provide the basis for the funding settlement. Using relative needs to determine the *increment* in grant allocation rather than the whole funding block would combine the benefits of a more rational needs-based approach with the stability of the Barnett system.

### *Fiscal Accountability*

The principal weakness of the Barnett system is the lack of fiscal accountability. While the devolved administrations are responsible for spending allocations they are not accountable to the electorate for the taxation decisions to finance them. There are, however, already some exceptions to it. The system of local government finance is substantially within devolved control (virtually completely in Scotland). There have been some divergences in how it has been managed, for example differential council tax rises, to a large extent driven by different grant regimes and also a different business rate policy in Scotland. While this allows, in effect, for different local revenue-raising in the devolved areas, because it is done through the local government finance system, it provides only very weak accountability.

Income tax is the primary candidate for devolution. The transfer of power over a certain portion of income tax revenue would not be a purely symbolic act buttressing the commitment to regional self-determination, it would present the Scottish Parliament and the Welsh and Northern Ireland Assemblies with the difficult trade-offs between taxation and spending that they have so far not been faced with. It would be possible to widen the scope of the existing power to vary the basic rate, or even to devolve many decisions about income tax, and assign the resulting revenue to the devolved administrations. In any event, a Barnett or a like formula, perhaps referenced to need as proposed above, could provide a stable and simple way of calculating the central contribution to devolved spending.

The widening of income tax powers would therefore be the main way of enhancing fiscal accountability. The existence of the “Tartan tax” arguably has been heightening the public and political interest in further tax powers to the Scottish Parliament, whereas there still appears to be relatively little interest in greater fiscal powers for the Welsh Assembly, and with the suspension of the Northern Ireland Assembly, a change in the fiscal regime there is low on the list of priorities. It is striking however that even in Scotland, where the debate on these issues has been most vocal, no party at present plans to use even the limited tax powers

available. In the longer run, all the devolved administrations may seek a review of the financing system, including greater powers of devolved taxation, but surely only once they have exercised the powers already available to them.

Combining needs-based grant finance and own resources has to include some revenue adjustment in order to take account of the differing resource capacities of the respective authorities. The system of local authority finance offers possible models for doing so, and shows also the weakness of such an arrangement: it is not transparent to voters who is responsible for tax changes. Additionally, the system has to incorporate some facility to smoothen revenue volatility, whether centrally administered or through the devolution of borrowing powers.

### *Financing Devolved Government*

The durability of the Barnett formula is not accidental. Although, like so much of UK public administration, it developed incrementally, it has evolved into a functioning solution to a problem that is the source of conflict in many jurisdictions. It has offered the new devolved administrations remarkable autonomy and stability, while preserving the UK Government's overall control of public spending. The relatively higher levels of spending it supports have not been systematically justified by need, but recent growth in public expenditure has narrowed the gaps to arguably more defensible levels.

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