Press Release

“Flaw” in Barnett formula protects Scotland and Northern Ireland from hundreds of millions of cuts

At present, the devolved governments in Scotland, Wales and Northern Ireland get most of their money in the form of a block grant from the UK Treasury. How this grant changes from year-to-year is largely determined by the Barnett formula – which aims at providing the same pounds-per-person change in funding for the devolved governments as is the case in England.

The devolved governments – particularly Scotland’s – may soon find themselves raising and keeping more of their own tax revenues. But the Barnett formula looks set to stay in place. A new report published today by the IFS, funded by the Economic and Social Research Council (ESRC), looks at how the Barnett formula interacts with business rates (a tax that is already fully devolved to Scotland and Northern Ireland), and the lessons that can be learned for further tax devolution.

The report argues that the way the Barnett formula deals with business rates is “flawed”. It finds that this flaw has been costly to the Treasury: the Scottish Government and Northern Irish Executive are set to see their budgets cut by around £600 million and £200 million less as a result of the 2010 and 2013 Spending Reviews, than they would have had a ‘corrected’ version of the formula been used. (In Scotland’s case this follows on from budget increases of £400 million more as a result of Spending Reviews during the 2000s, than it would have seen under a ‘corrected’ formula.)

The problems arise because the Barnett formula treats English business rates as part-funding the CLG: Local Government (CLG:LG) budget. The result is that most of the large cuts to this budget are excluded when calculating block grants for Scotland and Northern Ireland. This matters because the CLG budget has been cut much more than the other big devolved budgets of spending on the NHS and schools. So the block grants to Scotland and Northern Ireland have been cut by much less than the average cut faced by departments serving England.

A better way of accounting for devolved business rates would be to treat English business rates as part-funding all Whitehall departments largely serving England, rather than just part-funding the CLG:LG budget.

This demonstrates that the way the Barnett formula and block grant are adjusted to account for devolved taxes is more than just a technical matter. It is important to get right because it has implications for the type of revenue risks the devolved and UK governments face. Seemingly technical issues over adjustments which make little difference in the first year of devolution can have profound effects on how money is allocated across the UK in the longer run. The complexity of this decision is perhaps illustrated by the fact that just 5 months before they are to be devolved and over 2 years after the Act devolving them was passed, a decision has still not been taken how the grant will be adjusted in light of devolution of stamp duty land tax and landfill tax.

With this in mind, the report also looks at a number of implications for further tax devolution:

- In designing further tax devolution we should not make the same mistake of treating a devolved tax as funding a particular UK government department when working out how it will interact with the Barnett

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Contacts

Bonnie Brimstone
Institute for Fiscal Studies
020 7291 4800
formula unless there is a direct real link between that department’s budget and how much is raised from a particular tax. (Which is not the case with CLG:LG and English business rates – revenues from which have been increasing at the same time the CLG:LG budget has faced big cuts.)

- Analysis of how business rates interact with the Barnett formula also shows there is a link between the way block grants are adjusted to take account of tax devolution and the type of revenue risks that the devolved government (and, on the flip-side, the UK government) bears.

- There are a number of advantages to devolving taxes in a way that means the devolved government bears only the risk that its revenues grow more or less quickly than revenues from the comparable tax in the rest of the UK. We term this the relative risk.

- Doing this means that the devolved government bears the revenue risk associated with its policies. If for instance, changes in tax or other economic policy cause its revenues to grow more or less slowly than comparative revenues in the rest of the UK, it gains or loses the marginal revenues. This provides policy makers with incentives to make policy in a way that takes account of the feedback effects on its own tax revenues. On the other hand the UK government would bear the risk associated with UK-wide macro-economic cycles and revenue trends – risks that would be more difficult for the devolved government to bear.

- It is not always possible or desirable to devolve the relative risk, however. In such cases an alternative way of indexing block grant reductions is required. The lesson from the experience with business rates is that this choice must be carefully considered to ensure the devolved government and UK government are bearing the appropriate types of revenue risk, and neither side is gaining unfairly at the others’ expense.

David Phillips, a senior research economist at the Institute for Fiscal Studies and the author of the report said: “The Barnett formula looks set to remain in place for some years to come. This appears to rule out a move to a needs-based formula. But it makes it more important than ever to examine the Barnett formula to see if it is working in the way intended, and if flaws are found, to fix them.”

“Problems with the way the Barnett formula treats business rates mean that Scotland and Northern Ireland have avoided hundreds of millions of pounds of cuts that they would have faced under a corrected formula – cuts that England and Wales have faced. It is important to get the interaction between devolved taxes and the Barnett formula right. Whatever is decided about which taxes should be devolved, it is crucial to get right the seemingly technical issue of exactly how changes in revenues from those taxes translate into changes in funding.”

ENDS

Notes to Editors:

1. “Business and usual? The Barnett formula, business rates and further tax devolution” by David Phillips (IFS) will be published on Wednesday 12 November 2014. For embargoed copies of the report or other queries, contact: Bonnie Brimstone at IFS: 020 7291 4800, bonnie_b@ifs.org.uk

2. This work is funded by the Centre for Microeconomic Analysis of Public Policy (CPP), an ESRC research centre hosted by the IFS. It follows on from an earlier series of publications produced in the run up to the Scottish Referendum as part of the ESRC “The Future of the UK and Scotland” programme (which are available at: http://www.ifs.org.uk/research_areas/99).