

# **UNEQUAL SHARES:**

**THE DEFINITIVE GUIDE TO  
THE BARNETT FORMULA**

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## About the author

**Mike Denham** is a former Treasury economist who worked extensively on public spending and fiscal analysis during the 1970s and early 1980s. His work included cost benefit appraisal of public projects, analysis of public sector cost inflation and value for money studies. For the next 20 years he worked in the City as an investment manager, closely following fiscal and monetary policy developments. Now semi-retired, he scrutinises public spending on his blog, Burning Our Money.

## Executive Summary

In the last week, the allocation of money between England and Scotland has hit the headlines following plans by the Scottish National Party to abolish council tax in Scotland and replace it with a local income tax. In response, Gordon Brown said in his speech to CBI Scotland that the Calman Commission, set up to review devolution, will specifically investigate the financial accountability of the Scottish Parliament.

But funding disputes between Westminster and the devolved regions of the UK have a much longer history. This paper provides the comprehensive analysis of the Barnett Formula and its precursors that has been missing from the public debate, and will be submitted as evidence to the Calman Commission and to the House of Lords committee currently investigating this very problem.

For the last 30 years the Barnett Formula has been used to allocate British taxpayers' cash between England, Scotland, Wales, and Northern Ireland. It has been widely blamed for the substantial public spending gap that exists between England and the three devolved territories.

The key findings of the paper are:

- **Identifiable public spending per head in England** is running at **£7,535 pa** (2007-08). But in **Scotland it is 22 per cent (£1,644) higher, Wales 14 per cent (£1,042) higher, and Northern Ireland an extraordinary 30 per cent (£2,254) higher.**
- These spending gaps have persisted for many years. And in public expenditure terms they are big: just over the last two decades (since 1985-86), we calculate that higher spending in the three devolved territories has cost UK taxpayers a cumulative **£200 billion:**
  - **£102 billion in Scotland;**
  - **£43 billion in Wales;**
  - **£57 billion in Northern Ireland.**

In an era of devolved government, such spending gaps are impossible to justify to English taxpayers. They ask why they should subsidise higher Scottish, Welsh, and Irish spending? Why shouldn't those areas pay for their extra benefit themselves through higher local taxes? There is particular anger about the Scottish advantage because, whereas Northern Ireland's position is arguably justified on the basis of peace and reconstruction, there is no such case in Scotland.

The Barnett Formula cannot possibly withstand such pressure. Little more than a crude "back-of-envelope" rule for splitting *annual increases* in public spending, back in 1978 it was a short-term expedient, put in place as a



temporary measure prior to planned Scottish devolution. It was never designed to last for thirty years and to bear the public scrutiny and resentment it now engenders. Reform is essential.

A range of options has been suggested, including the use of needs assessment formulae.<sup>1</sup> But sustainable reform needs to address a major underlying problem: the structure of UK taxation is far too centralised. With only 4 per cent of total taxes raised locally, Britain has the most centralised tax system of *any* major economy. That's fundamentally at odds with the devolution of spending authority.

Unless there is a significant decentralisation of tax raising powers, it means that Westminster will always have ultimate control of the purse strings. And it means allocation will always be subject to the kind of blatant unfairness that exists today.

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<sup>1</sup> See for example [Fair Shares? Barnett and the politics of public expenditure](#), ippr 2008

## 1. The Barnett precursor: Scotland's Goschen bonus

Spending allocations between the principal territories of the UK have long been shrouded in secrecy. Successive governments have found it expedient to keep things hidden from public scrutiny. Indeed, the very existence of the Barnett Formula itself was not revealed to Parliament until almost two years after it had been introduced, and then only in response to questioning.<sup>2</sup>

What we now know is that the use of some sort of allocation formula dates back to 1888, when in preparation for Irish Home Rule, Chancellor George Goschen introduced his so-called "*Goschen proportions*". There is some dispute about his precise thinking, but it seems to have been based on the idea that devolved administrations in Dublin and Edinburgh should have some dependable revenue stream of their own, a stream not subject to constant wrangling at Westminster. But the Westminster government certainly didn't wish to cede them independent revenue raising *powers*, so instead they were to be given *shares* in the national revenue, specifically the revenue from probate duty.

The Goschen proportions were originally set at 80:11:9, for England and Wales, Scotland, and Ireland respectively. Goschen claimed that reflected the proportions in which the three major territories paid probate duty, although he never produced figures, and it seems more likely it was a political fudge: the first of many.

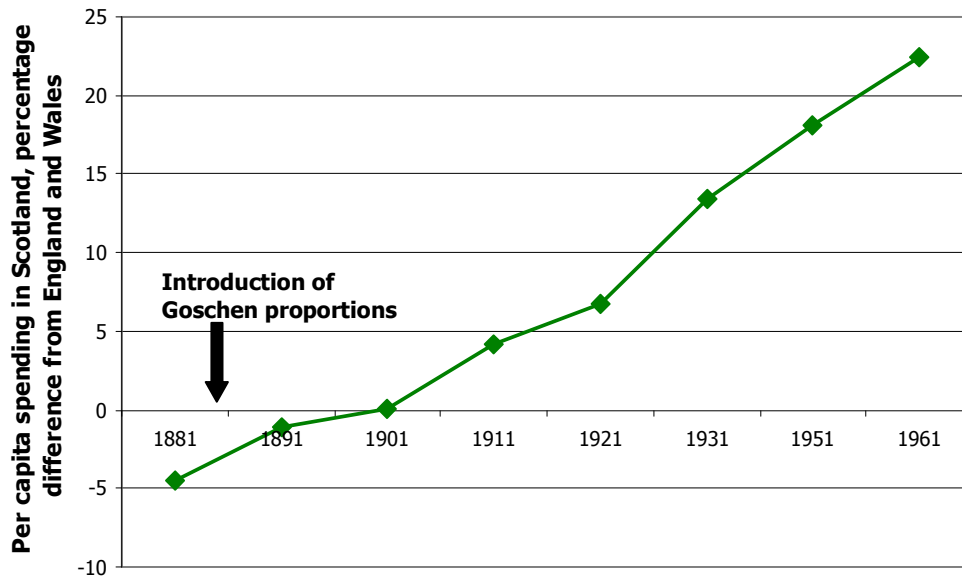
But however the proportions were first arrived at, over subsequent decades they were gradually cast in stone. Ireland went its own way after the First World War, but Scottish politicians and civil servants continued to insist that Scotland was entitled to *at least* its Goschen proportion – a minimum floor of 11/80ths of whatever England and Wales got (Wales being subsumed into England). In practice, that meant Scotland got an increasingly large share of spending per head, because while the Goschen proportion was fixed, Scotland's population growth lagged far behind that of England and Wales.

The following chart (Figure 1) shows how that effect would have built up over the years into a substantial "Goschen bonus". By 1961, Scotland's population was only 11.2 per cent of the England and Wales population, but under Goschen, it would still have got a fixed 13.75 per cent of the England and Wales spending total. That's equivalent to a 22 per cent bonus in terms of spending per head (which, interestingly, is the very same gap that still exists today).

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<sup>2</sup> For an excellent history of the Barnett formula and its broader fiscal context, see [The Fiscal Crisis of the United Kingdom](#), by Iain McLean and Alistair McMillan, Nuffield College Working Papers in Politics 2002 W10; also see [The Barnett Formula](#), House of Commons Library, 2001.

Figure 1: Scotland's Goschen bonus – how a fixed allocation boosted Scotland's per capita spending relative to England and Wales<sup>3</sup>



Actually, Scotland's historic spending advantage may well have been even higher than shown in the chart. Very often, Scottish politicians and civil servants seem to have negotiated significantly more than the "Goschen minimum", which was important given the UK's ballooning expenditure on public services (see below).

Predictably, there are no hard figures on any of this. Negotiations took place in smoke-filled rooms, and the spending gap was concealed from the public. Westminster politicians must have known, so quite why English MPs accepted it is a mystery. But there was apparently no serious challenge to the Goschen framework until the 1950s.

Finally, perhaps alarmed by the growing spending disparity, the 1951-64 Conservative government did move to downgrade Goschen. They switched to setting Scottish spending allocations by pure cabinet horse trading, just like with any other element of public expenditure. There may even have been some vague intention to reduce the gap over time, although naturally nothing was ever made public.

In any event, the discovery of North Sea oil in the 1960s changed the political landscape fundamentally. The consequent resurgence of Scottish nationalism put the whole fiscal settlement under pressure, and by the 1970s, the Labour

<sup>3</sup> Historic population statistics taken from Annual Abstract of Statistics 2007 (ONS), 1881 Census, and 1891 Census.



government reckoned it had to give some ground. So it offered a measure of Scottish independence in the form of devolution.

Just like Irish Home rule in the 1880s, this devolution was *not* intended to include the ceding of independent taxation power. As a minority government beset by huge economic problems, Labour could not countenance that, especially since 80-90 per cent of the oil was widely reckoned to be Scottish. They needed to find an alternative.

As it turned out, their proposed devolution failed in the referenda held in Scotland and Wales in 1979. But not before the government had already prepared the fiscal ground for success. Thus it was, in 1978, they secretly implemented the Barnett Formula.

Devised by legendary Treasury mandarin Sir Leo Pliatsky, the formula was subsequently named after the then Chief Secretary to the Treasury, (Lord) Joel Barnett. It was not revealed to Parliament until two years later, and Parliament has still never ratified it.

## 2. The Barnett Formula in action

The Barnett Formula was initially designed to allocate certain public expenditure funding between England and Scotland. Wales was included from 1980, and Northern Ireland added some time later. According to Lord Barnett himself, it saved a lot of time and anguish in cabinet spending negotiations.

It was and is applied only to *annual changes* in expenditure. So the previous year's spending is automatically rolled forward, and the formula applied only to next year's change (inevitably an increase). Thus the pre-existing pattern of territorial spending differences was built into the baseline, including the Scottish spending gap described above.

The formula also applies only to *some* elements of expenditure. The main items included are education, health and social services, and law and order (except in Wales, where the last still comes under the Home Office).<sup>4</sup> Obvious national items such as defence are excluded, and also social security benefits (or "social protection" as it's now labelled) – they're dealt with on a national basis as an "entitlement" programme (i.e. how much gets spent in each territory depends on individual need under national entitlement rules).

Detailed expenditure coverage has varied somewhat over time, and also varies somewhat between territories, but in aggregate, it currently covers some 80 per cent of the consolidated block funding passing from Westminster to the devolved governments. In 2007-08, the total block-funding allocations were:<sup>5</sup>

Scotland	£26.1 billion
Wales	£13.6 billion
Northern Ireland	£8.4 billion

These allocations are of course a key element of devolution. They constitute the vast bulk of the funding available to support the devolved governments' discretionary spending programmes.

The basis of Barnett allocation is population. But until 1992, the population proportions were held static at mid-1976 levels. There was then a one-off update, and since 1997 there has been an annual update.

This point is significant, and partly explains why the formula has not operated as originally intended. Because a key element in the formula's original design was that over time it should *reduce* Scotland's public spending advantage. And that's something it has manifestly failed to deliver.

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<sup>4</sup> For a detailed analysis of what's included, see Funding the Scottish Parliament, National Assembly for Wales, and Northern Ireland Assembly, HM Treasury, October 2007

<sup>5</sup> 2007 Comprehensive Spending Review, HM Treasury



### 3. How the Barnett Formula failed to close the public spending gap

As already described, Scotland has long enjoyed higher spending per capita. By the mid-1970s a Treasury study<sup>6</sup> put the spending gap at 22 per cent, and English taxpayers were becoming restive. They were particularly restive in the North-East, where locals could see at first hand better public service provision just across the Scottish border.<sup>7</sup>

The Barnett formula theoretically addressed this by ensuring all future spending *additions* would be on the same per capita basis as in England – i.e. there would be no Scottish premium for new money, and over time that would erode the Scottish advantage. It became known as "*the Barnett squeeze*".

But in practice, the squeeze hasn't happened: in fact it's been described as more of a "*gentle hug*".<sup>8</sup>

We can see that by looking at the Treasury's figures for per capita spending in each of the main territories since the mid-1980s<sup>9</sup> (so-called "*identifiable spending*" – i.e. spending that can be identified as being tied to a particular territory - covering about 80 per cent of total public expenditure). As the following chart (Figure 2) highlights, per capita spending in all three of the devolved territories has continued to run at a much higher level than in England.

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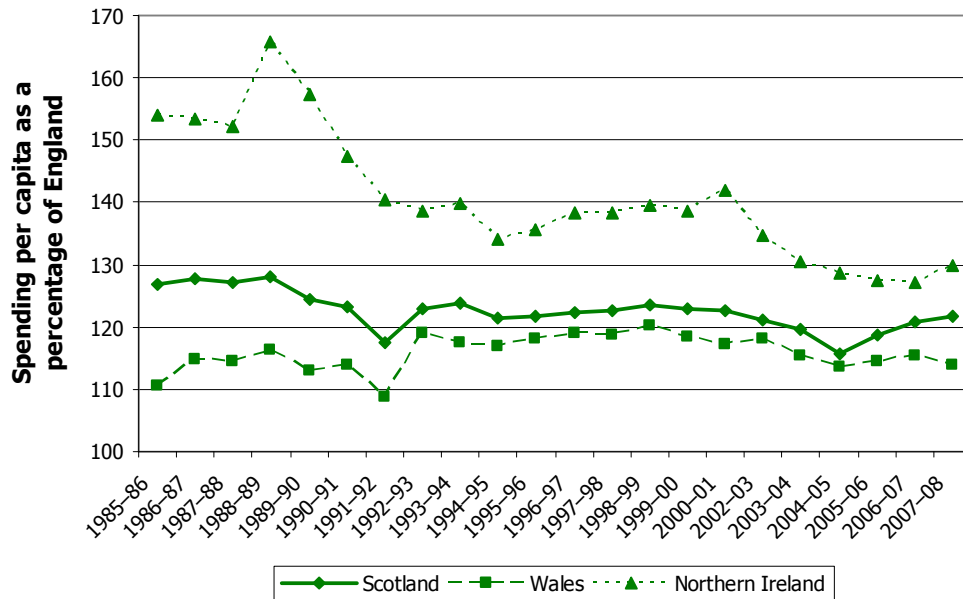
<sup>6</sup> HM Treasury, *Needs Assessment Study – Report*, 1979

<sup>7</sup> It's worth noting that North East England actually does well in terms of public spending *relative* to the rest of England. But relative to its Scottish neighbours it still does worse. For an excellent overview of regional tax and spending patterns see *Does Britain Have Regional Justice, Or Injustice, In Its Government Spending and Taxation?* by David B Smith, Economic Research Council, 2007.

<sup>8</sup> [The Fiscal Crisis of the United Kingdom](#), by Iain McLean and Alistair McMillan.

<sup>9</sup> The Treasury now publishes annual estimates of identifiable spending in each of the devolved territories, as well as England and its major regions. However, these were not published for the years prior to 1985-86. For a summary of the available data see Table 8.1 in [Public Expenditure Statistical Analyses 2002-03, HM Treasury, May 2002](#) .

Figure 2: Spending per capita – devolved territories as percentage of England<sup>10</sup>



Now, it is clear that the spending premium in Northern Ireland has drifted down over time, and with continued peace may well come down further. And some maintain the gap with Wales is already relatively narrow (indeed, Welsh politicians often complain they're actually disadvantaged relative to other areas).

But it's Scotland's advantage that's always been the real focus of concern for English taxpayers, and that remains high. The reality is that 2007-08 spending gap of 22 per cent is exactly the same – *exactly* the same – as it was in the mid-1970s before Barnett was ever implemented.

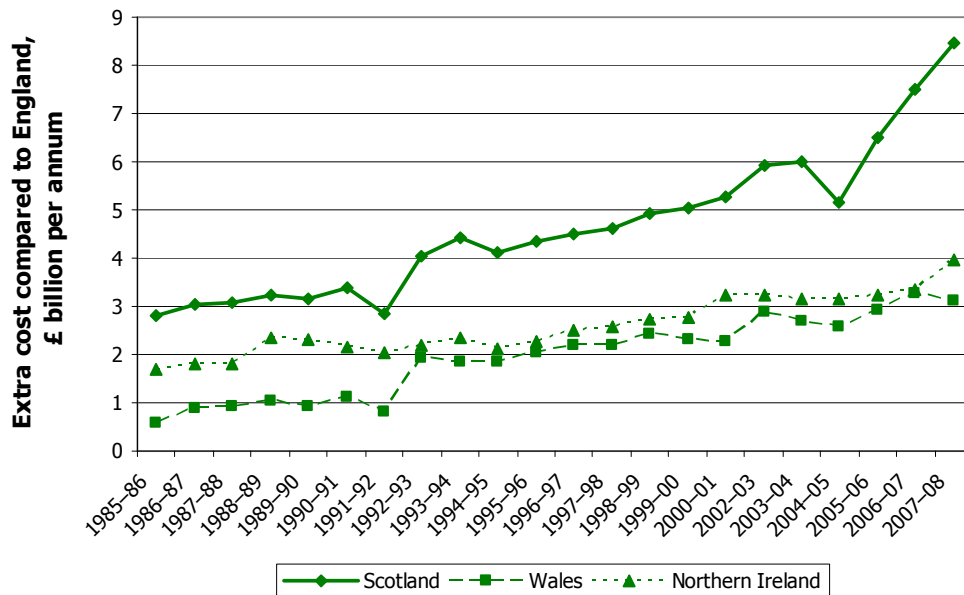
We can easily translate this into money terms. In 2007-08, identifiable spending in Scotland totalled £47.2 billion.<sup>11</sup> Since we know that was 22 per cent higher than England in per capita terms, the overall spending gap was £8.5 billion. In other words, public spending in Scotland was £8.5 billion higher than it would have been if the Scots had been held to the same level of per capita spend as the English.

Using the Treasury's figures we've calculated the corresponding spending gaps for each of the now devolved territories since 1985-86. The following chart (Figure 3) summarises the results.

<sup>10</sup> HM Treasury PESA

<sup>11</sup> PESA 2008, Chapter 9, HM Treasury

Figure 3: Public spending gaps – the extra cost of public services in the devolved territories<sup>12</sup>



As we can see, the gap has been increasing in all three devolved territories, even if we should be aware that coverage has changed somewhat though the period (especially in Wales). Scotland’s gap has trebled, from £2.8 billion to £8.5 billion.

So in money terms, how much have these spending gaps cost British taxpayers over the entire period since the Barnett Formula has been in place?

We can’t answer that question precisely because the Treasury has not published the necessary figures for the early years. But since 1985-86, the Scottish gap has totted up to £102 billion, the Welsh gap to £43 billion, and the Northern Irish gap to £57 billion – an **overall total of £200 billion**. In today’s money we could easily double that. (Arguably Northern Ireland should be excluded from the calculations because of all the other special factors at work – but that doesn’t alter the big picture).

Of course, these calculations *do* include social protection, which as already mentioned, is largely an individual entitlement programme standard across the UK. If we strip that out and concentrate just on devolved public services, identifiable spending in Scotland in 2007-08 comes down from £47.2 billion to £30.3 billion or £5,895 per capita. But since the equivalent figure for England is £4,597 per capita, Scotland’s advantage *excluding* social protection is 28 per cent – *even higher* than the 22 per cent overall gap.

<sup>12</sup> Figures derived as explained in the text from successive HM Treasury PESAs



So *excluding* national social security programmes, the spending gap between Scotland and England on devolved public services is currently running at around £6.6 billion pa, about one-quarter lower than the £8.5 billion headline figure, but still a big number. And the vast bulk of it is funded by UK national taxation, most of which is paid by English taxpayers.

## 4. North Sea oil has not funded the Scottish spending gap

Can this spending gap be justified somehow as a *quid pro quo* for North Sea oil revenue? Scottish nationalists have long argued that "*it's Scotland's oil*" and some argue that the higher public spending in Scotland is in some sense "funded" by North Sea tax revenues.

In the past, the nationalists have suggested that under international law an independent Scotland would be entitled to 95 per cent of the oil revenues. However, a detailed geographic analysis recently conducted for the Scottish Government puts the figure lower, at around 83 per cent.<sup>13</sup> Taking the latter figure, with total revenue currently running at £9-10 billion pa, Scotland might be entitled to around £8 billion pa, which would indeed roughly "*pay for*" Scotland's higher per capita spending.

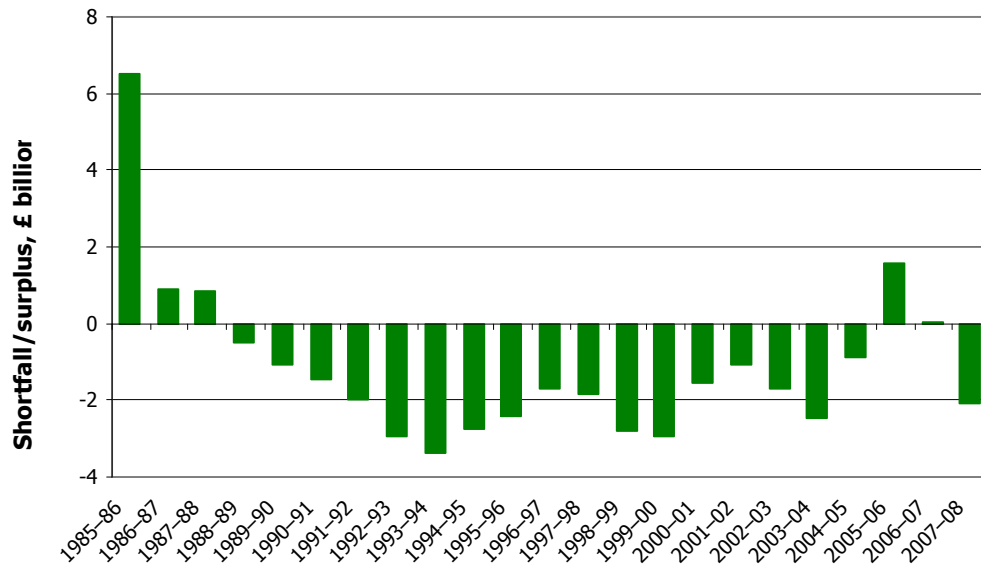
But the sums *only* balance so long as present very high oil prices persist. The long-term average is much lower. As recently as 2003-04, North Sea revenues were less than half current levels.

The following chart (Figure 4) shows the history from 1985-86, which is the first year for which HM Treasury have supplied separate country spending figures. The bars are the difference between the Scottish annual public spending gaps shown in Figure 3 above, and a notional 83 per cent share of North Sea revenues in each year.

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<sup>13</sup> Government Expenditure & Revenue in Scotland, The Scottish Government, 2008

Figure 4: Scotland's notional North Sea revenues minus Scotland's spending gap, £ billion<sup>14</sup>



As we can see, in every one of those 23 years bar five, even an 83 per cent share of North Sea revenues would not have funded the whole of Scotland's additional public spending. The cumulative total over the whole period is a Scottish deficit of £26 billion.

Looking to the future, North Sea revenues are even less likely to fund the spending gap. North Sea production has already declined by over 40 per cent since 1999 (from 137 million tonnes to 77 million tonnes)<sup>15</sup>, and is officially projected to fall by a further 50 per cent, to just 40 million tonnes, by 2020.<sup>16</sup>

So even taking account of oil, the underlying issue of English taxpayers funding premium public services in Scotland remains, and will become more serious in years to come.

<sup>14</sup> Spending data from HM Treasury PESA; North Sea revenue from Scottish Government GERS 2008; constant 83 per cent revenue share

<sup>15</sup> BERR, 'Digest of UK Energy Statistics', Table 3.1.1. 1999 indigenous production of crude oil compared with 2007

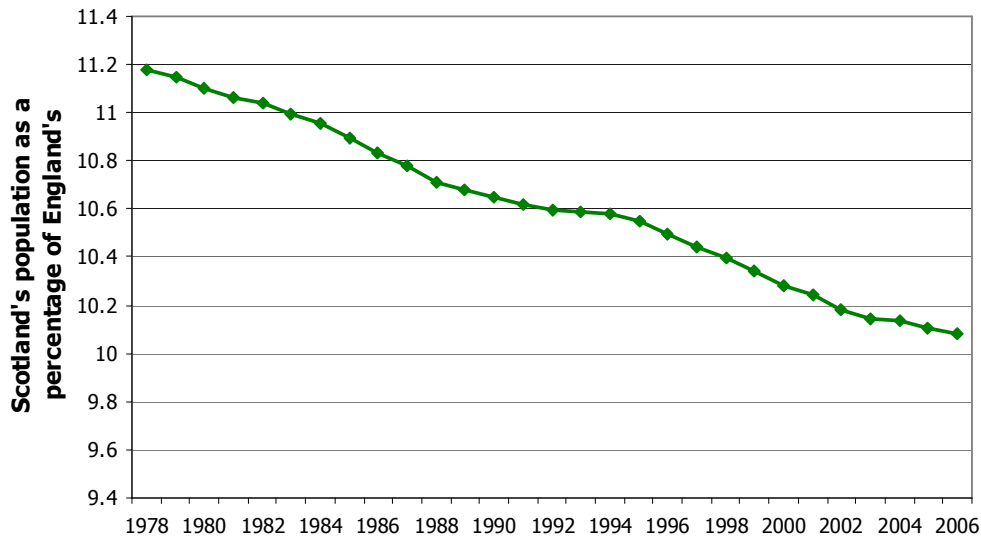
<sup>16</sup> Energy markets outlook: October 2007, BERR

## 5. Why Barnett failed

One reason the system failed to close the spending gap is the freezing of the formula's population ratio at its 1976 level, right up until 1992. In the intervening years, the Scottish population actually fell, so that the true ratio of Scotland's population to England's declined by more than one-half percentage point.

Scotland's relative population share has gone on falling, and over the whole period since the Barnett Formula was introduced it's down by more than one percentage point, as shown in Figure 5.

Figure 5: Scotland's shrinking population share<sup>17</sup>



The Formula's population ratios are now updated annually, but clearly a falling population share reduces the speed at which the formula will erode Scotland's baseline advantage.

But there's another important factor that stopped the Formula working as originally intended: Westminster politicians who were supposed to operate it shied away from doing so robustly.

Under the 1979-97 Conservative government, the formula seemed initially to have some effect. But once the recession of the early 90s kicked in, progress reversed, ministerial resolve apparently undermined by growing Scottish nationalism and the threat to Conservative seats in Scotland. Indeed, by the

<sup>17</sup> Population figures from Annual Abstract of Statistics 2007 (ONS)



1997 election, the Scottish Secretary was openly saying that the Conservatives had delivered a 30 per cent Scottish funding premium.<sup>18</sup>

When Labour returned to power in 1997, things were supposedly going to get better. They finally pushed through devolution, and as part of the package they publicly restated the Barnett Formula, reaffirming its operation as the basis for allocating future spending *growth*.

Yet as we saw in Figure 2, the per capita spending gap shows no sign of sustained narrowing. Indeed, after an apparent dip in 2004-05, Scotland's spending advantage has bounced right back up to its traditional level.

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<sup>18</sup> [Independent](#) 24.3.1997 (30 per cent was a slight exaggeration; it was actually around 23 per cent)



## 6. Options for reform

These days the Barnett Formula has few friends. English taxpayers are understandably incensed, the Conservatives have more or less promised to chop it if they win the next election,<sup>19</sup> and Lord Barnett himself argues for its abolition. He says:

*"It is a great embarrassment to have my name attached to so unfair a system. It was never meant to last this long, but it has gone on and on and it has become increasingly unfair to the regions of England. I didn't create this formula to give Scotland an advantage over the rest of the country when it comes to public funding. When I introduced it, it was going to last only a year. It has now lasted more than 20 years, because successive governments have failed to deal with it for fear of upsetting the Scots."<sup>20</sup>*

Clearly nobody wants to "upset the Scots", but even those on the receiving end of the largesse aren't always happy. Scottish politicians complain about *the Barnett Squeeze* (even if we've been unable to detect *any* sign of its actual operation). And the Scottish government produces detailed analyses contrasting the constrained value of their block grant receipts with what they might expect if they got their hands on "Scotland's oil".

Meanwhile, Welsh politicians complain constantly about being disadvantaged relative to Scotland and various English regions. They point to the high cost of running public services in a territory that suffers problems of urban poverty combined with the challenges of rural inaccessibility.

More broadly, critics attack the "arbitrary" nature of an allocation based purely on relative headcount. They argue for a more objective "needs based" allocation, modelled on the approach used to allocate revenue support grant funding among local authorities. Such an approach would take account not just of population, but also social and geographical factors.

And judging from the comments of David Cameron, Lord Barnett, and others, some form of needs based allocation is the reform Westminster is pursuing.

But is that the best path for taxpayers? In the area of local authority grant funding such formulae are themselves hotly disputed. They may employ complex statistical analyses, but what counts as "need" is ultimately subjective. And an aura of objectivity imparted by reams of statistics is not just illusory, it can be downright misleading: as taxpayers discovered long ago, one spending bureaucrat's "need" is often little more than a means of grabbing a bigger slice of the public pie.

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<sup>19</sup> [The Herald](#) 23.5.2008

<sup>20</sup> [Scotsman](#) 11.1.2004



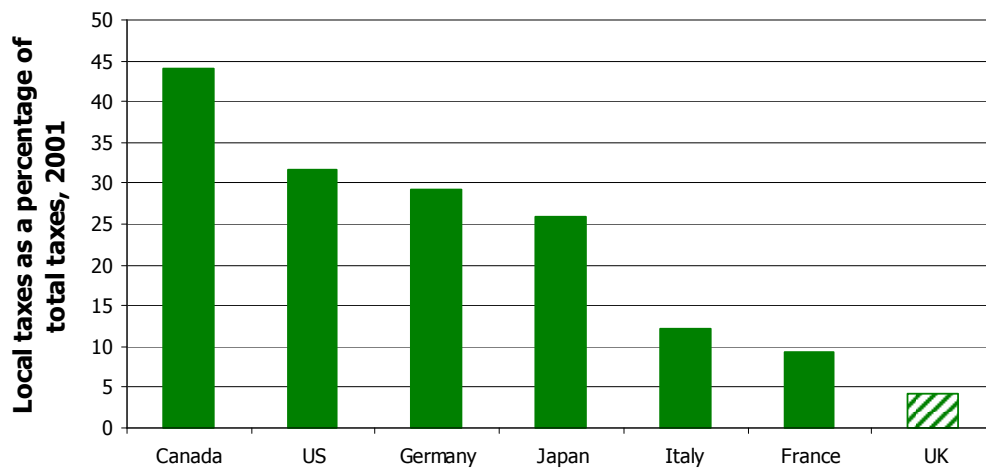
And behind all that, behind the formulae and the proposed special needs assessments, lurks the whole murky issue of political intervention. As we noted earlier, even when they've supposedly agreed an allocation formula, there's a long history of Westminster politicians over-riding its operation. And in the case of Scotland, the resurgence of nationalism has made Westminster politicians very wary of upsetting Scottish voters simply for the odd billion here or there.

Which brings us to the major issue facing *any* reform plan: as long as virtually all our taxes are set and collected centrally, Westminster politicians will *always* find ways of controlling the allocation of revenue. It's simply the nature of the beast. As we've seen, politicians nobbled *both* the Treasury's two previous attempts at using formulae to freeze them out.

## 7. The real problem – too much tax centralisation

The fundamental reason the Barnett Formula has failed to close the UK’s territorial spending gaps is that it is pitched against a massive centralisation of taxation power in the hands of Westminster politicians. Although not widely recognised, the UK has the most centralised tax system of *any* major economy, even those of other unitary states like France. Just 4 per cent of our taxes are both set and collected locally (and even this small proportion – essentially comprising Council Tax – is routinely subject to capping by Whitehall).

Figure 6: Local taxes as a percentage of total taxes<sup>21</sup>



Such a structure means devolution is seriously lop-sided: devolved governments can flex their spending patterns, but they can’t chose to cut taxes. It’s a system designed to encourage spending to the max.

The structure also means devolution is inherently unstable. The devolution of spending authority without commensurate tax raising responsibility means a highly visible and corrosive split between those who benefit and those who pay.

And it isn’t just the headline inequity of English taxpayers funding superior public services for the devolved territories. There’s also that vexed issue of who *does* own the North Sea oil revenue. That has *never* been resolved, even though it was the very issue that generated the pressure for devolution in the first place.

<sup>21</sup> Source: *Fiscal Relations across Government Levels*, OECD, 2003. The chart figures are taken from Table 1, and are the OECD’s attribution of tax revenues to state, provincial, and local government levels as a percentage of total national tax revenues.



The real solution to the “Barnett problem” lies not with some revamped formula, or even any of those complex needs assessments. The real solution is fiscal decentralisation. Alongside the devolution of spending authority, Westminster must finally devolve some of its tax raising powers.

In that way, those that benefit from higher local spending would also be required to pay for it. Not only is that fairer, but local taxpayers would then be the judge of whether their local public services justified the cost. And they would no longer be dependent on the murky, largely unaccountable deals of politicians hundreds of miles away in Westminster.

Which is why taxpayers on both sides of the border should pay close attention to the deliberations of the Calman Commission. Under the chairmanship of Sir Kenneth Calman, it is currently reviewing the first ten years experience of Scottish devolution. And critically, it is examining ways of improving the Scottish Parliament’s financial accountability.

The Prime Minister has identified the problem:

*“Devolution has worked, but I do see one problem: while there have been good reasons why this is so the Scottish Parliament is wholly accountable for the budget it spends but not for the size of its budget. And that budget is not linked to the success of the Scottish economy. That is why we asked the Calman Commission to look carefully at the financial accountability of the Scottish Parliament. And this is a critical part of Calman’s remit.”<sup>22</sup>*

Let us hope the Commission follows the logic of that remit. If the Scottish Parliament is to have real financial accountability, there needs to be a substantial decentralisation of tax raising responsibility away from Westminster. Both Scottish and English taxpayers would be its beneficiaries.

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<sup>22</sup> Speech to Scottish CBI, 5.9.2008