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② Barnett file

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MEMORANDUM E(02)___

FROM: FIRST MINISTER
DEPUTY FIRST MINISTER
MINISTER OF FINANCE & PERSONNEL

DATE: AUGUST 2002

TO: EXECUTIVE

SPENDING REVIEW OUTCOME AND BARNETT

Issue: Taking forward our challenge to the Barnett Formula following the outcome of SR2002.

Timetable: For discussion on 10 September 2002: also, a seminar is also planned for Ministers to draw out the background to the issues.

Recommendation: That the Executive should consider the implications of pursuing the challenge to Barnett as set out below, and indicate either their support for continuing the challenge (recognising that this will entail difficult collective decisions) or, if they regard the risks as unacceptable, how they would address the needs of public services within a Barnett-based system.

Detail

1. At the Executive meeting on 23 July it was agreed that we would circulate to colleagues the draft of a letter to the Chief Secretary proposing how we might, in the wake of the SR2002 settlement, begin to address with the Treasury our concerns about the implications and effects of the Barnett formula. Before taking this step however we need to reflect carefully on the consequences of a challenge to Barnett.

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The Case Against Barnett

2. Our case for reforming the Barnett formula rests on the powerful effect the formula has in converging per capita spending levels here towards the English average, which we believe cannot now be justified on the basis of relative need. Historically, the levels of funding available to services here may perhaps have permitted higher standards of service; but we have good reason to believe that any such differential has now been so eroded that in the coming years our services will decline below the necessary standards. It is our contention that taking account of our relative need, especially in the largest programmes such as health and education, our existing higher spending levels are fully justified and we do not have sufficient slack to absorb the convergence produced by the formula, particularly when English spending is rising rapidly.

Treasury Views

3. However, Treasury has strong opposing views – though our feeling is that they have not yet properly engaged with the detail of our analysis, claiming that there was not time in SR 2002. We should not underestimate their determination to defend Barnett, which is based on the realization that any challenge would destabilize the settlement for Scotland, Wales and the English Regions. Indeed, Treasury has expressed surprise that we are prepared to initiate a challenge as they focus on the (simplistic) facts that Northern Ireland has public spending which is 40% higher per person than England, and that we raise less revenue, proportionately, than any other region. The Chancellor specifically warned the First Minister and the Deputy First Minister against pressing our case.

The Way Ahead

4. We have now to decide whether to maintain our challenge to Barnett and if so by what means. We also have to have a clear idea what objectives we might

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realistically seek to achieve- In doing so we need to bear in mind the context in which we are operating. It is one of Treasury opposition and the lack of consensus with Scotland and Wales on the nature of reform. Indeed the Scottish Executive has made it very clear that it will argue for the retention of Barnett.

5. We could seek to alter the context by engaging with the other two devolved administrations in an attempt to persuade them that change is desirable all round. There are alternative models or criteria for the distribution of funding between regions (for example the Australian model), but we are a very long way from a consensus on how to proceed. However, mounting such an exercise would take time and contains no guarantee of success. Devolution to the English regions would be likely to complicate the exercise and thereby render it more protracted. However taking the initiative could have political advantages as well as risks.
6. In the short term, however, the SR 2002 settlement is final and there is no scope for improvement in the DEL allocations set out in the Chief Secretary's letter. This means that we have to address the Budget round for 2003-04 to 2005-06 on that basis, with the RRI borrowing or PPPs as the only possible sources of additional investment. We need first to make sure that we clarify the precise terms of the RRI and SR 2002 settlements in as favourable a way as possible, before opening the wider Barnett issues with all the complexity and potential difficulty that that will bring.
7. Looking a little further ahead, we will need to make the case in such a way as to maximise the chance of a better approach (Barnett plus) in the next Spending Review in 2004. Even if we were to challenge Barnett fundamentally, we may well be faced with learning to live with an accommodation that would take the rough edges off future Spending Review settlements but still leave the formula as the basis of our funding arrangements for the present.

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8. It can be argued that such an outcome might of course also be achievable without a full-scale assault on Barnett. We conclude however that only if we muster a very convincing case that our needs are not being properly met by the present operation of the formula will we even succeed in this approach.
9. Success in a challenge would clearly mean some material benefits for our public. However, such an enterprise cannot be pursued without a sober assessment of the risks of failure, as well as of the likelihood of success. Before we pursue this issue, we need to be sure we can deal with the consequences that might arise if the Treasury press on the main areas where our case is weak. **In particular, it is essential that we stand together on this issue. A collective approach is required both in seeking the benefits of challenging Barnett and accepting and endorsing the hard choices that may arise as a result of having initiated the challenge.** We believe we have reasonable answers to the main areas where Treasury will challenge us, but we need to be sure that those answers take us to a better outcome than we can have by standing back from the Barnett issue.

Weaknesses in our case

10. The issues from the Treasury's perspective are:
 - a. Prioritisation – Treasury will argue that we could improve provision for our priority programmes if we reduced spending on other services where we spend more than is the case in England.
 - b. Revenue – Treasury will underscore the fact that we contribute very much less to the cost of public services than is the case in GB – even in areas of greater social deprivation than here. Access to the new borrowing facility is conditional on loans being serviced from local revenue while the recent Settlement letter requires that we be committed to reform of the Water Service by January 2003.

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- c. Over-administration – Treasury has indicated its view that our service delivery problems are exacerbated by excessive layers of administration.
 - d. Public Sector Pay – Treasury argues that we have higher pay in the public sector than the private sector. They do not accept that we have to match parity with public sector pay in GB.
 - e. Underspending – Treasury will point to the relatively high level of end year flexibility.
11. We indicated to the Executive on Thursday 18 July that while we have a strong case in terms of overall need, as evidenced by the emerging results of the NEEs, we should not under-estimate the Treasury's determination to challenge us on the points summarised in the preceding paragraph. On these, the following answers can be given:
- a. On prioritisation – devolution means that we set our own priorities, and our case is based on the total overview of our DEL. Our case is that, adding together all the relative spending levels across all our programmes our net position is underprovision. Thus even if we adopted exactly the same relative prioritisation as England, we would not have sufficient to match service standards. However, we do have to recognise that where more is spent here than in England we need to demonstrate that such spending is fully justified in terms of those priorities, and that once a challenge is made, the Treasury will have full rights to question any aspect of our spending;
 - b. On revenue – The Executive is addressing local revenue through the Review of Rating Policy which has implications for the organisation as well as funding of the Water Services; the outcome to this review will also take into account the obligation to service any loans which we decide to draw down from the National Loans Fund. But the Treasury has made it clear that significantly higher levels and growth rates in

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revenue raising is a pre-condition for any further borrowing under the RRI. **But the point remains that opening the expenditure issues on Barnett with the Treasury will have no credibility unless we accept that we have to address the low level of local revenue;**

- c. On administration – The Executive has put in place the mechanisms for a very comprehensive and fundamental review of public administration; in addition the budget paper which has been circulated makes clear our determination to address administration and running costs across the Departments in the shorter term.
 - d. On public sector pay – This is a complex issue and not one as straightforward as Treasury 's claim suggests (nor is it one which we have yet addressed as an Executive). We have a good defence in some sectors such as health. But, in others, the Treasury may argue strongly that we do not need to match parity, and that our needs are hence overstated: we may lose some ground on this issue;
 - e. On underspending – The Minister of Finance and Personnel highlighted to the Assembly on 1 July the steps we can take to reduce the level of underspending, and this will be important in improving our defence to Treasury. We are determined to tackle the underspending issue in a concerted way.
12. We can defend our position on all of these points, but there is obvious scope for disagreement. These are the factors that have to be weighed alongside our case for more expenditure. The consequences of a challenge which is not ultimately accepted by Treasury would be the continuation of a Barnett only approach; but we should not under estimate the damage which could be caused on an on going basis by a hostile attitude on the part of the Treasury if the exercise caused them to be more aggressive towards us.

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13. Our assessment is that on balance we have a case, that is worth pressing based heavily in the large priority programmes, (and especially the argument that deprivation leads to higher health costs) and that we should follow through the decision we took in February to begin the challenge to the existing Formula. However, to ensure that we have a chance to manage the process of engagement with the Treasury, we can start with a focus on the detailed terms of the RRI and SR 2002 settlements, moving on thereafter to expenditure comparisons, and only widen the approach as that work develops.

Water Service

14. The Settlement letter includes the expected reference to the future of the Water Service. ~~We~~Ministers have known since March that the Treasury was going to adopt this approach – though we had not had any forewarning of the January 2003 deadline. This is a very direct proof of the kind of choices we face in dealing with Treasury. We attach a further note on RAB Stage 2 to draw out the financial consequences of this for us.
15. The Minister for Regional Development is actively considering some important ideas for the organisation and management of the Water Service which were discussed before the summer break. In very brief outline, the proposals from the Water Commissioner for Scotland would envisage:
- a. restructuring the Water Service as a public corporation, outside the Civil Service;
 - b. promoting very significant efficiency gains in operations and in capital procurement;
 - c. attractive terms for staff who would leave the Service (which could imply substantial up front costs);

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- d. a commitment not to introduce domestic water charges until substantive progress has been made on efficiency improvements (to secure confidence that any charges will not be out of line with GB); and
 - e. addressing the deficiencies in infrastructure through a managed capital investment programme – which could be a major plank of an RRI programme involving both borrowing for public sector capital, and PPPs.
16. These ideas need significant further analysis, and the Minister of Finance and Personnel proposes to continue in dialogue with analysis and development by the Minister for Regional Development to ensure Development. It is important that their implications are assessed fully and taken into account as appropriate in the Budget discussions in September and thereafter. By that time as well, the initial consultation on the Rating Review ~~will~~should have been concluded.

Approach To the Treasury

17. We have set out the issues as clearly as possible because it is very important that everyone knows what is involved in this enterprise. When the Executive has discussed the issue, we will circulate a draft of the letter that the Minister of Finance and Personnel might thus send to the Chief Secretary. After the necessary steps have been taken to clarify and confirm the terms of the RRI and SR 2002 settlements, which may take some time, the logical first step is a ~~relatively low-key~~ bilateral engagement with the Treasury on the details of our case: there is no question of a full blown Needs Assessment or Review of Barnett immediately, as those steps would require the agreement of the Scottish Executive and the Welsh Assembly Government. Our short term objective is to convince the Treasury that we have a case, which would then open up the question of what could be changed. This is our best way of pressing the issue without, at this stage, necessarily opening up all the associated issues in the short term.

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18. We should all be clear, however, that in opening up the issue there is no going back – if Treasury were to present evidence against us which was factual and persuasive we would have to face the consequences: these might be proposals for change that would work against us, though the very fact of the Government's commitment to Barnett is helpful here, in that on any reckoning the Barnett formula should still be available to us but that of course does not preclude the possibility that the Treasury would apply the existing system as unfavourably as they could within the objectivity of Barnett.
19. Thus before writing to the Treasury, we are seeking the views of each Minister as to how we should proceed with our Barnett challenge and we would be grateful to know whether or not you agree that we should continue to process the case. To help inform the discussion on 10 September, we propose to hold a workshop for Ministers to allow an opportunity for the factual background to these complex issues to be discussed outside the specific context of an Executive meeting, and this has been arranged for 5 September.
20. If we were to decide not to continue with a challenge to Barnett, we would need to find alternative ways of finding adequate provision for public services. The sources to be examined are few, and while each of the following is important, it would be wrong to conclude that they could remove all the effects of the Barnett problem :
 - a. We can only borrow if we raise more revenue, and one way forward would be to accept RRI as the only change to our position: however, the revenue issue is probably the most awkward of the reasons to hesitate over the challenge to Barnett, and thus if the proposal was to increase revenue as our main source of additional spending power, we might as well run the Barnett challenge as well;
 - b. Clearly we do need a major drive on public sector efficiency as part of our approach to this and future Budget rounds. But we do not believe

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that even the most radical approach to efficiency we could achieve would suffice to address the unmet needs in priority services. It would be dangerous to rely on this as our main solution to the issue of public service provision; we are nevertheless determined to pursue efficiencies where possible

- c. We also need to make the most of possible asset disposals. As the attached note draws out, RAB will penalise the retention of under-utilised assets, as the 6% charge for cost of capital, and the depreciation in the value of these assets, will be a call on DEL. The availability of accounting and budgeting information on these issues will also highlight the issue, not least to Treasury. Departments will have to act to manage assets more effectively, which should release some spending power for redistribution;
- d. Similarly, we need to address alternative sources of funding creatively but realistically. There are important debates about what should and should not count against the public sector both in the south, and in the health and transport sectors (especially) in GB. In our context, we have not yet found a viable model which secures additionality of investment without a very direct involvement of equity-based private finance. We may decide that such projects (adapted as appropriate, and as possible, to our policy considerations) can and should be a material element of our future financing strategy, and there may be other forms or models that could work. The SIB is the key to our approach. But realistically, it would be very optimistic to regard this as the sole solution, given that all models required flows of finance either from DEL or directly from revenues or charges. Thus our conclusion is that we cannot count on the "PPP/alternative sources" strand of RRI work as our only solution, and that the basic Barnett challenge remains a central issue, especially in relation to mainstream recurrent services.

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21. If we are to proceed then it is better to do so sooner rather than later. We would therefore be grateful for a response through or in advance of the Executive meeting on 10 September. If you have doubts about pursuing the challenge, it would be important to know how you would address the funding issues that we face, given the limitations on the alternatives set out above.

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