

PA Barnett file 38 2016

THE BARNETT FORMULA

LINES TO TAKE

- Barnett formula is the centrepiece of our funding arrangement and is the main driver of the expenditure over which we have discretion.
- The formula is based on our population share of similar additional spending in England but our need is greater than this so we are progressively squeezed over time towards English levels of spending per head.
- The very rapid increase in planned spending in England in the next three years will greatly exacerbate this convergence. On average, Barnett will only allow our spending to grow at $\frac{3}{4}$ of the growth in England.
- The introduction of Resource Budgeting would further increase the Barnett squeeze but the Treasury will try to fix this without undermining the formula.
- The Treasury are deeply committed to this formula and there is no consensus with Scotland and Wales on how it should be changed or replaced.

BACKGROUND

The Barnett formula was introduced for Northern Ireland in 1980 as a means of providing essentially automatic adjustments to the NI public expenditure block without the need for detailed negotiations.

The formula provides Northern Ireland with a population based share of any change (up or down) in a comparable Whitehall spending programme. It therefore adjusts the PE Block at the margins but the underlying baseline for the Block is the result of historical factors and is not set by any type of formula.

If the Barnett formula is applied rigorously then it will, over time, promote convergence in per capita spending in Northern Ireland towards the English average. This is because in per capita terms the existing baseline for the Block is greater than Northern Ireland's population share but additions through the formula reflect only the smaller population share.

The speed at which the formula drives convergence depends on the size of the initial per capita lead Northern Ireland enjoy in public expenditure and the rate of growth of English comparable spending. As a rule of thumb a 1% increase in the growth of English spending when translated through the formula will allow a $\frac{3}{4}$ % growth in the comparable spending in Northern Ireland.

The very rapid increases in planned English spending over the period of the 2000 Spending Review from 2001/02 to 2003/04 averaging 9.5% per annum is therefore expected to produce a significant degree of convergence through the formula.

There are other technical aspects of the formula and the way it is applied that can work either for or against Northern Ireland according to circumstances. The tradition has been to accept "the rough with the

smooth" in working the formula but in recent years the balance has swung markedly towards the rough.

Not all of the funding for Northern Ireland is regulated by the Barnett formula. Other resources, for instance for the EU Peace Programme, are provided outside the formula and all social security spending is handled on an entirely different basis. However, these other sources of funds are ring-fenced for specific purposes and cannot be reallocated by the Executive. The Barnett formula is the driver of the 'Assigned Budget' which is that part of spending in Northern Ireland over which the Executive exercises its discretion. This is why the performance of the Barnett formula is critically important for the Executive.

Changes in the public expenditure regime can require changes to be made to the Barnett formula. One such change is the shift to Resource Budgeting (RAB). This involves splitting the Budget into a Resource budget which is measured on an accruals basis and essentially meets operating expenditures (wages, purchases etc) and a capital budget which covers capital expenditures. The two budgets are linked by a set of charges that apply to the capital asset base such as depreciation and a cost of capital charge. The latter reflects the fact that investment by the public sector ties up resources that could earn a return in the private sector and for which a charge is appropriate to reflect this opportunity cost. These annual capital charges come out of the Resource budget and hence compete with other spending from that budget.

Because water and sewerage assets which are privatised in England and other assets such as some roads and the schools estate which are local authority responsibilities in England remain part of central

government in Northern Ireland, we have proportionately a much bigger asset base to which capital charges apply than is the case for Whitehall departments. It follows that if we only get a Barnett population share of changes in English capital charges this will fall well short of the actual capital charges our asset base will produce. The difference represents an additional squeeze on the Executives resource budget and hence the services it can provide. Discussions are ongoing with Treasury officials on how the Barnett formula needs to be adjusted to overcome this difficulty.

Despite the particular difficulties with the Barnett formula it is recognised that devolution requires some sort of formula funding arrangement to maintain the Executive's budget at arms length from detailed scrutiny by the Treasury. Unfortunately there is no consensus even among the devolved countries on what should replace Barnett. Despite complains from the English regions that the formula is too generous to the devolved countries the Treasury is very firmly attached to Barnett. From their perspective it is the lynchpin of the funding arrangements for devolution, it is reasonably simple to operate and offers a bonus by maintaining an incentive to efficiency by squeezing devolved budgets. There is also no obvious alternative. Thus the Treasury can be expected to go to great lengths to preserve the essential features of the Barnett formula.