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A New Settlement

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FISCAL POWERS IN NORTHERN IRELAND: A NEW SETTLEMENT

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ABSTRACT

Devolution has dramatically altered the political and economic makeup of the United Kingdom over the last 20 years. In more recent times, greater fiscal powers for devolved regions have become a key policy goal to achieving more balanced regional development in the UK. However, in Northern Ireland (NI) such measures always weighed against the risk that the resources for public expenditure might be threatened. Financial governance issues have been a source of instability for the NI Executive and it is far from clear that adding significant fiscal powers would improve that situation.

This paper contends that the current devolution settlement in NI incentivises poor expenditure decisions and policymaking particularly as it relates to economic affairs. The extent of expenditure devolution in NI is misleading and has led to most of the policy mistakes to date. In particular, the devolution to NI of spending on social transfers without full policy autonomy has never been reconciled. While the process of fiscal devolution in Scotland would likely be the model adopted for NI, this would be a mistake for NI. The current devolution settlement was not designed for the purposes to which it is now being put. If fiscal devolution is to take place, policy would be better focused on reforming the entirety of the current revenue and expenditure system to design one more appropriate for the political situation that now exists. Introducing a needs-based system to replace the Barnett formula would ensure that spending power for public services actually is equalised on a per capita basis among the regions. NI should only seek broader fiscal powers under a full system of fiscal equalisation which recognises the unique cost and revenue challenges of the region.

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SECTION 1: INTRODUCTION

Devolution, or the process of bringing government decision-making as close to the people affected by it as possible, has dramatically altered the political and economic makeup of the United Kingdom over the last 20 years. The first phase of devolution which took place across the United Kingdom from 1998 established governments for Scotland, Wales and Northern Ireland (NI). The exact nature of the devolution settlement was unique to each region, but all involved a large transfer of public expenditure from UK government departments to the new devolved governments. Scotland's devolution package stands apart because it contained some measure of fiscal autonomy in the form of tax varying powers related to income tax. However, it was in NI where the greatest proportion of public expenditure was devolved. In particular the devolution of social security spending has meant that for most of its existence, the NI Executive has been the most powerful government beyond Westminster.

In more recent times, greater fiscal powers for devolved regions have become a key policy tool for those wishing to bring more balanced regional development (Bartolini et al, 2016). Scotland has led the charge in this regard adding significantly to its fiscal competencies since 2015. There is a simplistic view that merely devolving greater fiscal powers will bring greater economic growth, but such 'silver bullet' thinking is misguided. Greater devolution cannot be an end in itself but must be about providing branches of government with the right incentive structure in order to make the most effective policy decisions.

Debates about fiscal powers in NI tend to be focused on the gap between the amount of public expenditure in NI and the amount of revenue raised in the region. Greater fiscal powers are always weighed against the risk that the resources for public expenditure might be threatened. NI is a region of the United Kingdom and thus a constituent part of the UK's transfer union and whilst it is a net recipient under most calculations of revenue and expenditure, it shares that distinction with 8 of the UK's 11 other regions (ONS, 2020). The scale of the gap in revenue and spending in NI also contributes to debates about Irish reunification and whether NI would present a financial burden to the Republic of Ireland in that event (FitzGerald & Morgenroth, 2019). Such discussions are at best hypothetical. In addition to the unique economic history of NI, its current financial position is a function of its place in the UK's transfer union and the powers which have been devolved to it.

It is this fixation with NI's purported fiscal deficit which has closed off much of the debate about fiscal devolution in NI. As devolution, both expenditure and fiscal, has advanced considerably in Scotland and Wales over the last number of years, the debate in NI has been reduced to policy proposals to raise small amounts of additional revenue through existing channels. This debate needs to move on and set about completing the process of devolution which began in 1998. Given the scale of expenditure devolution that already exists in NI, it would seem obvious that any further devolution would have to occur on the revenue side. However, recent issues related to devolved spending in NI have also shown that there are structural issues on the expenditure side of the devolution settlement in NI that require just as much attention. Controversies such as the Renewable Heat Incentive Scheme in NI have become a bad advertisement for devolution.

The aim of this paper is to show that fiscal devolution should not happen in isolation but must be accompanied by significant reform of public spending. In both cases these reforms should aim to create the kind of incentives for better economic policymaking in NI. Section 2 sets out the context of fiscal and expenditure devolution in NI and as it relates to the other devolved regions. Section 3 outlines specific issues related to public expenditure devolution which have led to suboptimal policy decisions. Section 4 will set out the challenges of greater fiscal devolution in NI particularly in the context the experience to date in Scotland. Finally, drawing on these observations, Section 5 will set out the principles of a new devolution settlement which could provide the appropriate incentive structure without undermining the resources of the devolved government.

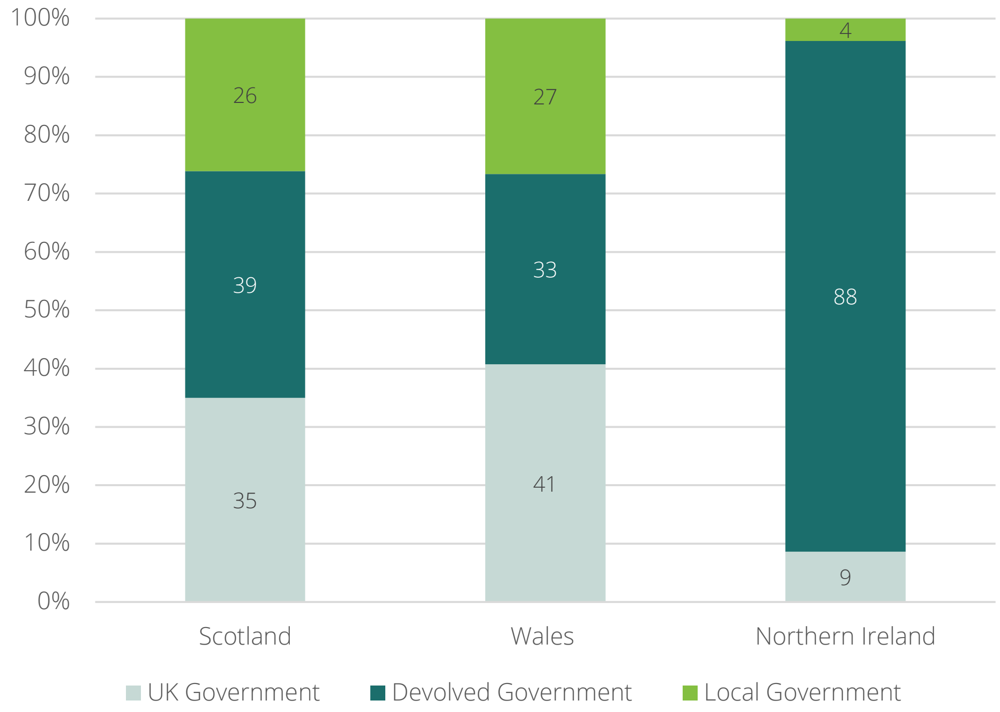
SECTION 2 WHO GOVERNS?

The debate over fiscal devolution in NI, as in other devolved UK regions, should not be framed on the overall balance of revenue and expenditure but should instead refocus toward the balance of revenue and expenditure powers between branches of government. Public expenditure in the devolved regions of the UK is carried out by the UK Government, the devolved governments and local government in addition to all their affiliated agencies and public bodies. Each of these branches of government also has some competence to raise revenue within the devolved regions. As this section will show, devolution has opened up fiscal gaps at all levels of government within the devolved regions between the governments which tax and the governments that spend.

Spending carried out by local and devolved governments can be accounted for regionally but with regard to UK Government expenditure, there is a distinction between identifiable and non-identifiable expenditure. The UK Government directly spends money in NI and this can be identified and accounted for relatively simply. The UK Government also spends money outside of NI, for the benefit of NI and this expenditure is treated as non-identifiable. The majority of non-identifiable expenditure is made up of public goods such as national defence, international aid and heritage and the vast majority of spending is attributed to regions on a per capita basis.

Identifiable expenditure is the main route through which governments can impact the economy of a particular region through the provision of services and social transfers. As Figure 2.1 shows, NI is unique among the devolved regions with almost 88% of all identifiable government expenditure occurring in NI under the remit of the devolved government. Whilst the UK Government is responsible for much more expenditure in Scotland and Wales, there is also a sizeable gap in the amount of expenditure carried out by local government in NI compared to the other regions.

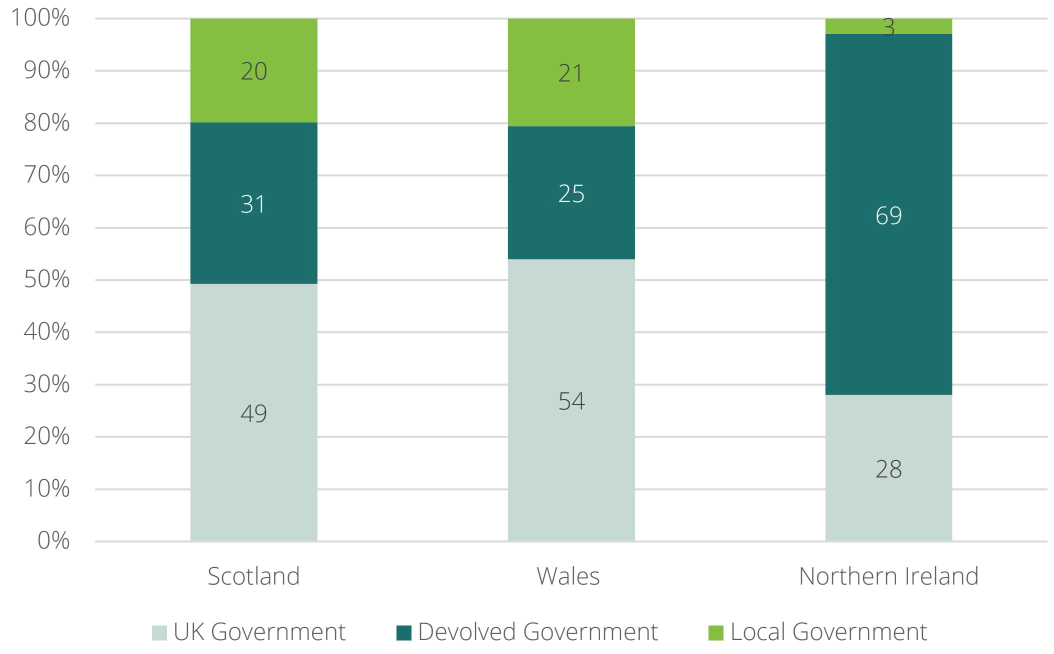
Figure 2.1: Share of Identifiable Expenditure by Branch of Government and UK Region 2019



Source: HMT (2020)

While identifiable expenditure gives the most accurate picture of expenditure among the regions, when comparing revenue and expenditure among the branches of government, non-identifiable must be included. This is because the revenue raised by the UK Government in all three regions is used to fund both identifiable and non-identifiable expenditure. Any comparison with identifiable expenditure would understate the expenditure role of the UK government while not making a similar adjustment to the revenue side. Figure 2.2 shows the expenditure roles of the three branches of government with non-identifiable expenditure attributed to the UK Government. The largest difference is in NI where the share of UK Government in expenditure increases by just under 20 percentage points.

Figure 2.2: Share of Total Expenditure by Branch of Government and UK Region 2019



Source: HMT (2020)

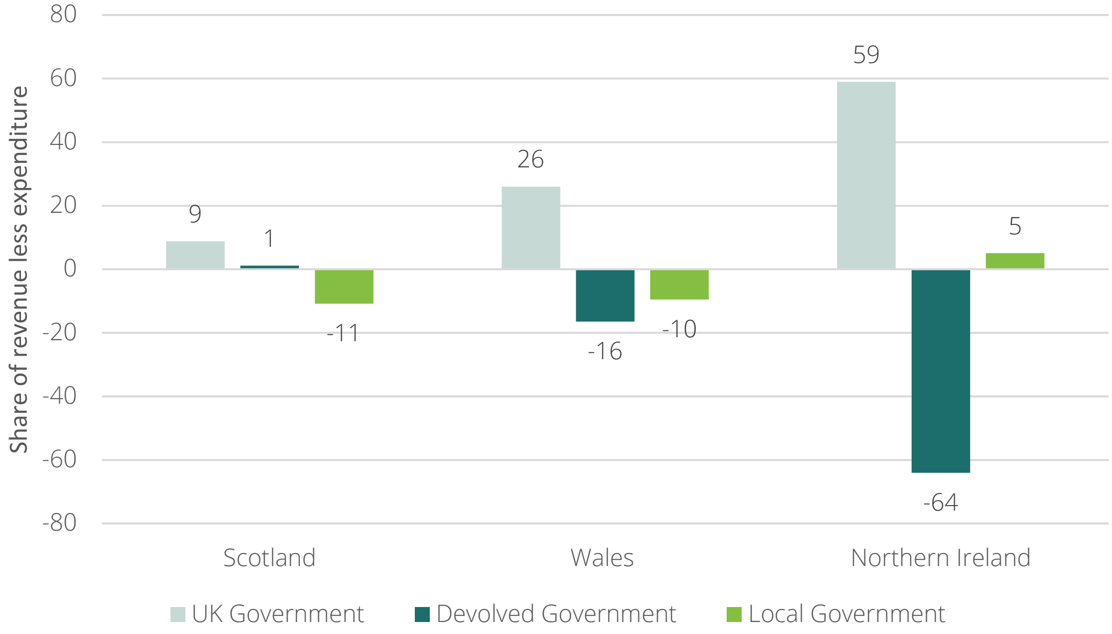
Turning then to revenue, the UK Government as the national government obviously commands the greatest fiscal competence of the three branches of government. It has the ultimate and unlimited authority to levy taxes and charges in all three regions. As is the case with expenditure, devolution of tax raising powers has followed an uneven course among the regions of the UK, with fiscal devolution having advanced considerably in Scotland. As Figure 2.3 shows the UK Government is responsible for the vast majority of revenue raising across the three regions although the Scottish Government now accounts for just under one third of total revenue raised there. All three regions have similar levels of local government revenue shares.

Figure 2.3 Share of total Revenue by Branch of Government and UK Region 2019

Source: Institute for Government (2019)

What stands out from Figures 2.2 and Figure 2.3 is the gap in share of spending and revenue between the branches of government. In Scotland, local government accounts for a much larger share of expenditure than revenue, while in NI and Wales it is the devolved government that has the largest gap. Figure 2.4 sets out the difference in shares of expenditure and revenue between the three branches of government in each of the three devolved regions. In this context, it is clear that Scotland's devolved government has closed its fiscal gap almost completely while local government still accounts for a larger share of expenditure in Scotland and Wales, but not NI.

Figure 2.4 Difference in share of Revenue and Expenditure by Branch of Government and UK Region 2019



Source: HMT (2020)

What Figure 2.4 shows is that while fiscal gaps remain in the three regions, the gap in spending and fiscal competency is greatest in NI between the UK and devolved governments. There is no rule that each branch of government should have an equal share of revenue and expenditure in a particular region and indeed it may suit the purposes of particular forms of public expenditure for spending to be carried out by a body with limited fiscal powers. However, the scale of the gap between expenditure and revenue in the exercise of devolved government in NI is so great that it does call into question the incentive structure that exists for the NI Executive.

In NI the devolution of spending powers was intended to provide a locally elected government with the capacity to make policy decisions that will benefit the regional economy. However, with almost no exposure to the consequences of those decisions in the form of tax revenue, it is unclear whether NI's devolution settlement can live up to the expectations that have been set for it. The devolution settlements for Scotland and Wales have changed considerably over the last 10 years and the process has been more evolutionary. NI started out with a lop-sided devolution package and it may well be that it is this imbalance which has trapped it in its current devolutionary stasis.

SECTION 3: PUBLIC SPENDING

Public expenditure throughout the UK is aggregated under two different frameworks. The first is the 'Total Expenditure on Services' (TES) framework which is based on public sector accounts and the second is the 'Total Managed Expenditure' (TME) framework which is constructed in the same way as National Accounts (HMT, 2020). These two methods of aggregation are only somewhat comparable. They are assembled separately and therefore there can be significant gaps between estimations. TES data is that which is presented in the previous section as it is the only way of showing identifiable expenditure broken down into function and sub-functions of expenditure, all of which can be attributed to region and the branch of government carrying out that expenditure. The TME method of aggregation is based more closely on the UK budgetary process and treats regional expenditure in terms of transfers to departments such as Health or Education. This method is important because it is used to calculate the budget of the devolved governments.

As set out in section 2, non-identifiable expenditure is only carried out by the UK Government and as it is only hypothetically allocated to each region, there is no regional breakdown of non-identifiable expenditure by function. Both TES and TME methods provide different ways of accounting for identifiable spending in the devolved regions. Once again, direct comparisons are not easy to make given the methodological differences in both aggregations. However, the TES method can show who spends money in NI and where they spend it while the TME method shows the nature of the public expenditure that takes place. Both methods provide different breakdowns of the same spending. The TES method shows how the scale of devolution in NI makes that government very different to those in Scotland and Wales. The TME method highlights the difficulties and constraints of how different branches of government can spend that money.

3.1 Total Expenditure on Services

Identifiable expenditure is carried out by all branches of government in each of the regions and there are considerable differences between regions in the degree to which functions of government expenditure have been devolved to branches of government. Figure 3.1 shows firstly what proportion of functional spending is carried out by each branch of government and secondly it shows what proportion of each government's expenditure is assigned to each function. Both presentations of the data yield important distinctions.

Figure 3.1 Total Expenditure on Services by Function, Branch of Government and UK Region 2019

	Scotland			Wales			NI		
As a % function	UK	Devolved	Local	UK	Devolved	Local	UK	Devolved	Local
General public services	9	46	45	14	47	39	14	86	0
Defence	0	0	100	0	0	100	0	0	0
Public order and safety	3	97	0	39	0	61	0	100	0
Economic affairs	36	42	22	39	44	17	13	85	2
Environment	22	18	60	16	22	62	5	18	77
Housing and amenities	0	52	48	1	37	61	0	72	28
Health	0	100	0	0	100	0	0	99	1
Recreation and culture	9	24	68	24	24	52	6	34	60
Education	0	31	68	0	29	71	0	100	0
Social protection	75	4	22	78	1	21	15	85	0
As a % of Expenditure									
General public services	1	2	4	1	2	2	3	2	0
Defence	0	0	0	0	0	0	0	0	0
Public order and safety	0	11	0	4	0	10	0	6	0
Economic affairs	12	12	10	8	11	5	14	8	5
Environment	1	1	5	1	1	4	1	0	24
Housing and amenities	0	5	7	0	3	6	0	3	26
Health	0	53	0	0	69	0	0	24	6
Recreation and culture	0	1	4	1	1	3	2	1	38
Education	0	11	37	0	11	34	0	14	0
Social protection	85	4	34	85	1	35	80	42	0

Source: HMT (2020)

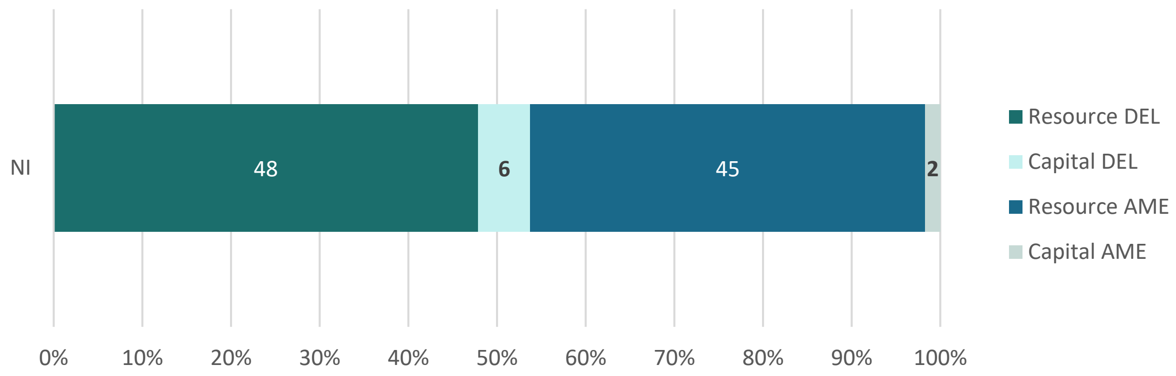
We know from Figure 2.1 that the devolved government in NI accounts for much more spending than in Scotland or Wales. What the first section of Figure 3.1 shows is that this not only reflects less UK Government spending but also significantly less spending by local government. Local government has a significant stake in all but 3 areas of public expenditure in Scotland and Wales, but local government features only in three areas of expenditure in NI. The UK Government has a greater role in Environment and Economic Affairs in Scotland and Wales but it is social protection spending where NI's devolved government stands apart. As the latter portion of Figure 3.1 shows, while the vast majority of devolved expenditure in Scotland and Wales is on health, in NI it is social protection. The roles of social protection spending in NI is often overlooked and to understand the reason why, it is necessary to analyse public expenditure under the TME method.

3.2 Total Managed Expenditure

As Figure 2.3 showed, both devolved and local government raise a small amount of revenue in NI. Local government is largely self-sufficient with a series of grants from both UK and devolved governments adding to its output. For devolved government the vast majority of public expenditure in NI emanates from the UK Exchequer. The UK Exchequer itself finances such expenditure on subsequent receipts of tax revenues levied by Her Majesty's Revenue and Customs across the UK, including NI. The UK Government obviously spends money directly from the exchequer but for the devolved government, that money comes in the form of cash transfers.

These transfers come in two forms, Departmental Expenditure Limits (DEL) and Annually Managed Expenditure (AME). This system of financing is used to fund UK Government departments as well as the devolved administrations in Scotland, Wales and NI. DEL are limited grants made by the UK exchequer to a government department or devolved authority to provide services. It is further granted in either capital or current (resource) expenditure form. In NI DEL is assigned to sub functions of the NI Executive through a budget process which allocates funding to departments. The total sum of DEL is more colloquially known as 'the block grant'. As Figure 3.2 shows, DEL accounts for 54% of NI's public expenditure with AME accounting for the remainder.

Figure 3.2 Total Managed Expenditure Northern Ireland 2019



Source: HMT (2020)

The annual change in the block grant for NI is determined by the Barnett Formula which also decides the growth in the levels of funding for Scotland and Wales too. The Barnett formula is not a simple population-based adjustment, it also recognises that different regions have differing levels of control over areas of expenditure and calculates how much of the increase in UK expenditure should be reflected in devolved budgets. It is important to note that the Barnett formula does not determine the size of the overall block grant, merely its rate of change. Barnett consequentials, as they are more commonly known, are intended, over the long term, to equalise per head public spending across the UK.

The second form of transfer is Annually Managed Expenditure which is provided for spending that cannot be subject to multi-year limits. Social and other cash transfers make up the bulk of this expenditure. For example, it is not possible to calculate each year how many people will seek to claim Job Seekers Allowance, therefore the total spend on this welfare benefit will be determined by the number of people entitled to claim this benefit over that time period. The distinction between these two funding streams has contributed to a significant number of controversies related to public expenditure in NI.

The NI Executive has over the course of its existence put in place both annual and multi-annual budgets but as they only allocate NI's DEL allocation for any given period they only cover just over half of identifiable public expenditure in NI. Over the years of devolution, AME has proved the most difficult area of expenditure to reconcile with devolution and two examples illustrate these difficulties. The first relates to the UK Government's Welfare Reform programme that began in 2010 and the second relates to the much-noted Renewable Heat Incentive scheme.

3.3 Perverse Incentives

Under the terms of NI's devolution settlement, all matters relating to social security were devolved to the NI Executive, in contrast to the settlements for Scotland and Wales. This gave the NI Executive the power to decide entitlement criteria for a range of benefits in NI. The benefits were then paid to recipients from the UK exchequer via the NI Social Security Agency. For much of the devolution period, the NI Executive chose to adopt qualifying criteria for these benefits that was comparable to the rest of the UK. In short, a benefit claimant in NI would receive the same level of benefit payment as they would have done had they claimed in England.

When the then UK Government began its programme of welfare reform in 2010, it tightened the criteria for many working-age benefits in an effort to reduce total AME expenditure. If less people were entitled to claim, less benefits would be paid out and less AME would be spent (Taylor-Gooby, 2011). However, the UK Government had no authority to tighten benefit criteria in NI and therefore the number of benefits paid out in NI would not decline and neither would the total AME spend in NI. This presented an obvious policy conflict. The NI Executive had no incentive to tighten the benefit criteria as the money that paid for this was paid directly by the UK exchequer through AME.

The NI Executive controls how the money is spent, but has no responsibility for how much money is spent. The UK Government had responsibility for AME, but was unable to affect how much of it was spent in NI. Ultimately, the UK Government devised a solution whereby, they would calculate how much AME would be saved in NI if the reforms in the rest of the UK were implemented in NI. This was a controversial policy choice given that the reforms in the rest of the UK had yet to be shown to save any money (Beatty & Fothergill, 2018). Nevertheless, they calculated what this amount would be and then threatened to reduce NI's DEL settlement by exactly this amount in order to provide an incentive for the NI Executive to carry out the reforms. After a political process between the various parties in the NI Executive it was decided that NI would forgo some of its DEL settlement in order not to have to implement some of the reform measures and would implement the remaining reforms.

The experience of welfare reform established that while the NI Executive did have policy autonomy on welfare paid for through AME, ultimately the UK Government had found a way to make the NI Executive financially responsible for their decisions.

This precedent came to haunt the NI Executive when they introduced the Renewable Heat Incentive scheme in 2012. In this instance, an RHI scheme was introduced by the UK Government which included funding for NI. As the policy area was devolved to NI, the NI Executive had the authority to amend the scheme to suit NI. The NI Executive undertook a number of changes which made the scheme more lucrative then the original UK scheme. At the same time forecasts of expenditure for the UK Government scheme began to rise considerably and the it was curtailed at GB level (McBride, 2019). However, in NI no action was taken and the NI amendments to the UK scheme only added to the forecast expenditure of the NI scheme. While the state and political failures of the RHI episode have now been detailed in a public inquiry, one of the key findings relates to a misunderstanding by The NI Executive of how AME worked in NI.

Originally the expenditure apportioned to NI under the RHI scheme was through the AME channel, as it was cash transfer from the government to business. At that point the UK Government was responsible for the financial burden of the scheme. However, when the NI Executive sought to alter the scheme, it then took on the financial responsibility. As with welfare reform, any expenditure over and above that projected for the UK scheme would be paid for by reductions in DEL. The NI Executive did not realise this until it was too late and the scheme was projected to cost multiples of what had originally been estimated.

What both of these experiences highlight is that the expenditure devolution that is outlined for NI in Figure 2.1 is an illusion. The current arrangement is a bad advertisement for devolution because it gives devolved government the appearance of authority without the financial clout. The solution that was arrived at in the welfare reform episode was particularly inappropriate given that it ignores the connections between expenditure on public services and expenditure on social transfers. An increase in spending on public services can reduce expenditure required for social transfers and vice versa. For example, spending more of health services can reduce the need for welfare payments by tackling chronic health conditions earlier. Ignoring this relationship removes many incentives for the NI Executive to attempt to fashion policies tailored to NI's particular environment. Rather than introducing financial discipline, such measures limit the reach of devolved government. Many of the dynamics outlined here regarding the division of spending streams also apply and have significant implications for fiscal devolution. The role of the block grant and any Barnett consequetials factor significantly in terms of any calculation regarding the devolution of any revenue raising powers.

SECTION 4: TAXATION

The restoration of the NI Executive in 2020 was also accompanied by increased emphasis on NI beginning to raise more of its own revenues (NIO, 2020). As Figure 2.3 showed previously, charges levied by the NI Executive amount to approximately 5% of NI's total revenue. It is posited that one way for the NI Executive to take a more assertive role in economic policy is for the Executive's expenditure to have some level of connection to the health of the NI economy. Regrettably much of the debate in this regard has focused on the NI Executive using its existing limited fiscal capacity to levy increased and additional charges to fund greater public expenditure in NI. Unfortunately, this line of policy starts out from the flawed assumption that financial pressures on public expenditure in NI are the responsibility of the NI Executive and even more erroneously suggests that the NI Executive has the competence to do something about it. In reality, the capacity of public expenditure in NI to meet the needs of public services and public welfare in NI is a function of the decisions taken by the UK Government and the Barnett related outcome that transpires subsequently.

It is of course possible that increased user charges and levies, which could be achieved without any further devolution, could raise additional funds but in this scenario the level of additional revenue would be minimal. A report for the Northern Ireland Council for Voluntary Action (PWC, 2013) examined what charges and levies the NI Executive could reasonably apply and estimated what level of additional revenue they could hope to gain. The report profiles more than a dozen measures ranging from the introduction of tuition fees for university places and domestic water charges to increased charges for medial prescriptions and public transport. Along with commercialising revenues from public sector bodies and agencies, the upper limit of what could be raised was estimated to be in the region of £400m. This is not an insignificant some of money, but it equates to less than 2% of NI public expenditure. Furthermore, most of the measures outlined are either user charges or levies that are not linked to income and so by their very nature are likely to be highly regressive.

Even in the scenario where NI does raise this amount of money, the financial boost to the NI Executive is likely to be short-lived. Any shortfalls in public expenditure are the direct result of funding shortfalls from UK Government decisions. Using £400m to plug existing gaps will not remove the likelihood of further shortfalls in the future. The sufficiency of public expenditure in NI is a UK wide issue. The UK has one of the lowest population-adjusted levels of public expenditure in Northern Europe. Most importantly from NI's perspective, the UK has one of the lowest levels of revenue per population, especially regarding employer social insurance contributions (Goldrick-Kelly et al, 2020). Debates about the proper funding of NI public services are a discussion best directed at UK revenue and expenditure levels.

In the same way that new levies and charges will not solve shortfalls in public expenditure in NI, greater fiscal powers do not offer a silver bullet either. The process of making the NI Executive responsible for revenue that currently flows directly to the UK Exchequer is about refocusing incentives in order that the Executive itself makes better expenditure decisions. Devolving the power to raise significant revenue streams such as income or consumption taxes is a significant reform and the implications for public expenditure need to be understood.

To understand how any such transfer of tax raising powers would work in NI it is instructive to look at the most recent experience of fiscal devolution in the UK. Following the report of the Smith Commission in 2014 various new tax raising powers were transferred from the UK Government to the Scottish Government. Among these new powers the Scottish Government now receives and sets the rates of income tax in Scotland. Scotland still receives a 'block grant' from the UK Government like NI does, but now part of that grant is reduced to reflect the loss to the UK exchequer of the income tax revenues that now go directly to the Scottish Government. This arrangement would affect no change to the Scottish Government's finances up until the point that it decides to vary the rate of income tax. At this point the UK Government adopts a solution similar to that used for NI during the welfare reform period. The UK Government continues to calculate what revenue it would have received had it levied income taxes in Scotland. It will then deduct this amount from the Scottish block grant. However, the deduction to the block grant and the revenue that the Scottish Government derives from income tax are no longer automatically equivalent.

The Scottish Government altered the rates of Scottish income tax in 2017, shifting the burden of taxation towards the upper end of the income distribution. In the two years since its introduction, the Scottish Government has experienced shortfalls in what it expected to collect in income tax. The out-turn of revenue from Scottish income tax has also fallen short of projections used by the UK Government to estimate what the reduction in the block grant should be. At least some of this lost potential revenue is due to Scottish income tax payers moving their income to other parts of the UK, and owing to this, there is a reconciliation process whereby the UK Government compensates the Scottish Government for some of this loss.

Tax competition among regions is quite common, especially in federal systems and the current settlement for Scotland acknowledges this. However, the UK is not a federal system and in the current context Scotland is attempting to fashion its own tax policy as a small region existing next to a much larger one. The OECD has looked at sub regional tax competition and made some important findings regarding relative size of the regions involved (Blöchliger & Pinero-Campos, 2011). They found that regions with greater tax raising capacity have lower tax rates with poorer regions having to levy higher rates in order to garner the same revenue. When you have the lopsided relationship such as exists between

Scotland and the remainder of the UK, any attempts by Scotland to raise revenue will be blunted by this. The rest of the UK will always be able to charge lower rates of taxation and raise sufficient revenues.

For tax competition among regions to produce better outcomes, the competition needs to be balanced. On the positive side, the OECD also note that tax in more economically evenly matched systems and where regions have significant tax raising autonomy, tax rates tended to rise rather than precipitate a race to the bottom. Furthermore, tax disparities between regions tended to decrease, implying some level of fiscal convergence. The experience of Scottish income tax highlights that there are significant pitfalls for NI as a region seeking to greatly diverge from current UK tax rates as a way of boosting growth or funding additional services. Sub regional tax competition can be possible, but the system is too unbalanced at present to allow this.

NI experienced some of these arguments during the debate over the devolution of corporate tax to NI (Birnie & Brownlow, 2017). The stated policy of the 2007-2017 NI Executives was to devolve the power to levy corporate taxes to NI and for NI to change the rate to match that in the Republic of Ireland. The policy would have seen the UK Government calculate what it would have raised in corporation tax in NI and then deduct this from the NI block grant. As in Scotland, once NI altered rates, there would be a gap between what was deducted from the block grant and what was raised in revenue. However, the discussion of this policy highlighted another danger inherent in devolving power over individual revenue sources.

Those proposing the devolution of corporation tax argued that reducing the rate would generate new economic activity and overall revenue would increase. Therefore, the policy was propagated on the idea that it would be 'self-financing'. Whether or not the cut in corporation tax would have achieved an increase in activity is a separate debate, but the claim that it would be self-financing is misleading. It is possible such a policy would be self-financing for the UK, but not for NI. The revenue buoyancy that they projected would result from lowering the rate of corporation tax would be spread among all revenue streams and not limited to corporation tax receipts. This was acknowledged in a report produced for the

NI Executive at the time (EAG, 2011). Without devolution of other revenue streams, NI would likely be worse off from a public expenditure point of view and would have faced all the cost of cutting corporation tax rates while only seeing a fraction of the hoped-for benefits.

The devolution of VAT revenue to Scotland possibly provides a better example for NI. In this area, the Scottish Government receives half of the revenue raised by VAT but cannot alter the rates levied (HMT, 2016). The government is exposed to impacts of its economic policies on tax revenue but is also shielded from some of the volatility. This follows the example of the arrangement between the federal government and the states in Germany where personal income tax, value added tax and corporate income tax are shared on an almost equal basis between state and federal governments (Werner 2008). A region in this scenario is shielded by only being exposed to half of the revenue and is also shielded from volatility by being exposed to revenues from both income and expenditure.

Devolving revenue raising to NI could allow the Executive to adopt more interventionist policies and assume greater responsibility for economic growth in NI, but the process must acknowledge the dangers of doing so in a piecemeal fashion. Having exposure to revenue streams can be beneficial, but varying rates can lead to significant volatility. Having exposure to a fraction of all revenues is preferable to having total exposure to some. However, even if this level of fiscal devolution could be agreed, it would not solve many of the issues related to public expenditure in NI.

The system of public expenditure disbursement in the UK was not intended for the political settlement that is now in place. The Barnett formula unnecessarily limits the debate around public expenditure in the regions and diverts attention away from the central role of the UK exchequer. The mechanisms of expenditure devolution were never intended to exist alongside significant fiscal devolution to the regions. The system of DEL and AME have been warped in order to accommodate greater fiscal devolution in Scotland, but it is an unnecessary compromise. If fiscal devolution is to take place, policy would be better focused on reforming the entirety of the current revenue and expenditure system to design one more appropriate for the political situation that now exists.

SECTION 5: A NEW SETTLEMENT

As this paper has set out, there are a number of issues related to the devolution of revenue and expenditure powers across the UK. The experience of Scotland has illuminated some of the challenges that will be posed by moving further down the path of fiscal devolution. These challenges are not insurmountable, but given the issues that already exist within currently devolved structures, any further devolution should be taken as an opportunity to question whether we continue making amendments to our current settlement or do we push for something new. There are lessons that can be learnt from other regional systems, but rather than attempting to supplant one system with another we need to be clear about what is currently at fault and what needs to be reformed. A new devolution settlement should seek to have some level of balance between expenditure and revenue. Branches of government do not need to be financially independent, but the lopsided arrangement in NI presents and obvious policy misallocation.

The division in spending in NI between public services and social transfers is unsustainable. Yes, social transfers can be hard to predict in terms of expenditure, but as recent experiences with the health system has shown, this is not exclusive to social transfers. Following the report of the Smith Commission greater welfare powers were devolved to Scotland in 2016. The mechanism that was agreed entailed separating the AME expenditure related to the benefits that were due to be devolved. This amount of AME is then be transferred to the Scottish Government in a similar way to how DEL is apportioned. In this instance the UK Government calculates what it would have spent on welfare in Scotland and gives that amount to the Scottish Government. The welfare powers devolved to Scotland did not include automatic stabilisers such as unemployment benefit, and therefore the amount of AME expenditure was easier to predict. Nevertheless, this possibly provides a future model for NI in the context of broader reforms.

The current split of these streams of expenditure also poses problems for fiscal devolution. Volatility from tax revenue cannot be borne by public services spending alone. The imbalance of economic power between the regions of the UK must temper any inclination towards divergence of tax rates in the event of greater fiscal devolution. Ideally, greater devolution to Scotland, Wales and NI would also see a greater devolution to the English regions, but absent this, the current imbalance remains. Volatility in revenues can also be amplified if devolution is limited to cyclical or mobile tax revenues.

In addition to these issues, there needs to be an acceptance that moving toward greater fiscal devolution undermines one of the key planks of the current settlement, the Barnett formula. The Barnett formula relies on devolved spending being tied to transfers from the UK exchequer. As more and more public spending is provided for regionally administered revenues, the capacity of the Barnett formula to achieve its aim of equal per capita public spending is undermined. This is possibly the strongest case for creating a new devolution settlement, as the Barnett formula has been the linchpin of the current system since its inception.

Calls for the reform of the Barnett formula long predate this current phase of devolution. It is worth reconsidering some of those issues in the context that we now find ourselves in. The most enduring criticism of the Barnett formula is its simplicity. The Barnett formula seeks only to apportion the same level of increase in devolved areas of spending between the regions and the rest of the UK. At no point does the formula seek to take into account any unique or extenuating circumstances that exist within a region. In fact, the Barnett formula is designed specifically to avoid discussion over special regional circumstances. The Barnett formula was designed by 1978 to replace the system of annual bargaining that took place between Scotland and the UK Government (Heald & McLeod, 2005). While no one is arguing for the return to annual bargaining, it is possible to construct a mechanism that takes into account special circumstances whilst preserving the uniformity of a formula.

A needs-based approach to regional funding has been long argued for and its case would only be strengthened with greater fiscal devolution. Simply put, the needs-based approach acknowledges that regions face different costs in providing public services and some of these are structural differences that cannot be overcome by reform or greater efficiencies. Regions can also face issues such as a disproportionately large population of over 65 or a higher than average school age population which would necessitate a larger per capita spend on public services or transfers. A needs-based approach would also help to alleviate the appearance that some regions arbitrarily benefit more than others in the disbursement of public funds. As Heald & McLeod (2005) notes, there are an equal number of papers claiming that each of the three regions all lose out from the current Barnett formula. A needs-based approach has the advantage of spelling out why some regions receive more than others.

5.1 Fiscal Equalisation

Introducing a needs-based system to replace the Barnett formula would ensure that spending power for public services actually is equalised on a per capita basis among the regions. However, a needs-based approach to public expenditure could also be one part of a proper system of fiscal equalisation. The OECD define fiscal equalisation as:

'a transfer of fiscal resources across jurisdictions with the aim of offsetting differences in revenue raising capacity or public service cost. Its principal objective is to allow sub-central governments to provide their citizens with similar sets of public services at a similar tax burden.' (Blöchliger et al, 2007)

Replacing the Barnett formula with a needs-based system of public expenditure appropriation is a necessary but not sufficient condition for the new settlement needed for NI and the other UK regions. As stated at the outset, the goal for NI is to improve the incentive structure for policymakers in the devolved government. The other side of the new settlement should focus on revenue raising capacities and what can be expected of regions and devolved government.

To understand what a system of fiscal equalisation might look like it is necessary to make a distinction between two different forms of equalisation, vertical and horizontal. Vertical equalisation is where central government transfer resources to regional and local governments and horizontal equalisation is where the transfers occur between regional and sub-national governments. Horizontal and vertical can apply to both cost equalisation and revenue equalisation. Vertical equalisation is by far the most common form of equalisation, but horizontal equalisation has important implications that will be discussed further.

To begin with, a needs-based approach would represent a vertical cost equalisation. It recognises that the cost of providing services in regions differ or that the level of service they need to provide is greater and so central government provides additional funds to the devolved government. In this scenario, however, the devolved government is considered to be dependent on its own revenue raising to fund the bulk of its expenditure. Vertical revenue equalisation would be where the central government tops up the revenue collected in each of the regions, based on what that region would be expected to raise given its existing resources. In this sense, the devolved government is responsible for raising its own revenue, but fiscal equalisation ensures that its responsibility is tempered by the unique conditions that exist in that region.

Revenue equalisation has been almost completely absent from the debate about reform of devolution in the UK. Given that the original devolution settlement focused almost entirely on devolving expenditure powers this is perhaps unsurprising, but as greater fiscal powers are devolved it has to be a central part of any reform. Revenue equalisation matters particularly for the UK because of the imbalance in the relative size of devolved regions. As mentioned from the outset, the goal should never be about making NI or any other region financially independent. A system of revenue equalisation would entrench this. From the outset it would be accepted that NI's capacity to raise revenue would be a function of its own resources and not arbitrarily tied to the costs of running public services and social transfers.

As the OECD (Blöchliger et al, 2007) note, in countries that practice vertical equalisation, the majority favour cost equalisation over revenue equalisation, but revenue equalisation is most important for creating the right incentives for devolved governments. In essence, the devolved government is incentivised to maximize revenue, but there is a recognition that the upper limit on potential tax revenue need not match the cost of public spending. The incentive is therefore appropriate and proportional. That is not to say that fiscal equalisation does not create problems as well. Much of the criticism centres on perverse incentives that can be created by such arrangements. Many of these problems centre around the idea that compensating regions for structural issues related to costs or revenue can lead to development traps (Boadway and Tremblay, 2010). However, in most of the examples, the perverse incentive derives from a lack of appropriate policy design or implementation rather than an issue with the principle of equalisation itself.

The most important aspect of fiscal equalisation, both cost and revenue, is for the policy to be dynamic and reactive. Most of the disincentives or unintended consequences in fiscal equalisation arise from systems where regions can game a system that lacks the ability to react to new developments. In this case, there needs to be a firm distinction between cost and revenue constraints that are beyond the control of devolved governments and those that are within their control. In terms of revenue equalisation, such a process would take account of wages, demography, natural resources and other mitigating factors. For example, the equalisation process could compensate a region for having a lower proportion of working age adults. This is beyond the immediate control of the devolved government and so should be fully compensated for. However, a region would also be compensated for having lower wages. In this case the compensation for this should be up to a certain percentage only to ensure that the region has an incremental incentive to gradually drive up wages. The same applies to cost equalisation. For example, the economies of scale that are present in the NHS in England are unavailable to the NI system, and NI should be compensated fully for this. However, for increased costs related to the duplication of educational facilities, and incremental incentive to reform would be appropriate.

There also needs to be some proportionality between the cost and revenue equalisation adjustments. The OECD (Blöchliger et al, 2007) note examples from Austria where fluctuations in cost equalisation are not proportional to those in revenue equalisation. This is particularly important for NI given the imbalance between fiscal and expenditure devolution. In order for fiscal equalisation to work, there would have to be a balancing of revenue and expenditure powers between central government and the NI Executive in order to avoid such outcomes.

So far, this discussion on equalisation has focused on public service expenditure, the equivalent to DEL or the block grant in NI. This obviously omits the system of welfare spending from consideration within fiscal equalisation. This is because decentralisation of welfare spending is quite uncommon among other countries, both federal and unitary. The OECD note that on average 40% of health expenditure is decentralised in OECD countries while less than 10% of social protection spending is decentralized (DeBaise et al, 2020). This is where the UK experience of devolution and particularly NI's settlement stands out internationally. Denmark is the only country where social protection expenditure is decentralised to the same extent as in NI and so there are fewer examples of how to improve that system. As noted earlier, welfare functions that have been devolved to Scotland have been transferred as under block grant arrangements rather than AME. This would be more difficult to implement for the full suite of benefits currently devolved to NI, but would be superior to the current arrangement.

Finally, as so much of this analysis focuses on transfers between central and devolved government it is worth noting that systems of horizontal fiscal equalisation are also possible. Australia operates a system of horizontal equalisation whereby the Goods and Services Tax is collected by both the federal government and the state governments (Pincus, 2011). GST revenues are then redistributed among the states based on both cost and revenue equalisation. This federal government collects income taxes which are used to fund federal services and social transfers which are not delegated to the states. Horizontal equalisation has the advantage of putting fiscal transfers in the context of existing regional inequalities rather than as poor regions being bailed out by central government. While devolution in the UK remains confined to Scotland, Wales and NI, such a system is not possible. However, were the UK to move toward a federal structure with a fully devolved English region or regions, horizontal equalisation should be a policy goal.

5.2 A model for Northern Ireland

So, what would a fiscal equalisation settlement in the UK look like and what would it mean for NI? In the first instance such a settlement would see the devolution of up to 50% of all taxes to NI along the lines of the arrangements between the states and the federal government of Germany. This would ensure that NI is not overly exposed to volatility in any one source of revenue. Tax varying powers for income tax could be a part of that packages, but as outlined previously, the imbalance in the regions makes such tax competition counterproductive. The full extent of revenue devolution should be a function of the extent of expenditure devolution. Welfare spending will be key to determining this and there appear to be only two options in this regard. Either welfare spending is added to the block grant as in Scotland or there is a return of welfare powers to the UK Government. The latter would significantly reduce the level of tax revenue that would need to be devolved to NI in order to provide a base for funding such expenditure.

Some form of fiscal equalisation council, possibly modelled on the Office for Budget Responsibility in the UK, should be charged with devising the revenue and cost equalisation criteria to be applied to each region. Once taxation has been collected in NI, this body would then make an adjustment to NI's funding based on the extent to which NI's revenue raising capacity falls short of that of other areas of the UK. It is important to stress that these mitigations must be reactive, and NI should not be completely compensated for structural issues that are within its competence to improve.

Following the adjustment for revenue, there should then be a further adjustment that takes account of the cost difference in the provision of public services. Once again, such compensation should allow incentives for NI to reduce costs where they can reasonably be mitigated by the NI Executive. This model would give the NI Executive incentives to increase revenue and to see the benefit of it. It would allow this to be done whilst not undermining the resources available for public services. Attempting to add greater fiscal power to the existing system of devolution is a suboptimal option as the experience to date in Scotland has shown. Such a system could be introduced in NI alone, but would make much more sense to be adopted UK-wide.

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