



making business sense

**Evidence to House of Lords Select Committee on Barnett
Formula**

**Evidence from Douglas McWilliams, Chief Executive and
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Introduction

This short note is a response to the Select Committee's request for evidence. The response deals primarily with Questions 1a and 1b of the questions set out by the committee.

Levels of public expenditure as a share of GVA

It is conventional to consider public expenditure in a region or country of the UK in relation to public expenditure per head. This is certainly an important indicator and should not be discarded. But the requirements for public expenditure and the cost of public expenditure are also influenced by the levels of prices and earnings in the different regions/countries and their levels of GDP or GVA.

The cost of providing equivalent levels of services will be affected by price and earnings differentials. This is an obvious point and does not need reinforcement. What is less obvious, but no less true, is that some of the requirements for services are affected by the levels of GDP/GVA. For example, transport projects are conventionally prioritised by the use of benefit/cost ratios. The relative benefit element of these ratios will largely be driven by relative GDP/GVA levels. Arguably some of the benefits of training, skills and education are also driven by the levels of regional prosperity.

It is conventional also to think of high levels of regional GDP/GVA per capita as an inverse proxy for extent of social problems and hence as in some way justifying relatively low levels of public expenditure per head. But the evidence from the UK does not support this. The most glaring anomaly is that London has a regional GVA per capita of more than 50% above the UK average. Despite this, its regional unemployment level is one of the highest in the UK, 7.2% compared to 6.3% for the national average for the UK¹. Moreover, the local area with the highest rate of unemployment in the UK, Tower Hamlets, is in London. Looking in detail at the extent of social problems on a wide range of measures shows that London despite its higher level of GDP/GVA has much higher levels of social deprivation and hence needs than other regions.

Since the evidence for the UK does not support the view that a high level of GDP/GVA per capital indicates a low requirement for public expenditure as a percentage of regional/country GVA it is worth examining the data for regional/country public expenditure as a percentage of regional/country GVA. The IMF points out that '*International comparisons of public expenditure composition in relation to economic and social indicators can provide a useful basis for addressing imbalances in the use of public resources*²'.

¹ Office for National Statistics, '*Labour Market Statistics, First Release*' (February 2009)

² IMF Pamphlet 48 '*Unproductive Public Expenditures: A Pragmatic Approach To Policy Analysis Appendix: Patterns of Government Expenditure by Country Groups*'

cebr has for some years made this analysis, taking account of the regional data for public expenditure and the regional accounts and adjusting the data for consistency.

The results for total identifiable expenditure on services for UK regions and countries as a share of regional/country GVA are shown in Table 1. This forms part of cebr work carried out this year for The Sunday Times³. A graph of public expenditure per capita and GVA per capita for UK regions and countries is shown in Figure 1.

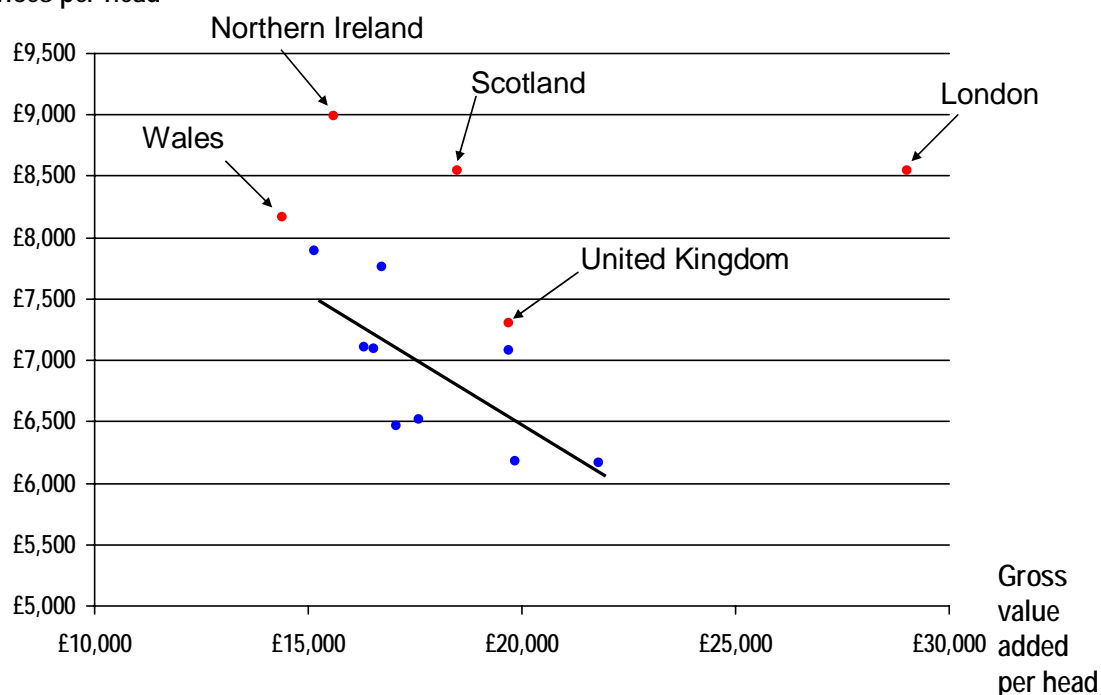
Table 1

	2003-04	2004-05	2005-06	2006-07
North East	50.7%	51.2%	52.3%	50.8%
North West	43.5%	44.8%	45.3%	45.1%
Yorkshire and Humberside	40.6%	42.1%	43.0%	42.4%
East Midlands	35.2%	36.6%	37.0%	36.8%
West Midlands	38.7%	40.6%	41.7%	41.8%
Eastern	28.5%	29.5%	30.2%	30.2%
London	28.8%	28.8%	29.2%	28.5%
South East	26.4%	27.7%	27.7%	27.4%
South West	34.9%	36.1%	36.3%	35.9%
Total England	33.8%	34.8%	35.3%	34.9%
Scotland	43.9%	43.5%	44.7%	45.0%
Wales	52.6%	53.7%	55.2%	55.4%
Northern Ireland	56.5%	57.0%	56.7%	55.9%
UK identifiable expenditure	35.8%	36.7%	37.3%	36.9%
Outside UK	44.0%	45.4%	38.8%	39.0%
Total identifiable expenditure	36.0%	36.9%	37.3%	37.0%

³ See The Sunday Times, 25 January 2009

Figure 1

Total identifiable expenditure on services per head



Source: Public Expenditure Statistical Analyses (PESA) 2008, ONS Regional Accounts 2008

Included in the Annex to this evidence is the cebr Forecasting Eye Special from March 11, 2008. This document shows that public expenditure as a share of GDP has risen to an estimated 43.0% of GDP in 2007/08. The Forecasting Eye Special also outlines our methodology for calculating public expenditure from total identifiable and non-identifiable expenditure from HM Treasury statistics.

Implications of the variations in regional public expenditure as a percentage of GVA.

The unusually large variations in regional public expenditure as a percentage of GDP/GVA mean that in the higher income regions, many public services are disproportionately badly funded. This particularly affects unfairly those at the lower end of the income scale who are most dependent on public services.

The implications of the variation of the levels of regional public expenditure as a share of GDP/GVA are exaggerated in the UK by the existence of a progressive tax system that does not take account of local variations in the cost of living. As a result of the shape of the UK tax system, where the progressivity is concentrated at the lower end, the effects of this also particularly hit those at the lower end of the income scale in the higher income regions. They pay a higher effective rate of tax than those with equivalent real incomes in lower income regions.

Moreover, a further implication of the relatively high levels of public spending in relation to GVA in some regions/countries of the UK is that the private sector is crowded out. The large numbers of public sector jobs mean that employment patterns become distorted. Public sector pay in some regions is noticeably higher than in the private sector. It is no surprise that rates of business start ups in the regions/countries of the UK with levels of public spending as a share of GVA well above 50% are very much lower than in the areas with much lower public spending. The tendency to look to the public sector to provide subsidised solutions to problems becomes built in.

Can the model of funding relatively high levels of public expenditure in relation to GVA in the North of England, Scotland, Wales and Northern Ireland be afforded in the future?

Cebr has generated a provisional analysis of the prospects for public finances that has underpinned the speech given by one of the co-authors (Douglas McWilliams) to the Associate Parliamentary Group on Wholesale Financial Markets & Services in the House of Commons on 11 February 2009. This analysis was reflected in the following section of the speech

‘The calculations about fiscal transfers from the early 2000s indicated that London subsidised the rest of the UK by about £13 billion. My rough and ready estimate is that this rose to about £30 billion by 2007. This comes mainly from a mixture of corporation tax, national insurance contributions, income tax and VAT on spending raised on the relatively higher incomes and spending in London.

I expect this to drop back to about £8 billion next year and to edge up to about £12 billion by 2013, and to continue to grow very slowly thereafter.

What this means is that there is a shortfall of just under £20 billion (1.5%) of GDP that will ultimately have to be made up. Now in a world where multi billion banking bailout packages seem to be announced almost monthly, this may seem like small beer. But unlike some of the other figures, which are often exaggerated and where the government has realistic hopes that it might eventually get most of its money back, this is a real shortfall.

Can it be replaced? One option is higher tax rates, but very few studies are optimistic that this raises much more money. A second potential option is sustained high borrowing. But the bond markets would be most unlikely to accept it. The only alternative is for the regions with higher levels of public spending to cut their coats according to the cloth available. The high spending parts of the UK – Scotland, Wales, Northern Ireland, the North of England, the North West and Yorkshire and Humberside will need to cut their levels of public spending as a share of GDP by around 5% of local GDP to offset the end of the subsidy from the rest of the country but mainly from London’.

Implications for the Barnett Formula

The Barnett Formula is designed to preserve in aspic the shares of public spending per capita for Scotland in particular.

Yet our analysis infers that public spending per capita in the parts of the UK where public spending is high will have to be reduced disproportionately; partly because it builds in unfairness, partly because it damages the private sector and entrepreneurship and particularly because the money to finance high public spending is unlikely to be available in the medium term.

There is therefore a need to change the Barnett formula to generate an outcome with a lower level of public spending in relation to the rest of the UK for the high public spending regions.

Annex

Forecasting Eye Special – embargoed 00:05am Monday 11 March 2008

How public money is spent in each region and country of the UK

The gap in public spending as a share of GDP across UK regions has been widening.

Introduction

cebr has analysed in detail where public funds go, particularly in the context of the London economy, and we have had a number of projects which have required us to update this information.

We have repeated the analysis we conducted two years ago of public expenditure as a share of GDP for each region and country in the UK, updating the figures for financial year 2001/02 to 2005/06 and calculating new figures for 2006/07 and 2007/08 – the last financial year. The new calculations are based on the latest issue of *Public Expenditure Statistical Analyses 2007* and incorporate the latest cebr regional forecasts⁴.

Key points

The analysis shows that public expenditure as a share of GDP in the UK has risen from 39.0% of GDP in 2001/02 to an estimated 43.0% in 2007/08.

This has happened at a time when the public spending share in most Continental countries has been falling. As a result the public spending share was higher in the UK than in Germany in 2007 for the first time since 1974.

Total UK public spending as a share of GDP is now forecast to stabilise – but if the economy remains weak the share could start to rise again.

Revised data suggests that the dispersion of public spending as a share of GDP between regions rose from 2001/02 to 2006/07.

Public spending as a share of GDP is rising fastest in the West Midlands, Wales and Yorkshire and Humberside. It is rising slowest in London.

⁴ cebr, *the prospects service*, Regional Prospects, 14 January 2008

How are the figures calculated?

This work is much easier now than 10 years ago because the government produces a little known report called *Public Expenditure Statistical Analyses*. In the past, **cebr** analysts have sweated over public expenditure line items looking at up to 4,000 different categories and then splitting them by various probable criteria such as population, local GDP and on other bases. Now the government makes its own split replicating much of the work that cebr analysts have carried out in the past, and this is published in these statistical analyses.

If you know how to interpret the information, it is a goldmine, telling you in great detail which regions and countries benefit from public spending and how this has changed. Not only does this show how total spending in the different regions and countries in the UK differs but also how the composition varies.

To understand the information properly and to make the comparisons that might normally be made on an international basis, it is best to scale the spending in each region by expressing it as a proportion of regional GDP. This is because regions vary by size and by cost of living. Crude comparisons of regions looking at spending per person can mislead because the cost of spending and the amount of economic activity that it is meant to support varies between region and country.

We have taken the figures showing the split of public spending by region and country straight from Table 9.1 of '*Public Expenditure Statistical Analyses 2007*⁵'. This gives the regional and country split for the identifiable 83 per cent of 'Total Managed Public Expenditure, which is one of the standard measures of total public spending. What is excluded is spending overseas and some types of public spending where it is conceptually difficult to allocate the spending by region or country including defence, debt interest and EU transactions.

In our estimates the figures for identifiable public spending are then scaled up for the non-identifiable items, assuming that they are split in relation to GDP. The logic of this is that allocating something like defence is perhaps most fairly done by allocating it against the economic activity that in some sense is being defended. This may be generous to the high spending areas, since they are likely to have contributed disproportionately to the build-up of debt interest and some benefit disproportionately from defence spending.

The estimates of public spending for 2007/08 are based on Table 9.15 of *Public Expenditure Statistical Analyses 2007*, which gives the data for spending for central government and for public corporations. To get a total for all public spending the figures are scaled up assuming that the ratio of spending by local authorities to spending by central government and public corporations for each region remains as in 2006/07.

⁵ Public expenditure statistical analyses 2007, HM Treasury, April 2007

We then divide these totals by workplace-based GDP from the official regionally disaggregated GDP data downloaded from the National Statistics website⁶. The regional data from National Statistics is for Gross Value Added (GVA), which is similar to GDP but because the figures are measured at basic prices rather than at market prices the totals are lower. Since public expenditure shares both in the UK and internationally are conventionally measured as a share of GDP, to make the data comparable with international data around the world we have scaled up the GVA data by the ratio of national GVA to GDP to provide estimates of regional GDP. The figures are updated using cebr's regional GVA forecasts and estimates to Q1 2008⁷.

All these adjustments are made to ensure that the shares of regional public spending in GDP are not exaggerated by the use of statistics that might otherwise be only partly comparable.

For the international comparisons, we have scaled the regional figures by the ratio of UK public spending shares on the total managed expenditure basis to the latest OECD estimate for UK public spending as a share of GDP. We have adjusted the figures for calendar years and have made an estimate of the 2006 position. These are compared with Eurostat or OECD data for the individual countries.

What do the results show?

Total spending in each UK region

There are four key messages emerging from the analysis for total spending in each region of the UK, which is shown in Table 1.

1) The public expenditure share of GDP for the UK as a whole has risen significantly in the past 6 years. In 2001/02 the share was 39.0%; in 2007/08 the share had risen to 43.0%.

2) Levels of public spending across the regions vary more than they did in 2001/02. In 2001/02, spending varied from 29.1% of GDP in the South East to 58.1% in Northern Ireland. In 2007/08 the range is from 34.1% in the South East to 62.7% in Northern Ireland. Over this period, the standard deviation of public spending as a share of GDP over the regions has risen from .086 to .089.

⁶ National Statistics: Regional Gross Value Added, NUTS1 data tables, Table 1.1

⁷ This may slightly exaggerate that growth in the divergence in public spending is growing noticeably faster than GDP, that those regions with high shares of public spending might be likely to have faster than average GDP growth. However, the recent history has not in general supported this theoretical conclusion and so as a base assumption we have assumed GDP growth in line with that for the UK unless there is a good reason for assuming otherwise (in Scotland and London where we have more up-to-date estimates – though these show growth in GDP in both areas fairly close to the UK average).

3) The fastest growth in the public expenditure share from 2001/02 to 2007/08 has been in the West Midlands, Wales and the North West. The slowest growth in the public expenditure share has been in London, the East Midlands and the South West.

4) The revised public spending data between 2006 and 2007 reduces the estimated public spending shares in many of the high spending regions (compare Table 1 and Table 2). The new figures look more plausible than the older figures.

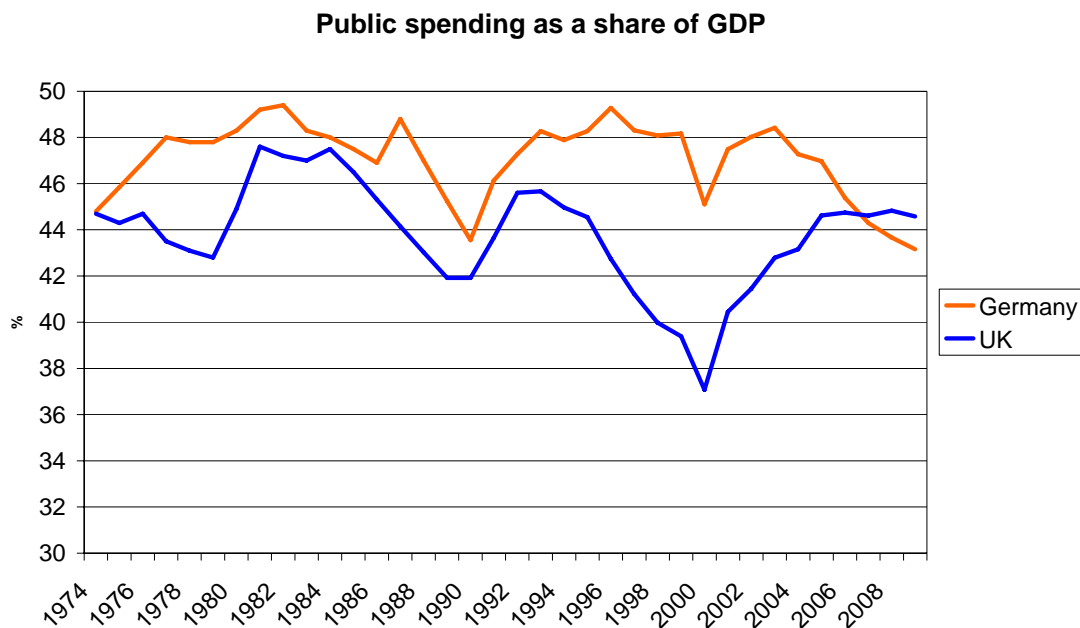
5) It remains the case that public spending as a share of GDP is higher than 50% in all the three countries with devolved governments (Scotland, Wales and Northern Ireland) as well as in the North East and North West of England. By contrast, public spending is below 40% in the South East of England, the East of England and in London.

International Comparisons

Figure 1 shows how the UK's position in public spending compares with that for Germany. It shows how rapidly the German share has fallen recently and how it is forecast by OECD to fall further. Indeed, the data indicates that for the first time since 1974, the public spending share in the UK has overtaken the German share.

Table 4 shows that this is not just a German phenomenon. For the euro zone as a whole, public spending shares have been falling since 2003 and are forecast by 2009 to be only slightly higher than in the UK.

Figure 1



Conclusions

The analysis shows how great is the scale of divergence in public spending between region in the UK as a share of GDP.

It also shows that public spending as a share of GDP is rising in most regions in the UK as well as nationally.

To what extent this public expenditure can be afforded is a complex subject. **cebr** is on record as predicting that current UK spending plans will require tax rises if they are to be implemented.

However the links between public spending and taxation as shares of GDP and economic performance are complex. In general high public spending and taxation are bad for economic growth and low public spending and taxation are good for growth but there are plenty of exceptions to these rules.

We would reemphasise, however, our comment from two years that parts of the UK have become so dependent on public spending that it can crowd out private enterprise in these regions and countries. It is partly a chicken and egg situation – public spending in these regions is high because they are doing less well economically, but on the other hand a high public spending share can make a revival of the private sector difficult to achieve. And the latest data suggests that this problem is getting worse.

Douglas McWilliams, Charles Davis and Richard Snook
cebr

Table 1

	Public spending as share of GDP by UK region							
	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	
North East	53.0%	54.0%	55.3%	55.6%	56.5%	56.8%	57.1%	
North West	45.4%	46.7%	47.9%	48.9%	49.7%	50.0%	50.1%	
Yorkshire and the Humber	43.3%	44.3%	44.9%	46.2%	47.0%	47.3%	47.0%	
East Midlands	38.3%	38.7%	39.3%	40.5%	40.9%	41.6%	41.7%	
West Midlands	40.4%	41.6%	42.9%	44.1%	45.0%	45.4%	45.9%	
East Anglia	31.3%	32.7%	33.6%	34.4%	35.0%	35.2%	35.7%	
London	34.0%	34.9%	36.2%	36.3%	37.3%	37.3%	37.0%	
South East	29.8%	30.9%	31.8%	33.0%	33.1%	33.8%	34.1%	
South West	38.6%	38.6%	39.6%	40.7%	41.2%	41.8%	42.1%	
England	37.2%	38.1%	39.1%	40.0%	40.6%	41.0%	41.1%	
Wales	52.3%	54.7%	55.3%	55.9%	56.9%	57.6%	57.4%	
Scotland	46.3%	47.0%	48.2%	48.2%	49.9%	50.7%	50.3%	
Northern Ireland	58.1%	59.7%	59.5%	60.1%	61.2%	63.5%	62.7%	
UK	39.0%	40.0%	40.9%	41.7%	42.5%	42.9%	43.0%	

Table 2 Public spending as share of GDP UK regions/countries from cebr's last report on the subject in May 2006

Total GDP (£ million)	2001-02	2002-03	2003-04	2004-05	2005-06
United Kingdom	38.9%	39.9%	41.0%	42.0%	43.0%
North East	56.4%	57.4%	58.0%	59.0%	61.5%
North West	47.8%	49.1%	50.1%	51.3%	52.6%
Yorkshire & the Humber	44.8%	45.2%	45.7%	47.2%	48.9%
East Midlands	39.1%	39.6%	40.7%	42.2%	43.6%
West Midlands	41.7%	42.6%	44.0%	45.4%	46.3%
East of England	34.5%	35.8%	36.8%	38.1%	38.5%
London	29.1%	30.3%	32.0%	33.3%	33.4%
South East	30.4%	31.3%	32.2%	33.9%	33.9%
South West	39.9%	39.6%	40.9%	42.3%	42.9%
England	37.5%	38.4%	39.5%	40.9%	41.5%
Wales	56.3%	58.8%	59.5%	60.3%	62.4%
Scotland	50.0%	50.4%	51.9%	52.0%	54.9%
Northern Ireland	65.2%	67.0%	66.6%	67.4%	71.3%

Table 3 Standard Deviation of public spending as a share of GDP between UK regions/countries (latest data as in Table 1)

	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007/08
Standard deviation	0.08635	0.08896	0.08732	0.08567	0.08790	0.09139	0.08911

Table 4 International comparison using OECD data for public spending as a share of GDP

	2001	2002	2003	2004	2005	2006	2007	2008	2009	Change 2001 to 2009
OECD UK figure calendar year	40.4%	41.4%	42.8%	43.2%	44.6%	44.7%	44.6%	44.6%	44.6%	4.2%
OECD German figure calendar year	47.5%	48.0%	48.4%	47.3%	47.0%	45.4%	44.3%	44.3%	44.3%	-3.2%
OECD euro zone figure calendar year	47.3%	47.6%	48.1%	47.6%	47.5%	47.1%	46.4%	46.4%	46.4%	-0.9%

