NI Fiscal Council response to: 2021 Spending Review

Northern Ireland Fiscal Council

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The prospective return to multi-year budgeting

Leaving aside the sums of money involved, the most significant and beneficial impact of the Spending Review is that by setting the Executive's Block Grant for the next three years (albeit subject to future revisions) it holds out the prospect of a return to multi-year budgeting by the Executive after seven successive single-year Budgets.

Following the restoration of the power-sharing institutions in 2007, the Executive agreed two multi-year Budgets from 2008-09 to 2010-11 and 2011-12 to 2014-15. These coincided with the final multi-year Spending Review of the Labour Government and the first under the Coalition. The move to single-year Budgets in NI began when the Coalition opted for a single-year Spending Review in the general election year of 2015-16. The incoming Conservative Government then announced a Spending Review covering the years from 2016-17 to 2019-20, but this was not matched by a multi-year Budget in NI, initially because of the political crisis around welfare reform in 2014 and then the collapse of the institutions in 2017. Once Stormont was up and running again, the UK Government was forced to set single-year Reviews for 2020-21 and 2021-22 to reflect the disruption first from the Brexit negotiations and then the pandemic.

One of the most consistent messages that we heard from stakeholders across the political spectrum in our initial engagement process was that single-year Budgets had stymied long-term thinking and policy action by the Executive, for example in areas such as health care reform and building a pipeline of infrastructure projects. It might be argued that there could have been more long-term thinking even in the absence of a multi-year Block Grant settlement, but there is certainly opportunity for it now.

To take full advantage of the relative financial predictability provided by the Spending Review settlement, there will of course need to be a functioning Executive and Assembly in place to run the Budget process and develop and pursue reform in each NI Department. At the outset, the main challenge for the parties in the Executive will be to reach agreement on a shared set of priorities that can be reflected in the Draft and Final Budgets. In practice the key decisions are likely to be how much of the additional resources provided in the Spending Review to devote to health – widely recognised as the Executive's top priority – and then which objectives to prioritise thereafter. As many stakeholders have told us, this priority-setting is complicated in the mandatory coalition by the need to allocate resources between the political parties as well as between policy priorities – all the more so with an Assembly election on the horizon.

Stakeholders have also expressed frustration in the past when there has been a relatively short period for consultation between the Draft and Final Budgets. The sooner that the Executive can agree the Draft Budget, the longer that consultation period can be. A lengthy consultation period would be particularly valuable given that there will be three years of spending plans to consult on rather than just one.

The judgements underpinning the Spending Review

The NI Finance Minister has argued that the Spending Review settlement is not as large as he would have liked. But it is larger than most observers would have expected. The Block Grant settlements for the devolved administrations largely reflect the 'Barnett consequentials' of the Chancellor's spending decisions as they affect England. But the key judgements underpinning the Budget and Spending Review reflect the overall level of spending that the Chancellor wishes to see for the UK as whole, given simultaneous decisions on taxation and the desired profile for public borrowing and debt.

At the time of the last UK Budget in March, the Chancellor extended the short-term support available for individuals and businesses through the pandemic, but announced a number of measures to strengthen the public finances in the longer term – notably an increase in corporation tax rates, a freeze in income tax thresholds and allowances and a cut in planned public spending totals. This was sufficient to deliver a falling ratio of debt-to-GDP at the end of the Office for Budget Responsibility's five-year forecast. But many commentators – the OBR included – questioned whether the public spending cuts could be delivered given pressures in several areas of public services.

The fiscal outlook has now improved materially since the spring. Public sector borrowing has come in lower than expected, largely because the success of the vaccine programme and greater opening of the economy. This has seen tax revenues outperform the OBR forecast while restraining the cost of government support for individuals and businesses. Looking ahead, the OBR has reduced its estimate of the long-term 'scarring' of the real economy by the pandemic (from lower investment, business failures and reduced labour supply) from 3 per cent to 2 per cent. Thanks to an unexpectedly big increase in inflation, which (even though it is expected to be temporary) pushes the price level permanently higher, the cash size of the economy is forecast to return to its pre-pandemic path with no scarring at all. This means that in the OBR's view the outlook for tax revenues is significantly stronger than it expected in March. The rise in cash incomes and spending is also expected to be more 'tax rich', in part because the freezing of income tax allowances and thresholds increases the potency of 'fiscal drag' by pulling more people into the income tax net and more income into higher marginal rate tax brackets as wages rise. So revenues have been revised higher not just in cash terms but also as a share of nominal or cash GDP. These positive revisions outweigh higher expected debt interest bills as a result of higher inflation and higher market expectations for interest rates.

Presented with this windfall, the Chancellor chose in the Spending Review to reverse the provisional spending cuts that he had pencilled in outside health. And the Review also incorporated the decision in September to increase spending on health (initially) and social care (subsequently), ultimately paid for by a new Health and Social Care Levy (in effect additional National Insurance Contributions with a widened base). With revenue rising more than spending, the Chancellor has put the budget deficit on an even lower prospective path than prior to the pandemic (albeit not back on course to achieve the balanced budget target that for a little while at least remains on the statute book) and to keep the debt-to-GDP ratio falling at the five-year forecast horizon.

Once the temporary damage to the public finances of Covid-19 and the immediate policy response to it have passed, the aggregate impact of the Chancellor's decisions and changes to the OBR's forecasts will be to make the UK a noticeably higher spending and higher taxing economy coming out of the pandemic than it was going in. The ratio of tax receipts to GDP is forecast to rise to its highest level since the early 1950s and public spending is forecast to settle at around 41.5 per cent of GDP compared to less than 40 per cent prior both to the pandemic and the 2008-09 financial crisis.

The operation of the Barnett formula means that the 'tax and spend' decisions taken by the UK Government over the period since March translate into a rather higher Block Grant for the Executive over the next three years than might have been expected. The Chancellor has said that he hopes to have the tax-to-GDP ratio falling by the end of the Parliament, which implies that future positive forecast surprises may be more likely to translate into tax cuts than further spending increases and negative forecast surprises more likely to translate into spending cuts than further tax increases. But experience also suggests that redirecting the 'temporary' increase in NHS spending (to clear backlogs) to the financing of social care may prove easier said than done, which could create pressure for further increases in overall spending plans for any given forecast.

The announced settlement for the Block Grant

Under the Treasury's control framework for the UK public finances, spending by the devolved administrations and Whitehall departments is divided into two categories: Departmental Expenditure Limits (DEL) and Annually Managed Expenditure (AME). The Treasury sets DELs for spending that it judges departments/administrations to have control over in the short term and the ability to plan over the medium term. AME covers items judged *"demand-led and volatile in a way that could not adequately be controlled by the devolved administrations; and/or that are so large that the devolved administrations could not be expected to absorb the effects of volatility within DEL"*.[1]

DEL spending has four components for which the Treasury sets separate control totals for the years covered by a Spending Review. These are:

- **Resource DEL (RDEL)** – which covers day-to-day spending on the running of public services, grants and administration. The Department of Finance has described this as the 'focus' of the Executive Budget process.
- **Conventional Capital DEL (CDEL)** – this covers longer-term investment in infrastructure, buildings and machinery, as well as capital grants
- **Financial Transactions Capital (FTC)** – this is ringfenced within capital DEL and can only be used to lend or make equity investments in the private sector.
- **Ringfenced Resource DEL (Ringfenced RDEL)** – this covers depreciation and impairments and does not contribute to the UK public sector debt or deficit.

The limits set for the first three of these components make up Total Departmental Expenditure Limits (TDEL) excluding depreciation. They constitute the Block Grant for which the UK Parliament votes cash to the Executive (along with the cash for AME spending, which is dominated by state pensions and social security). TDEL is a net limit, so the Executive can and does spend more than this. Income from fees and

[1] HM Treasury, Statement of Funding Policy 2021

charges, EU funding, Regional Rates revenue and other income are treated as 'negative DEL' by the Treasury, creating room for more gross spending within the net limit.

The three components of the Block Grant are largely determined by the Barnett formula, which ensures that when the UK Government finances an increase in spending outside NI from UK taxation or borrowing in a function for which the Executive is responsible in NI, its Block Grant funding rises by a broadly equivalent amount in pounds per head. The changes in spending to which the Barnett formula applies are relative to a Treasury-determined baseline that excludes one-off or time-limited items. RDEL also includes a small number of 'non-Barnett additions'.

Table 1 shows the Block Grant / TDEL plans announced for the Executive at the Spending Review, broken down into the Barnett formula baseline relevant for each year, the Barnett 'consequentials' of changes in UK Government spending relative to that baseline and the 'non-Barnett additions' confirmed at the Review. (The baseline for 2021-22 is the one set at the 2020 Spending Review and is based on spending in 2020-21, while the baseline for 2022-23, 2023-24 and 2024-25 is the one set at the 2021 Spending review and based on spending in 2021-22.) For comparison the table also shows the Final Budget plans for 2021-22 published by the Executive in April.

Table 1 – Components of the Executive's Block Grant

	2021-22	2022-23	2023-24	2024-25
Barnett baseline	**12,871**	**13,025**	**13,025**	**13,025**
of which RDEL	*11,180*	*11,365*	*11,365*	*11,365*
CDEL	*1,510*	*1,524*	*1,524*	*1,524*
FTC	*181*	*136*	*136*	*136*
Barnett consequentials	**2,256**	**1,409**	**1,616**	**1,781**
of which RDEL	*2,126*	*1,220*	*1,425*	*1,619*
CDEL	*218*	*162*	*260*	*235*
FTC	*-88*	*27*	*-69*	*-73*
Non-Barnett additions	**747**	**351**	**365**	**366**
of which RDEL	*640*	*351*	*365*	*366*
CDEL	*107*	*0*	*0*	*0*
FTC	*0*	*0*	*0*	*0*
PLANS/ BLOCK GRANT	**15,874**	**14,785**	**15,006**	**15,172**
of which RDEL	*13,946*	*12,936*	*13,155*	*13,351*
CDEL	*1,835*	*1,686*	*1,785*	*1,759*
FTC	*93*	*163*	*66*	*62*
Memo: Executive Budget (April)	**14,169**			
Of which RDEL	12,485			
CDEL	1,611			
FTC	74			

Note: The 2021-22 uses SR20 baseline. 2022-23 onwards used baselines set at SR21.
Source: HM Treasury

The table shows that:

- The Executive's **Block Grant for the current financial year** is now £15,874 million – or around £8,400 per head of the NI population. This is £1,705 million higher than at the time of the Executive's last Budget, which largely reflects the Barnett consequentials of additional UK Government spending in response to Covid-19, plus funding carried forward from 2020-21 (£327m) and non-Barnett funding confirmed at Main Estimates 2021 (£379m) largely in relation to various NI-specific agreements. Most of this had already been incorporated at Main Estimates in June, but the Spending Review announced an additional £175 million of RDEL consequentials and £61 million of CDEL consequentials.

- The Treasury has set a **baseline for the calculation of Barnett consequentials** in the three years covered by the Spending Review of £13,025 million. This is based on planned spending in the current year, 2021-22, but significantly lower than the headline DEL of £15,874 million. This reflects the exclusion of the Barnett consequentials of temporary Covid-19 support and various smaller one-off or time-limited items including farm and fisheries support and funding from political agreements. (The £12,871 million baseline for the calculation of Barnett consequentials for 2021-22 was set at the 2020 Spending Review, based on plans for 2020-21 and excluding one-off items.)

- The **Barnett consequentials** of the increases in UK Government spending outside NI announced at the Spending Review increase the Block Grant (relative to the baseline) by £1,409 million in 2022-23, £1,616 million in 2023-24 and £1,781 million in 2024-25. These consequentials derive mainly from higher planned UK Government spending on health, education and transport, all of which are the responsibility of the Executive in NI. (The Barnett consequentials shown in the table for 2021-22 are calculated on the basis of the £12,871 million Treasury baseline set at the 2020 Spending Review.)

- The Treasury confirmed **non-Barnett additions** within RDEL of £351 million in 2022-23, rising to £365 million in 2023-24 and £366 million in 2024-25. These are dominated by UK Government support for farming and fisheries to replace payments from the European Union's Common Agricultural and Fisheries Policies that are being foregone as a result of Brexit – £316 million in 2022-23, rising to £332 million in 2024-25. The remaining additions are £32 million a year of security funding and £5 million a year for the Tackling Paramilitarism Programme. The Review settlement did not include any additions for City Deals or financial support for political packages, which explains the drop in non-Barnett additions from the 2021-22 plans, where these are included. These items will only be considered at Main Estimates, the Treasury's rationale for this being that the funding for City Deals is really funding for local areas that is channelled through the Executive and that the funding for political agreements is subject to conditions. This does not make the interpretation of the Spending Review settlement any easier.

As one might expect, the UK Chancellor and NI Minister of Finance had different interpretations of the generosity or otherwise of the Spending Review settlement:

- In its Budget Red Book, the **Treasury** trumpeted the fact that: *"The government is providing the Northern Ireland Executive with an additional £1.6 billion per year on average through the Barnett formula over the SR21 period, on top of its annual baseline funding of £13.4 billion."*[2] The £1.6 billion is the average of the Barnett differentials shown in the table above (£1,409 million, £1,616 million and £1,781 million), while the £13.4 billion is the sum of the Barnett baseline of

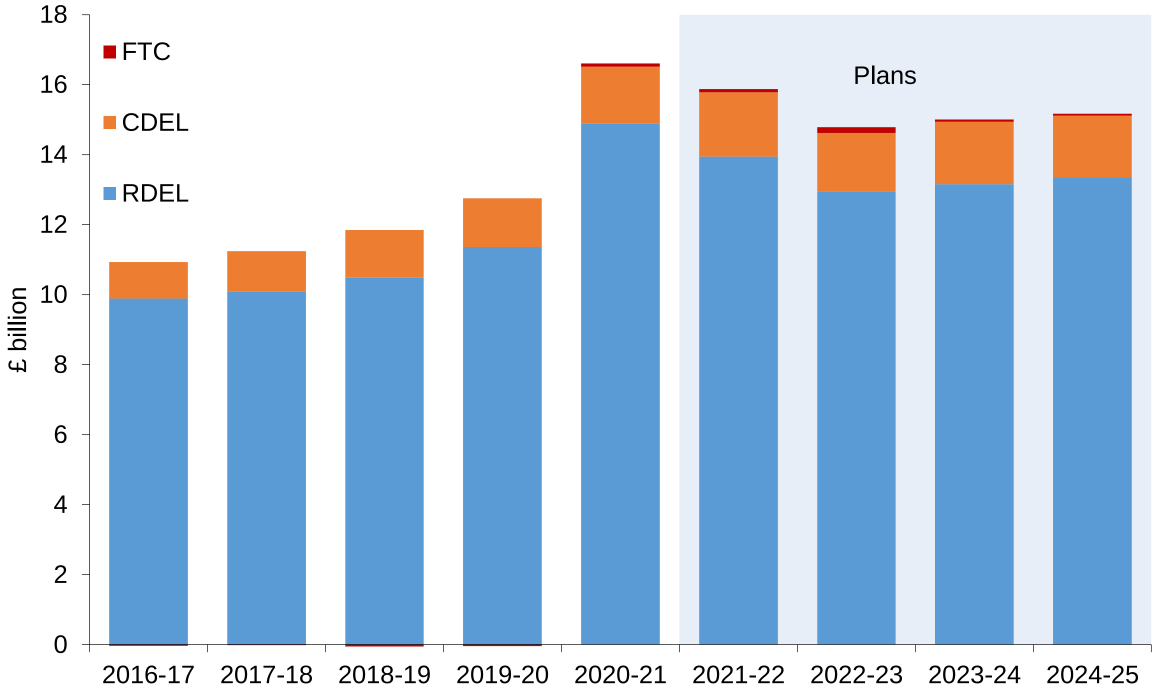
[2]https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1029973/Budget_AB2021_Print.pdf

£13,025 (shown in the table above) and a non-Barnett additions 'baseline' of £351 million which (consistent with the presentation described above) excludes the funding in plans for City Deals and political agreements.

- The NI **Department of Finance**, by contrast, lamented that the Review only *"provides a marginal real terms increase in funding next year which will be far outweighed by increased demands on public services"*.[3] This conclusion was derived by comparing the RDEL settlement adjusted for inflation (using the GDP deflator) to the Executive's April 2021 RDEL Budget for 2021-22, giving real increases of 0.9 per cent, 0.4 per cent and zero across the three years.

Each calculation has its flaws as a basis for comparison – spending in the private and public sector almost always rises in cash terms over time and the Executive's Budget for 2021-22 was still being inflated by the Barnett consequentials of temporary spending in response to Covid-19. There is no definitive way to judge the generosity of the Block Grant settlement but putting it into slightly longer historical perspective rather than focussing too much on comparisons with 2021-22 (still a relatively unusual year) can be informative. Chart 1 shows the composition of the TDEL plans / Block Grants set at the Spending Review along with outturn figures back to 2016-17.

Chart 1 – Executive DEL outturns and plans



Source: HM Treasury PESA 2021 (outturn) and SR 2021 (plans)

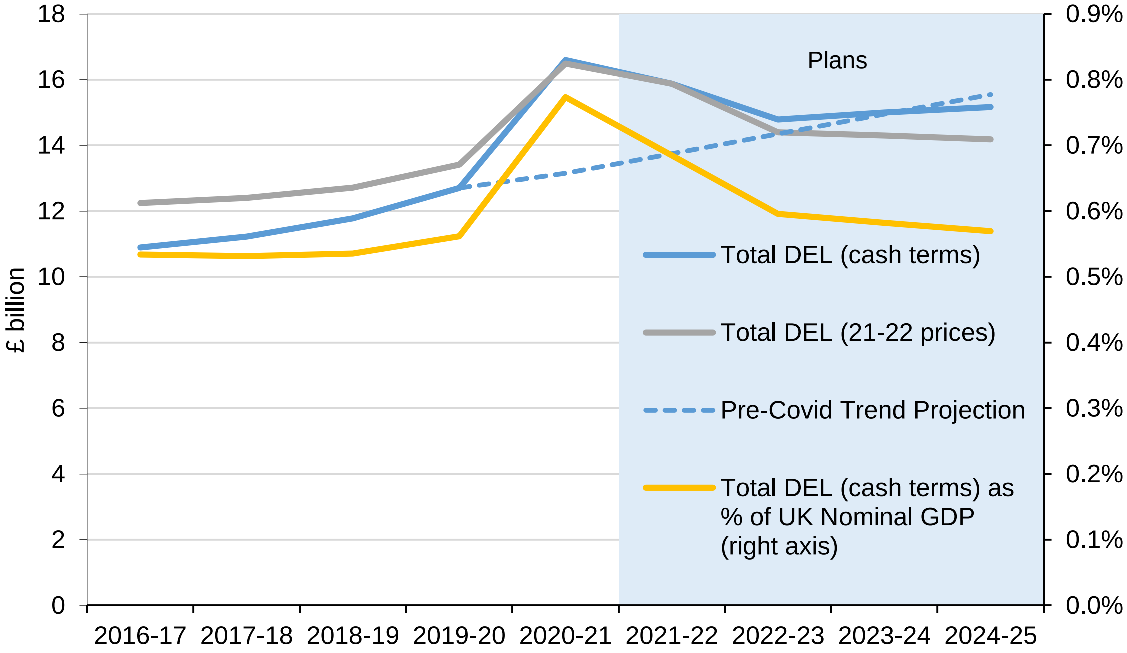
Chart 2 shows the path of TDEL outturns and the latest plans on three bases – in cash terms, real terms and as a share of UK nominal GDP (based on the Office for Budget Responsibility's October 2021 economic forecasts). In each case, the picture is dominated by the jump in the DEL outturn in 2020-21 as a result of pandemic-response spending (partially reversed in 2021-22). In each case, the Block Grant moves

[3] https://www.finance-ni.gov.uk/news/spending-review-leaves-public-services-under-pressure-murphy

to a higher level coming out of the pandemic than going into it, although the difference is relatively modest by the end of the Review period as a share of GDP.

It could be argued that the Review simply returns the cash Block Grant to the rising path it was on prior to the pandemic. But that path reflected unfunded spending increases and the jettisoning of fiscal objectives at the UK level, suggesting that 'more of the same' would not have been sustainable. The latest settlement looks more firmly founded as the UK spending increases underpinning it reflect both tax increases and a better underlying forecast outlook. But future reversals cannot of course be ruled out.

Chart 2 – Executive DEL outturns and plans



Note: We express NI DEL as a share of UK GDP becasue the Block Grant reflects an overall judgement on the level of UK spending as a share of UK GDP
Source: HMT PESA 2021 and Spending Rreview 2021 (DELs) and OBR databank October 2021 (UK Nominal GDP)

Revisions to the 'Statement of Funding Policy'

The Treasury published a new *Statement of Funding Policy* with the Spending Review.[4] It sets out *"the policies and procedures which underpin the UK government's funding of the devolved administrations, to set out the elements of that funding, and to explain the interactions with the funding that the devolved administrations raise themselves"*.

There were few substantive changes to the version accompanying last year's single-year Spending Review. As regards the operation of the Barnett formula, there were no changes to the published 'comparability factors' that capture the proportion of spending by Whitehall departments that the Executive is responsible for in NI. And there was a tiny reduction in the estimate of NI's population relative to that of England from 3.36 to 3.35 per cent. The Review aimed off the departmental comparability factors in some cases, for example to reflect the particularities of Covid-19 support. More information will be published in the Treasury's next *Block Grant Transparency*

[4] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1030043/Statement_of_Funding_Policy_2021_-_FINAL.pdf

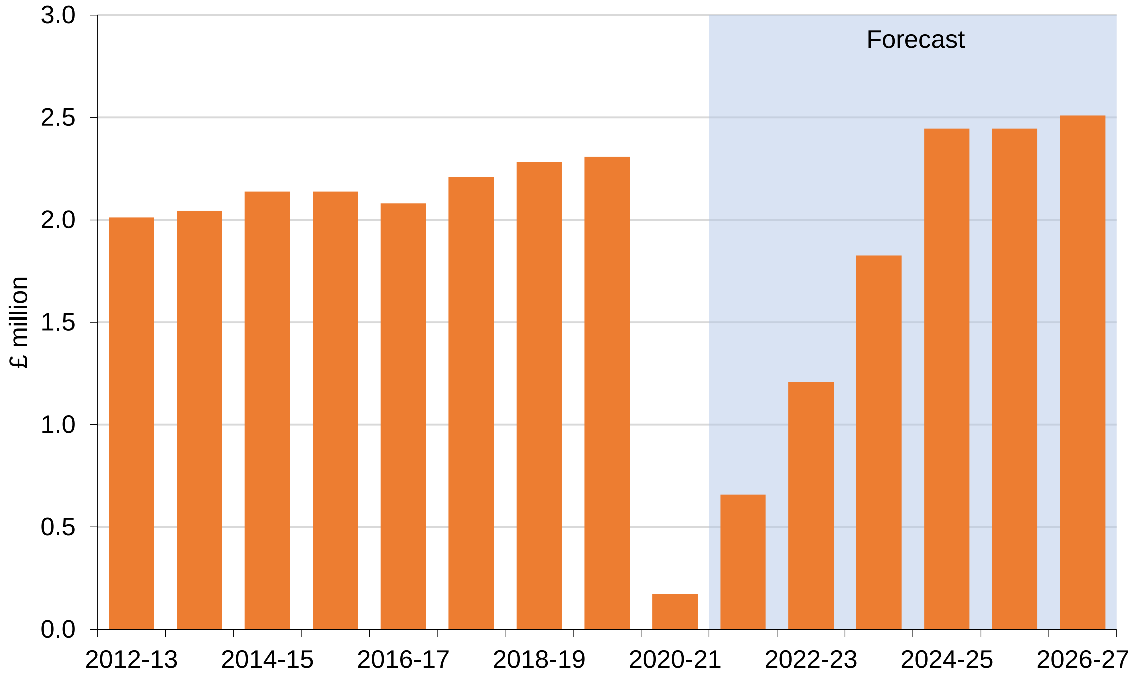
publication. But in broad terms the mechanics of the flow-through from changes in Whitehall spending to the Block Grant are much the same as at the 2020 Review.

Air Passenger Duty (APD)

Once Barnett consequentials have been added to the Block Grant baseline, 'Block Grant adjustments' are implemented to reflect the devolution of different tax and welfare spending responsibilities to each of the devolved administrations. In the case of the Executive, the only adjustment of this sort is for the devolution of air passenger duty on long-haul flights from NI which was set to zero by the Executive from January 2013. The Executive took this action largely to support regular flights from Belfast to New York, but these ceased when Norwegian ended its regular service in 2018.

The NI Block Grant was reduced originally by £2.04 million in 2013-14, based on the revenues foregone by the Treasury due to devolution (as in Scotland and Wales). Instead of indexing the adjustment against corresponding UK Government tax revenues, as in Scotland and Wales, the APD adjustment is indexed against passenger numbers in the rest of the UK, and so has dropped due to the impact of Covid-19. The Spending Review announced that having fallen from £2.31 million in 2019-20 to £0.17 million in 2020-21, the adjustment is set to rise to £1.83 million in 2023-24 and to £2.45 million in 2024-25 as passenger numbers return to more normal levels (Chart 3). This is still a tiny reduction relative to the overall Block Grant and it was a risk the Executive knowingly took. But it does look odd when the tax base has disappeared.

Chart 3 – NI Block Grant Adjustment for Long-Haul Air Passenger Duty



Source: HM Treasury

The Spending Review also announced a 50 per cent cut in domestic APD, which will apply to all flights between airports in England, Scotland, Wales and Northern Ireland – excluding by private jets. The new domestic level of APD will be set at £6.50 (down from £13 currently) and will apply from 2023, paid for by a new 'ultra-long-haul' band for international flights of greater than 5,500 miles. Air connectivity has been long been seen as important economic and social issue for NI. The loss of service from Flybmi at the City of Derry Airport in 2019 and Flybe from Belfast City Airport in early 2020 illustrated how vulnerable NI is to shocks that decrease the viability of air routes. The short-haul APD reduction has been strongly welcomed by NI airports, but it remains to be seen what impact it will have on airlines' perceptions of the viability of routes to and from NI. It is better for the Executive to see APD cut across the UK than to seek the power to reduce it unilaterally as this would involve a loss of revenue.

UK Government funds that bypass the Executive

The UK Government announced some new funding for NI that will either bypass the Block Grant or be ringfenced within it (in either case bypassing the decision-making role of the Executive). For example, £300,000 was announced for the Glens Digital Hub in Cushendall from the first round of the Community Ownership Fund, and an additional £70 million funding for the British Business Bank's programmes in NI.

The Spending Review also confirmed NI's allocations in relation to a number of UK Government funds that replace funding from the EU lost as a result of Brexit. For example, the Chancellor allocated funding for the first round of bids from the Levelling Up Fund, of which £50 million was for projects in Northern Ireland. This represents 2.94 per cent of the total fund allocated to date (£1.7 billion). The Chancellor described this funding to the devolved administrations as *"more than their Barnett shares"*. However, the relevant comparator for many in NI will be the level of EU funding previously received, which was not related to a Barnett share of UK funding.

EU funding was typically paid to the Executive and then passed on to eligible recipients, but applications for the new funds will be made directly by the UK Government even though the spending will ultimately be largely on functions for which the Executive is responsible. The devolved administrations have already complained that this undermines the devolution settlement. In NI it is likely to make it harder to align funding with the Executive's strategic priorities and may even result in the Executive and the UK Government funding competing projects in the same area. This is especially true in the absence of an agreed Executive Programme for Government. Routing the funds in this way may also dilute local accountability, visibility and the scrutiny functions of the NI Audit Office and Public Accounts Committee

Changes to business rates in England

As part of the Spending Review, the Chancellor announced changes to the rating system in England. These included rates reliefs for green technologies, and for heat networks, as well as a temporary reduction for certain retail, hospitality and leisure properties between 2022 and 2023. The Executive is likely to be pressed for similar changes in NI, especially as business rates are already comparatively high in NI, even with the Covid-19 related reliefs in place. While the Executive has received positive Barnett consequentials from the changes in England (£185 million over three years), these are un-hypothecated. Any reduction in income as a result of changes to Executive policy would require additional receipts to be generated elsewhere or a reduction in the overall funding envelope for allocation to public services.