Northern Ireland Fiscal Council

Bringing transparency to NI's public finances

# Sustainability Report 2022

September 2022

# Contents

# Foreword

The Northern Ireland (NI) Fiscal Council was established in 2021 to bring greater transparency and independent scrutiny to the region's public finances, focusing in particular on the finances of the NI Executive. In doing so we hope to inform both public debate and policy decisions to everyone's benefit.[1]

Within this overall mission, our Terms of Reference require us to *"prepare [an] annual report on the sustainability of the Executive's public finances, including the implications of spending policy and the effectiveness of long-term efficiency measures"*.[2] This allows us to look at long-term opportunities and challenges confronting the NI public finances alongside the short- to medium-term issues covered by our reports on the Executive's (Draft) Budgets.

Having discussed the potential scope with stakeholders, we have decided to structure it in two separate reports: first, a discussion of sustainability in general terms; and second, a more detailed discussion of a special topic. For our first special topic report the obvious candidate was health, which dominates the Executive's Budget and is seen as a source of pressure on many countries' public finances.

Fiscal Council members are responsible for the content of the report, but we have relied on the hard work and expertise of our colleagues Jonathan McAdams, Karen Weir, Colin Pidgeon, Tamara Ferguson, Philippa Todd and Paul Montgomery. We are also very grateful for the time and patience of officials from the Department of Finance, the Office for Budget Responsibility and HM Treasury and for invaluable comments from many outside stakeholders. But what follows is our independent assessment. We have come under no pressure from NI Executive or UK Government Ministers, advisers or officials to include, exclude or change any material. The report is structured as follows:

- Chapter 1 is an **executive summary**.
- Chapter 2 describes how **fiscal sustainability is assessed at the UK level**.
- Chapter 3 explains **how we interpret sustainability for NI** specifically.
- Chapter 4 reviews the **characteristics of the population in NI and estimates of the relative need for public spending**.
- Chapter 5 asks if the **NI Executive Block Grant is being squeezed**.
- Chapter 6 examines the **scope to top up the Block Grant**.
- Chapter 7 sets out some **conclusions**.

[1] Find out more about the NI Fiscal Council at www.nifiscalcouncil.org
[2] https://www.nifiscalcouncil.org/publications/initial-terms-reference

There are of course many other issues affecting fiscal and other dimensions of sustainability that we hope to return to in future reports. Among them:

- the challenges for **NI's current and future infrastructure needs**. Many stakeholders have spoken to us of an 'infrastructure deficit' in NI. In this broad context, water and wastewater presents a distinct challenge. For example, over £2 billion of investment in water infrastructure is reportedly required over the current price control period from 2021 to 2027.[3]

- the cost of **getting to net zero** carbon emissions. The NI Assembly passed the Climate Change (No. 2) Bill before the 2022 election.[4] This sets a target for net zero by 2050, which will require proportionately more effort for NI than elsewhere in the UK because of the importance of the agricultural sector and the widespread use of oil for domestic heating. NI accounted for 4.7 per cent of UK greenhouse gas emissions in 2019 (the latest year for which figures are available) while having only 2.8 per cent of the UK's population and 2.2 per cent of UK's economic output in 2019. In terms of emissions per capita, NI produced 11.3 tonnes of $CO_2$ per person compared with a UK figure of 6.8 tonnes of $CO_2$ per person.[5]

- **wider environmental issues** such as waste management, where sustainable solutions still need to be found.

- **education and skills**. Training and retraining to build the skillsets that NI's future economy will need is an Executive priority. This again was an area that many stakeholders suggested was a key sustainability issue because of economic and demographic changes, and with Education as the next biggest Departmental Expenditure Limit spending department after Health.

Another issue that we have not considered explicitly in this report is the resilience of NI's economy and public finances to shocks. Since 2016, we have experienced Brexit, Covid, extreme weather and the Russian invasion of the Ukraine. There is clearly potential for other such shocks to disrupt current forecasts and projections. Such events also seem to be becoming more frequent, which will inevitably create demands for fiscal responses to them. Governments may wish to build more resilience into the economic and public service systems, but such resilience may have an up-front cost both for the UK Government and the NI Executive.

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[3] https://www.niwater.com/sitefiles/resources/2020/annual-report/pdf/niw-annual-integrated-report-accounts.pdf
[4] The Bill completed its final stage on 8 March 2022.
[5] https://www.daera-ni.gov.uk/sites/default/files/publications/daera/Northern%20Ireland%20Carbon%20Intensity%20Indicators%202021.pdf

# 1 Executive Summary

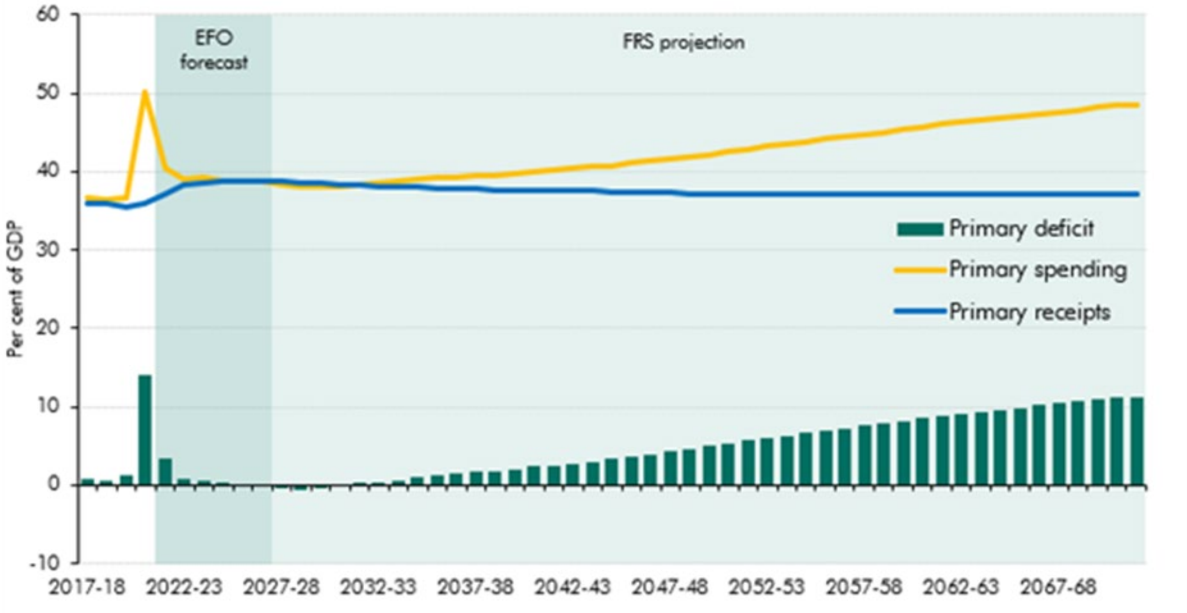
## Fiscal sustainability at the UK level

The sustainability of the public finances needs to be interpreted in different ways for the United Kingdom (UK) Government and the Northern Ireland (NI) Executive, but assessments at both levels will be relevant to the people of NI in determining the taxes they will pay and the public services they will be able to consume.

The Office for Budget Responsibility (OBR) regularly assesses the sustainability of the UK public finances by preparing 50-year projections of public spending, revenue, borrowing and debt. In analyses of this sort, the fiscal position is judged unsustainable if spending is set to exceed tax revenue sufficiently such that public borrowing and debt rise inexorably as shares of Gross Domestic Product (GDP).

In its most recent July 2022 assessment, the OBR concluded (as it has in each assessment to date) that the UK public finances were on an unsustainable path on this definition. It projected that UK tax receipts would fall slightly as a share of GDP over the next 50 years in part because of the loss of fuel duty as electric vehicles replace petrol and diesel ones and that public spending would rise significantly because of the ageing population and additional cost pressures in health, for example to reap the benefits of technological advances. This would push the primary budget deficit (which excludes interest payments) to 11 per cent of GDP by 2071-72 (Chart 1.1).

### Chart 1.1 – OBR spending and revenues projections




Source: OBR Economic and fiscal outlook (EFO) and Fiscal risks and sustainability (FRS) projection

In practice, fiscal policy would have to tighten long before this horizon was reached. That could affect people in NI in three ways: first, increases in UK taxes (paid in part by people in NI); second, cuts in UK-wide pension and social security benefits (reducing the value of those payments for people in NI); and third, cuts in public services spending relative to the increase projected by the OBR. The UK-level cuts in public services spending would be reflected in the Executive's Block Grant from the UK Government, with neither administration fully accommodating upward pressures on their spending.

## Sustainability in Northern Ireland

The sustainability of the NI Executive's finances cannot be assessed in quite the same way as the UK Government's, primarily because its ability to borrow and accumulate debt is much more constrained – by legislation and agreement with the Treasury. As such, the Executive could not see its debt and deficit rise persistently as a share of GDP, threatening the sort of sovereign debt crisis the UK could suffer.

The responsibilities of the NI Executive are set out in the Northern Ireland Act 1998 (as amended), and these determine the scope of its spending. In common with Whitehall departments and the other Devolved Administrations, the Treasury divides the Executive's spending into that covered by Departmental Expenditure Limits (where spending can be planned and controlled over several years) and Annually Managed Expenditure (which is more volatile and demand-led). The Executive's Annually Managed Expenditure (dominated by pensions and social security benefits) is fully and automatically financed by the UK Government, unless the Executive decides to make these policies more generous ('super parity') in which case it has to meet the additional cost. So spending pressures here (primarily from an ageing population) are a challenge for the sustainability of the UK Government's finances rather than the Executive's.

The Executive's Budgets – and our assessment of sustainability – therefore focus on the spending covered by its Departmental Expenditure Limit (DEL): the day-to-day costs of public services, grants and administration, plus capital investment. Spending on these[6] totalled £16.3 billion in 2021-22 (£21,300 per household)[7] with the two biggest spending departments being Health (45 per cent) and Education (17 per cent). The next largest spending departments are Justice and Infrastructure (both at 8 per cent) and Economy and Communities (both at 7 per cent).

83 per cent of this spending was financed by the core Block Grant from the UK Government, which is based on historic spending levels adjusted at each UK Spending Review, UK Fiscal Event and as part of the NI Estimates process to reflect changes in the UK Government's spending on the same items in the rest of the UK[8]

[6] After interest payments.

[7] https://www.nisra.gov.uk/system/files/statistics/census-2021-population-and-household-estimates-for-northern-ireland-report-24-may-2022.pdf Table 4

[8] Around 92% of NI's Barnett allocation for 2024-25 was purely due to changes in the funding for the provision of services in England. Although the remaining 8% was for services that also covered Wales (Home Office) or Wales & Scotland (Work and Pensions), this funding was also dominated by spending in England.

according to the 'Barnett formula'. The Block Grant also includes 'non-Barnett additions', among them funding for political agreements like New Decade, New Approach, City and Growth Deals and farm and fisheries support to replace funding previously received from the European Union (EU). Beyond the Block Grant, the Executive raises additional finance from the Regional Rates, permitted capital borrowing, fees and charges, EU funding and a modest sum from the Irish Government for a cross border roads project (the A5). (Fees and charges and EU funding are treated as negative spending by recipient departments and not shown in the Executive Budget, which does not aid transparency and understanding.)

### Table 1.1 - Executive financing and spending 2021-22

| | | £ million<br>2021-22 |
|---|---|---|
| **FINANCING** | | |
| **Resource** | | |
| | Block grant: core Barnett | 11,974 |
| | Block Grant: specific allocations | 350 |
| | Block Grant: political agreements | 1,798 |
| | Regional Rates (post debt repayment) | 370 |
| **Capital** | | |
| | Block Grant: core Barnett | 1,609 |
| | Block Grant: agreements and City deals | 170 |
| | Capital borrowing (RRI) | 80 |
| | Irish Government funding for A5 | 0 |
| **FTC** | | |
| | Block Grant: core Barnett | 42 |
| **TOTAL FINANCING** | | **16,393** |
| | *pays for* | |
| **SPENDING** | | |
| **Resource** | | |
| | Health | 7,052 |
| | Education | 2,500 |
| | Justice | 1,180 |
| | Other | 3,714 |
| **Capital** | | |
| | Health | 330 |
| | Education | 209 |
| | Justice | 73 |
| | Other | 1,247 |
| **FTC** | | |
| | Health | -1 |
| | Education | 0 |
| | Justice | 0 |
| | Other | 43 |
| **Debt interest** | | 45 |
| **TOTAL SPENDING** | | **16,393** |

Note. Resource financing and spending in this table excludes depreciation.

Source: Department of Finance

Given the Executive's relatively limited room for manoeuvre in determining the overall size of its budget, sustainability in NI is arguably best interpreted largely as a question of sufficiency:

> *"Given the outlook for the external funding that it can expect, and its relatively limited ability to top that up through its own policy decisions, could the Executive expect to be able to finance a quality and quantity of public services in NI broadly equivalent to that deliverable in the rest of the UK?".*

This treats the sufficiency of spending on services as a relative rather than an absolute concept, the latter ultimately being a matter of preference and political choice (although it could also be assessed as the ability to sustain past quality and quantity of services).

Judging the quality and quantity of services in NI relative to other nations/regions is not straightforward, but if prospective funding did look insufficient on current policy, the options for the Executive would be: simply to accept that; to try to increase the efficiency with which services are provided; to cease or reduce the provision of lowest priority services; to make additional fiscal effort (raising the Regional Rates and/or fees and charges); to seek greater tax raising or borrowing powers from the UK Government; or to seek additional funding from the Treasury either as part of another political agreement or more durably by trying to persuade the UK Government to incorporate an assessment of relative need for spending per head to deliver equivalent services in the calculation of the Block Grant.

## Population characteristics and relative need for public spending

Our definition of sustainability in a devolved context (i.e. that the Executive can deliver the same quantity and quality of public services as in the rest of the UK) requires funding per head at least equal to some appropriate (albeit hard to estimate) measure of relative 'need' for spending per head. This 'need' would reflect the proportion of people requiring each service (due to the age structure and other characteristics of the population), as well as the variations in the cost of providing it. For example, a younger population would likely have a greater relative need for schools, which might be compounded by it costing more to provide schooling in a deprived or rural area. In order to provide the same quantity and quality of service in education, the Executive would therefore need additional resources that could come from the Block Grant, or revenue raising, or a combination of both.

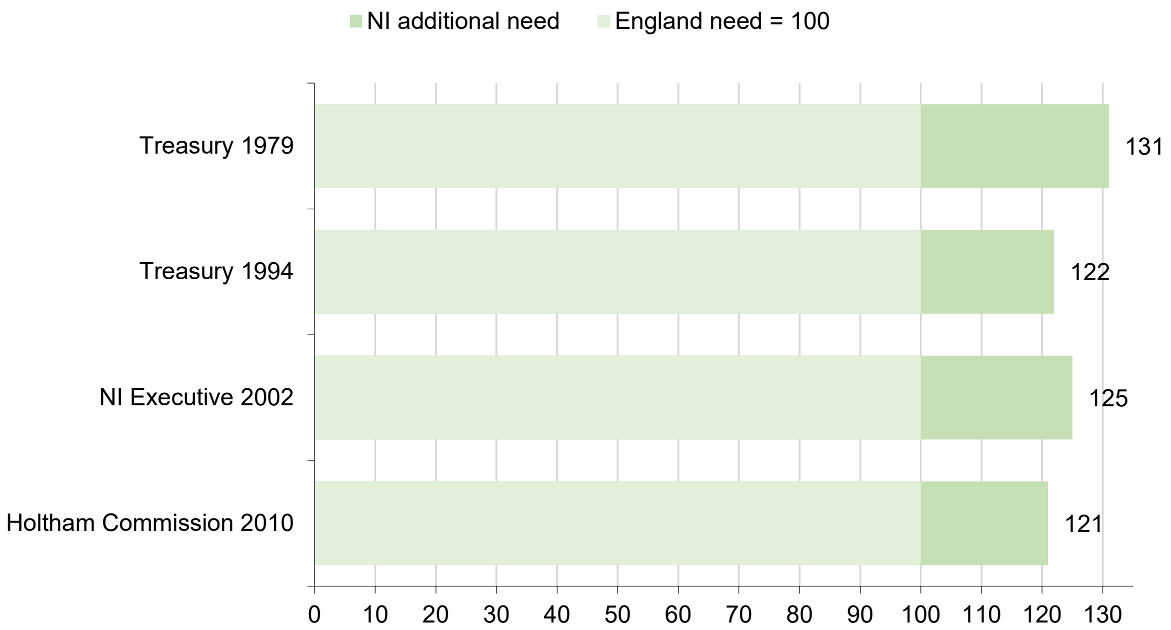
Various studies have been undertaken over the years to assess the relative need for spending on public services per head between the different nations/regions of the UK, based in general on underlying characteristics of the population, geography and economy of each nation/region that evolve relatively slowly over time.

The first systematic official assessment was coordinated by the Treasury in 1978-79, focusing on six responsibilities intended for devolution to Scotland and Wales; it suggested that NI needed to spend 31 per cent more per head on these than England to deliver equivalent services. The Treasury updated the analysis in 1994, lowering the estimated premium to 22 per cent. The NI Executive then updated the methodology and increased its scope in 2002, raising it slightly to 25 per cent (but varying widely from 242 per cent for agriculture to 12 per cent for employment).

A House of Lords Committee argued in 2009 that: "*Public spending per head of population should be allocated across the UK on the basis of relative need, so that those parts of the UK which have a greater need receive more public funds to help them pay for the additional levels of public services they require as a result.*"[9] Without estimating a precise number, it concluded that NI and Wales had greater need for spending per head than Scotland, which in turn had higher need than England.

The most recent systematic needs assessment was undertaken by the Independent Commission on Funding and Finance for Wales (also known as the Holtham Commission) in 2010, examining the merits of further fiscal devolution in Wales. Based on the age structure of the population and the proportions of people on social security benefits, with long-term illnesses, from ethnic minorities and living in rural areas, it concluded that spending per head needed to be 21 per cent higher in NI, 15 per cent higher in Wales and 5 per cent higher in Scotland than in England.[10] But it cautioned that the figures for NI were "*only broadly indicative*".[11]

## Chart 1.2 - Previous estimates of the need for public spending in NI




Sources: House of Lords - The Barnett Formula - Select Committee on the Barnett Formula; Department of Finance; Independent Commission on Funding and Finance for Wales.

Given that this is the most recent assessment, and that one might expect the earlier assessment conducted by the Executive to be somewhat self-serving, 20 per cent

[9] https://publications.parliament.uk/pa/ld200809/ldselect/ldbarnett/139/13904.htm

[10] The Commission found that four of the six needs indicators were higher for NI than for the other UK nations: combined benefit rate; under 16 dependency; sparsity; and limiting long term illness. For the two other indicators, pensioner dependency ratio and ethnicity, NI was the lowest among the UK nations.

[11] https://gov.wales/sites/default/files/publications/2018-10/fairness-and-accountability.pdf

looks a reasonable ballpark figure for the additional spending per head required in NI to deliver comparable services. Looking at a range of other indicators, including health and socio-economic conditions, does not paint an obviously conflicting picture.

Whatever figure you start at, it would be useful to know if need was likely to rise or fall over time relative to England (as the main comparator and basis for the Barnett formula allocations), reflecting changes in demand for different types of service or the cost of providing them. There is no obvious overall trend, although with NI having a relatively young but more rapidly ageing population you might expect upward pressures on health spending to outweigh downward pressures in education to a greater degree in NI than in the other nations/regions of the UK over the medium-to long-term.

The estimates of need are all based on the relative need for public spending in NI compared to England, rather than an absolute level. There are significant challenges in coming to an agreed position on the relative level of need, although this has been achieved for Wales using a fairly simple model. One drawback of this approach is that a focus on relative need implicitly assumes that the level of public spending in England is sufficient in an absolute sense, which it may not be. Defining absolute need is even more challenging than relative need, ranging from an unaffordable utopian ideal to such basic levels of provision that it would leave many individual needs unmet. Ultimately this is a matter of preference and political choice.

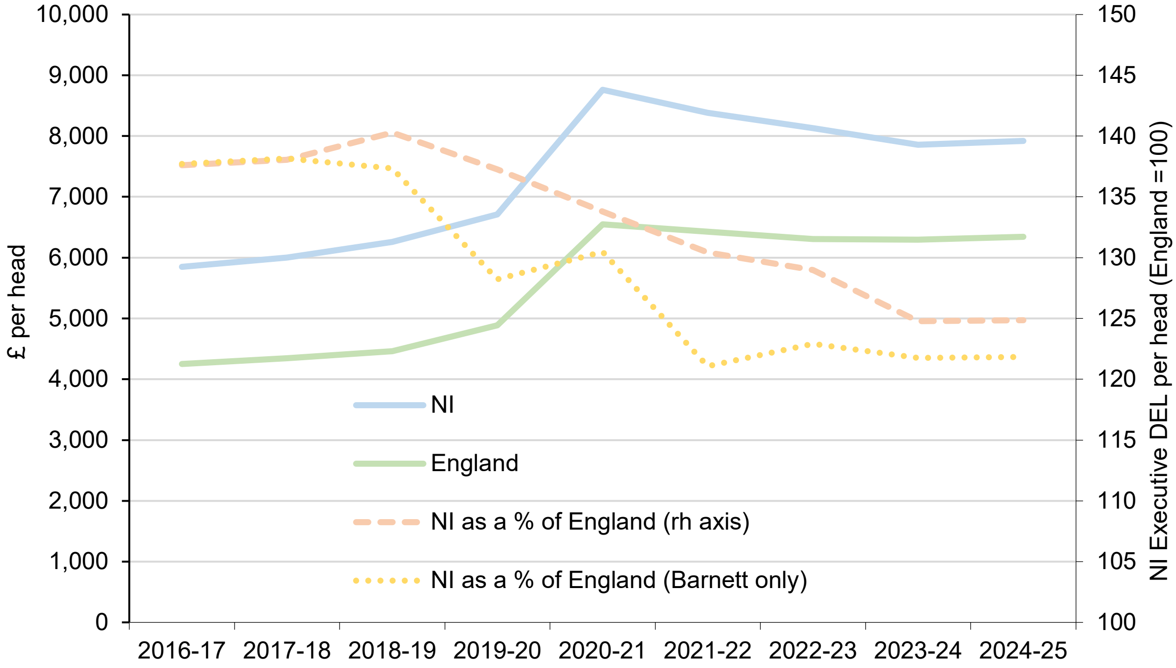
## Is the Block Grant being squeezed?

The core component of the NI Block Grant is determined initially at UK Spending Reviews and adjusted through each financial year according to the Barnett formula, first implemented in 1979. Put simply, this ensures that when the UK Government increases spending in the rest of the UK on services for which the Executive is responsible in NI, the Block Grant rises by the same amount in pounds per head.

Because spending per head starts higher in NI than in England, increasing spending per head by the same cash amount means a smaller percentage increase in NI and gradual convergence over time in NI relative to UK Government spending in the rest of the UK. If (as seems plausible) the Executive needs to spend a given percentage more to deliver equivalent services, then this 'Barnett squeeze' will put pressure on fiscal sustainability in NI in the sense that we have defined it.

The operation of the Barnett formula has seen a trend decline in spending per head in NI relative to UK Government spending in the rest of the UK over most of the last four decades, but there have been fluctuations along the way reflecting changes in other funding (for example from political agreements). Because of the way in which the formula operates, the faster spending across the UK rises, the faster the NI-to-England (or UK) premium declines. In principle the premium would rise if spending across the UK fell, although this rarely happens, particularly as the Barnett formula is applied to nominal changes in spending rather than real (inflation-adjusted) ones.

Chart 1.3 - NI Block Grant and comparable UK spending per head




See notes to Chart 5.2
Source: HM Treasury and Northern Ireland Fiscal Council calculations

Chart 1.3 shows that the NI spending premium is expected to be significantly lower over the three years of the current UK Spending Review to 2024-25 than in previous years. Treasury figures show that the NI Block Grant is set to rise by 3.6 per cent a year between 2019-20 and 2024-25, compared to a 6.0 per cent annual increase in the DEL for the UK as a whole, 5.1 per cent for Wales for 4.9 per cent for Scotland.[12] As well as the impact of the Barnett formula, the slower growth in the NI Block Grant is in part due to the withdrawal of previous time limited allocations, including from political agreements. This slower growth would see the Block Grant fall from 38 per cent above UK equivalent spending per head of population in 2017-18 to 25 per cent above in 2024-25. (Excluding non-Barnett additions to the Block Grant, the premium would be 22 per cent.)

The Barnett squeeze would be expected to persist over the longer term. We project that the NI Block Grant premium over equivalent spending per head would fall below 20 per cent in 2030-31, 10 per cent in the late 2040s and would end the 50-year projection slightly above 5 per cent in the early 2070s. If the 2021 Spending Review plans left NI's overall funding advantage at 38 per cent, rather than prospectively reducing it to 25 per cent, the Block Grant would be £1.5 billion higher in 2024-25 (in 2020-21 prices).[13] This reduction in relative spending advantage is equivalent to approximately £2,000 per household and confronts the

[12] These comparisons will also reflect changes in the coverage of DELs as a result of the fiscal savings from Brexit, and any changes in the composition of DELs, post-Brexit.
[13] The figure of a 38 per cent funding advantage for NI over England reflects a recent historical position rather than the Council's assessment of relative need in NI. Most needs studies (although none were carried out recently) have concluded on a figure nearer 20 per cent, and this is the figure we use as an estimate of relative additional need in NI.

Executive with a significant near-term sustainability challenge in terms of delivering equivalent quality and quantity of services to those in England.

As the projection implies, there is no explicit mechanism to ensure that the NI Block Grant premium does not fall below the 20 per cent figure that looks broadly consistent with NI's relative need for spending per head over England (or any other estimate one might choose). This is in contrast to the situation in Wales, where the UK and Welsh Governments agreed in 2015 that the Block Grant there would not fall below the 15 per cent needs premium identified by the Holtham Commission. In 2016 the UK and Welsh Government also agreed a 5 per cent uplift to future Welsh 'Barnett consequentials', slowing the decline in the premium towards that floor.

## Topping up the Block Grant

The Executive has various sources of financing with which it can top up the core Block Grant, some of which are more under its control than others. On current policy none of them look likely to offset the impact of the ongoing Barnett squeeze on its ability to deliver comparable services in a significant and predictable way.

**Regional Rates** raised £497 million in 2021-22, after 'paying' for the Business Rate Holiday (at a cost of £222 million) and other reliefs with £127 million earmarked to repay capital borrowing. Rates are levied on the assessed capital value of domestic properties and the assessed rental value of non-domestic properties at a set point in time. So revenue depends on the number of properties in each sector, their capital and rental values and the 'poundage' set annually for each sector by the Executive. Revenue grew rapidly in the 2000s but has grown more slowly since – in part because of reluctance to increase poundages, especially for household payers. A Land & Property Services projection assuming a 1.0 per cent a year average increase in poundages (in line with recent history) and a 0.5 per cent a year average increase in the tax base (reflecting slowing growth in the number of households) would see revenue halve relative to the size of the Block Grant by the mid-2050s.

The Executive's **capital borrowing** is currently restricted to £200 million pounds a year by agreement with the Treasury, with a £3 billion limit on outstanding debt set in UK legislation in 2006. The *2022-2025 Draft Budget*[14] proposed increasing net borrowing to the £200 million limit by 2024-25, which would take debt to £1.7 billion. We estimate that if the Executive continued to borrow £200 million a year, with an average term of 15 years, outstanding debt would remain below £2 billion, while debt interest would remain below £50 million a year at recent borrowing rates. Borrowing could increase to £340 million a year (equivalent to only 2 per cent of the core Block Grant in 2024-25) without breaching the £3 billion limit, and even if borrowing costs rose to 5 per cent the interest bill would only reach £155 million a year. This underlines the fact that the constraints on the Executive's borrowing powers limit the additional contribution it can make to financing service

[14] https://www.finance-ni.gov.uk/sites/default/files/publications/dfp/Draft%20Budget%20document%202022-25%20accessible.pdf

delivery – especially as the benefits of investment spending for service quality take a long time to emerge – but they also limit its exposure to interest rate risk.

The Department of Finance treats **fees and charges** as negative spending for the departments that levy them, allowing them to spend more within the net DEL they are allocated. Fees and charges are not identified separately in NI Budget documents but they raised around £700 million in 2020-21, the biggest revenue raisers being non-domestic water charges and Health Trust receipts. But some of these charges are payments from one public sector entity to another, so it is not clear exactly what contribution they make overall to the Executive's spending power. Given the variety of items involved, it would be hard to produce a meaningful long-term projection in a bottom-up way, based on current policy. If they were to rise in line with inflation or the Executive's overall spending, they would not significantly ease the sustainability challenge.

Turning to potential policy changes, the most frequently suggested ways to increase fiscal effort and raise more money to finance service delivery are through bigger **increases in the Regional Rates and/or increases in fees and charges**, the most frequently cited of which are domestic water charges. NI households paid an average of £1,036 a year in rates in 2021-22, compared to an average £1,836 in council tax and water charges in England. Closing this gap could raise up to an extra £615 million, which would be sufficient to increase total Executive spending by 4 per cent in 2024-25 but no doubt at the cost of significant political controversy.

The Executive also receives some **additional external financing** that is not in its power to change, for example EU funding - much reduced since Brexit, to around £136 million in 2020-21, but still flowing via the PEACE PLUS programme which is agreed through to 2027. The Irish Government is also providing £75 million to the A5 road programme as part of the New Decade, New Approach political agreement. But neither is likely to increase much if at all.

As noted already, the core Barnett component of the Block Grant is topped up by non-Barnett additions, among them funding for political agreements like New Decade, New Approach. It would be a brave person who bet that this would be the last time NI secures additional resources to help restore or sustain the Stormont institutions, but this money is typically time-limited and earmarked for specific purposes so is not ideally suited to long-term service planning and reform.

## Conclusion

The biggest threat to the sustainability of the Executive's finances, in terms of its ability of deliver services comparable to those in the rest of the UK, is the Barnett squeeze – the fact that an x per cent increase in UK Government spending in the rest of the UK on services that the Executive provides in NI will result in a less-than-x per cent increase in the core Block Grant with which to finance them.

The Barnett squeeze implies a Barnett paradox – the greater the increase in the Block Grant in absolute terms, the greater the squeeze in relative terms. It is an interesting question to what extent people in NI care more about spending or service quality in absolute terms or relative to England. If the OBR's long-term forecast is broadly correct, then the UK public finances are on an unsustainable path. The recent increases in public spending in England have tightened the Barnett squeeze, accelerating the convergence of NI funding per head towards that in England. Recent political deals have had a temporary effect of delaying the full impact of the Barnett squeeze in NI. Part of the solution to the unsustainable trajectory of the UK public finances may be not to accommodate some upward pressures on public spending at the UK level. This would ease the proportionate squeeze on the NI Block Grant but would reduce its absolute size.

The Executive's ability to top up the Block Grant through its own policy action is limited but not negligible. Restrictions on the size and purpose of its borrowing rule out meaningful deficit finance, but the Executive could increase Regional Rates and/or fees and charges. Household rates bills in NI are significantly smaller than council tax bills and water charges elsewhere in the UK, but eliminating the gap might not be popular. Part of a longer-term solution may involve seeking changes to the fiscal framework to incorporate an assessment of need in the operation of the Barnett formula, as the Treasury has agreed to do with the Welsh Government. (This assumes the Treasury and NI Executive could reach an agreed view on NI's relative needs.) This would place a floor below which its spending premium would not fall, but the Executive would still need to respond to the new fiscal position following the 2021 Spending Review with the NI spending premium no longer significantly higher than the relative need for public spending.

Against this backdrop, the Executive will have to make every effort to maximise the efficiency and value for money of every pound spent in NI's public services.

# 2 Fiscal sustainability at the UK level

Many fiscal watchdogs around the world prepare analyses of the long-term sustainability of their public finances, but in most cases they do so for governments or administrations that have considerable freedom in deciding how much to spend, tax and borrow. Northern Ireland (NI) is in a different position. The Executive is free to allocate its budget largely as it sees fit across the public services and other activities for which it has been given responsibility, but it has few tax-raising powers (even by the standards of the other Devolved Administrations) and its ability to borrow is tightly constrained both by legislation and agreement with Treasury.

In this chapter we begin by looking at how fiscal sustainability is interpreted and assessed for jurisdictions with greater policy autonomy. We focus on the Office for Budget Responsibility's (OBR) most recent assessment of the sustainability of UK public finances in the *Fiscal risks and sustainability report* (FRSR) published on 7 July 2022.[15] In Chapter 3 we ask how this approach can be adapted to NI, but the OBR's assessment at the UK level is also relevant to NI in its own right. As a consequence of the Barnett formula, any cuts or constraining of growth in public services spending deemed necessary to move the UK public finances to a more sustainable path would have implications for the Block Grant that pays for most NI Executive spending. So, in this chapter we also draw some conclusions for NI from the UK's outlook.

## Long-term projections of the public finances

Assessments of fiscal sustainability tend to have a long-term perspective, rather than the short- to medium- term focus of government spending plans or fiscal and economic forecasts. The fundamental question they ask is whether current policy settings and decisions could realistically be maintained over the long term or whether a future government would at some point need to change them. If current policy is deemed unsustainable, this signals the need for present and would-be policymakers to consider when and what action might best be taken.

Assessments of sustainability usually begin by choosing a 'jumping-off point' for public spending, revenue, financial transactions, borrowing and debt and then projecting how they would evolve thereafter under unchanged current policy. The OBR's projections 'jump off' from the five-year horizon of its most recent medium-term forecast in 2026-27 and extend for a further 45 years. These are not forecasts of how the public finances will evolve, but rather conditional projections of how they might in the highly unlikely event that policy did not change over that period.

In order to produce these projections, various assumptions are required:

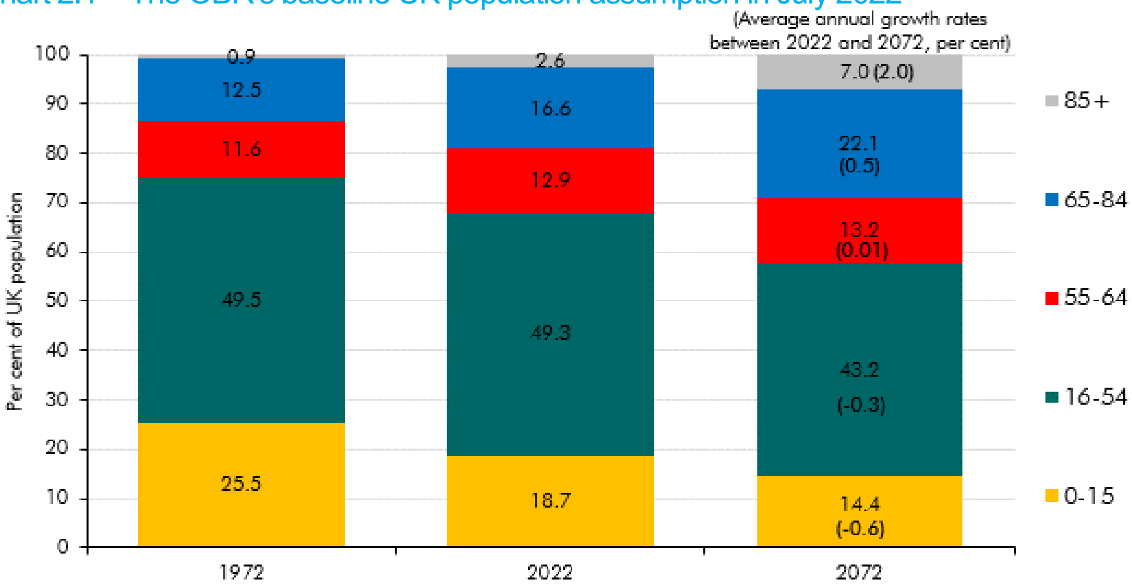
- **Demographics:** The size and age structure of the population has significant implications for the size of the economy and the public finances, in part

[15] https://obr.uk//docs/dlm_uploads/Fiscal_risks_and_sustainability_2022-1.pdf

because people of different ages consume different amounts and types of public spending and contribute different amounts and types of revenue.

We can be reasonably certain about some future population trends, for example that the demographic bulges created by the post-WWII and early-1960s baby booms will continue to pass through the projections as these cohorts age and that past trends of declining fertility and increasing longevity are producing an 'ageing population' (as in most advanced economies). But different assumptions about future fertility, mortality and net migration can generate widely different outcomes when cumulated over decades. For the FRSR, the OBR took the latest principal population projection by the Office for National Statistics (ONS) and assumed slightly lower net inward migration to reflect the impact of the post-Brexit migration regime. On this basis the UK population is projected to be broadly flat over the next three decades at around 68 million before declining from the late 2040s to reach around 66 million by the projection horizon in 2072. In contrast, the ONS project that the UK population will rise to 72 million. (The OBR's assumed decline in the population means that servicing a given amount of previously incurred debt would impose a greater burden per person, but the pressure on some public services and on environmental costs might be eased.) Chart 2.1 shows that the proportion of the population aged 65 and above is projected to rise from 19 per cent today to 29 per cent in 2072, while the proportion aged below 16 is set to drop from 19 to 14 per cent. The working-age population (aged 16-64) shrinks from 62 per cent of the total population today to 56 per cent in 2072.

## Chart 2.1 – The OBR's baseline UK population assumption in July 2022




Note: 2022 and 2072 readings are from the OBR low migration baseline.
Source: ONS, OBR

- **Economics:** Projections for public spending and revenue depend on the size and composition of the economy, as most taxes are levied on part of national income or spending and the effective tax rate varies from one to another.

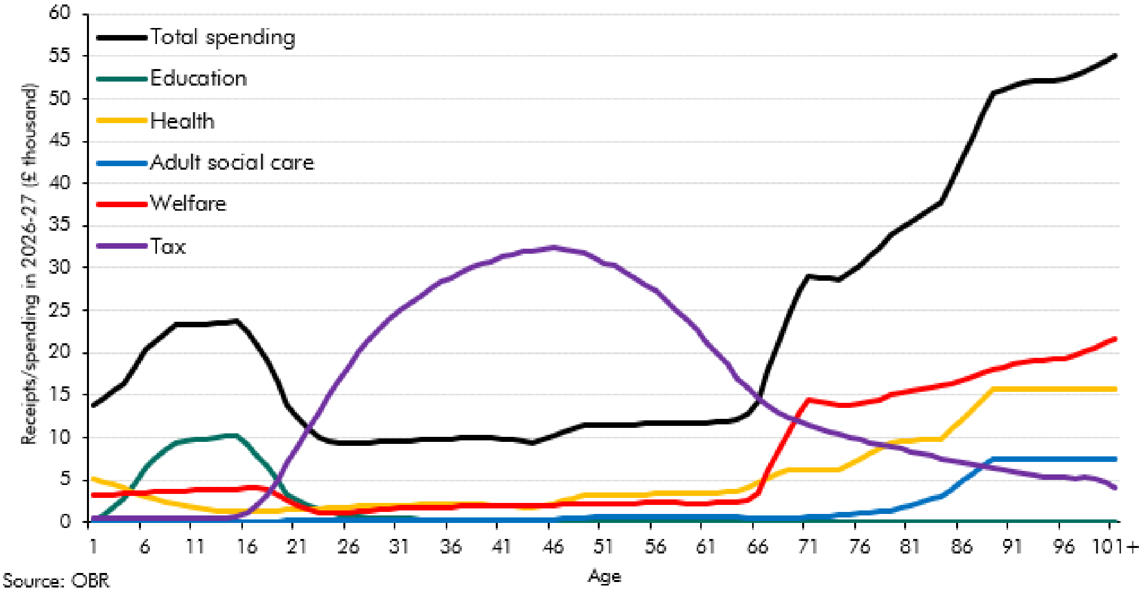
The OBR's projections reflect its views of the underlying growth rate of productivity (or output per hour) and total hours worked (based on the population projections and assumptions about labour market participation at different ages and average hours worked). Beyond the medium term, the OBR assumes that GDP growth averages 1.4 per cent a year. Variations year by year primarily reflect changes in the size of the population – in common with most sustainability analyses the OBR assumes away the ups and downs of the economic cycle to focus on underlying trends. Other key economic assumptions are that the Consumer Prices Index (CPI) measure of inflation remains at its 2 per cent target rate and that interest rates average 3.9 per cent, a little higher than average growth in the cash size of the economy.

- **Policy:** If the purpose of a sustainability analysis is to judge whether current policy can be maintained over the long term, you need to define current policy. This is not always straightforward. The legal requirement on the OBR to produce five-year forecasts based on current policy requires the Treasury to tell it what tax and spending policy will be over that period, explicitly or with reference to default settings. But, in some cases, default settings that are plausible over a five-year horizon are implausible over a much longer one. Tax thresholds and allowances and working-age welfare payments are generally assumed to rise in line with inflation unless otherwise stated over the medium term, but this is implausible over the longer term as wages have tended to rise more quickly than prices. An ever-higher proportion of people's income would be drawn into higher tax brackets ('fiscal drag' or 'bracket creep') and benefit payments would fall relative to the living standards of those in work. So the OBR assumes that allowances, thresholds and working-age benefits rise with earnings (3.8 per cent a year) rather than prices beyond the medium term, which is closer to what we observe in practice. (There are some areas where policy changes are explicitly signalled for the longer term, most notably changes in the future state pension age.)

Having made this set of assumptions, the next step is to produce projections of spending and revenues, excluding debt interest payments and receipts respectively. This generates a projection for the so-called primary budget balance – the gap between the two. Combined with the current stock of debt and assumptions about government borrowing costs, this can then be used to derive projections for net interest payments, the total budget balance and net debt. The path of net debt is also affected by financial transactions that affect the government's cash requirement.

To project most individual categories of spending and revenue, the OBR assumes that the amount of spending consumed and revenue contributed by people of different ages rises with average earnings and the cash size of the economy per head from their estimated levels at the end of the medium-term forecast. In the absence of changes in the structure of the population this would result in spending, revenue and the deficit remaining constant as shares of GDP. But, as Chart 2.2 shows, people tend to be relatively high consumers of public spending at younger and (especially) older ages, while they tend to contribute most revenue during the middle years when they are of working age. So changes in the age structure can change spending and revenue as shares of GDP by making the average individual more or less of a revenue contributor or spending consumer.

## Chart 2.2 – Representative spending and revenue profiles used by the OBR



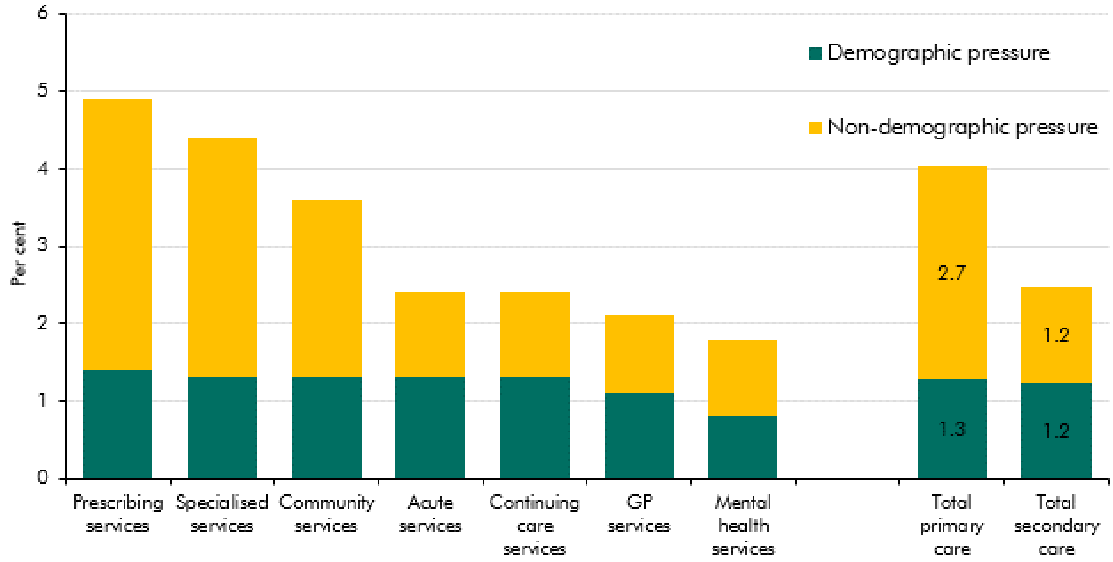

Source: OBR

In addition to the implications of the ageing population, the OBR's projection for health spending crucially reflects an assumption that spending rises to accommodate non-demographic cost pressures (including from technological advances and the relatively labour-intensive nature of health care). Motivated by historical experience, this is a frequent assumption in fiscal sustainability analyses around the world and will be a key issue in our discussion of sustainability in NI.

Based on a study by NHS England for 2015-16,[16] the OBR assumes that non-demographic cost pressures will initially push Primary care spending up by 2.7 per cent a year and Secondary care spending by 1.2 per cent a year, but in both cases dropping gradually from the late 2030s to 1.0 per cent a year from 2042-43 as health spending takes up an ever-larger share of national income. The ageing of the population is expected to increase spending by an average of 1.2-1.3 per cent a year. So non-demographic factors are expected to contribute more to the growth in health spending than changes in the size and composition of the population.

[16] NHS England (2016), 'NHS Five Year Forward View: Recap briefing for the Health Select Committee', May. https://www.england.nhs.uk/wp-content/uploads/2016/05/fyfv-tech-note-090516.pdf

## Chart 2.3 – The OBR's assumptions on annual spending pressures in health




Source: NHS England, OBR

Other departures from simple use of the age profiles in Chart 2.2 include: an assumption that fuel duty will disappear as electric vehicles replace petrol and diesel ones; direct modelling of pension and social security benefit spending undertaken with the help of the Department for Work and Pensions; and the use of social care spending projections from the Department of Health and Social Care.

## Table 2.1 – Summary results of the OBR's July 2022 projections

| % of GDP | 2021-22 | 2026-27 | 2071-72 |
|---|---|---|---|
| **Non-interest receipts** | **37.0** | **38.9** | **37.2** |
| *minus* | | | |
| **Non-interest spending** | **40.3** | **38.7** | **48.4** |
| *of which:* | | | |
| *Health* | 9.1 | 8.3 | 15.0 |
| *Adult social care* | 1.2 | 1.4 | 2.5 |
| *Education* | 4.2 | 4.2 | 3.3 |
| *State pensions and pensioner benefits* | 5.6 | 5.9 | 9.6 |
| *Public service pensions* | 2.0 | 2.0 | 1.7 |
| *equals* | | | |
| **Primary budget balance** | **-3.3** | **0.2** | **-11.2** |
| *minus* | | | |
| **Net interest spending** | **2.1** | **1.3** | **9.0** |
| *equals* | | | |
| **Public sector net borrowing** | **5.4** | **1.1** | **20.3** |
| *leads (alongside financial transactions) to* | | | |
| **Public sector net debt** | **95.6** | **83.6** | **267.0** |

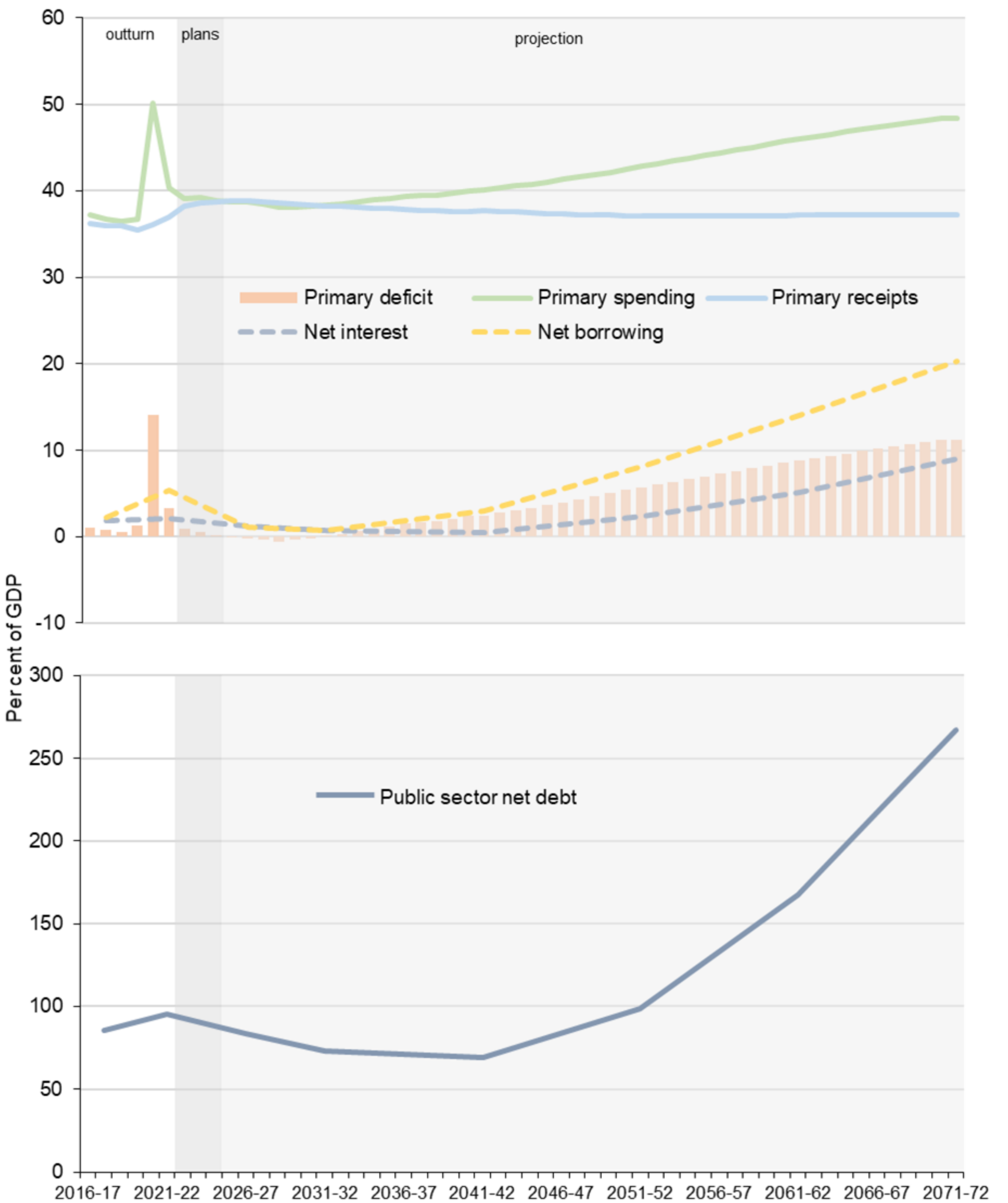
Source: OBR

Table 2.1 above summarises the OBR's July 2022 projections, with figures for the latest year, the jumping-off point at the end of the March 2022 medium-term forecast (to 2026-27) and the horizon year for the projections. Chart 2.4 below shows how the figures evolve over the intervening years. Key points include:

- **Non-interest receipts** decline slightly as a share of GDP beyond the jumping-off point, largely because of the loss of fuel duty.

- **Non-interest spending** rises steadily from 38.7 per cent of GDP at the jumping-off point to 48.4 per cent by 2071-72 – an increase of 9.7 per cent of GDP or £8,714 per household in today's terms. Health is by far the biggest contributor, increasing by 6.7 percentage points to reach an estimated 15 per cent of UK GDP by 2071-72. But there is of course considerable uncertainty around both. The state pension and pensioner benefits are the second biggest contributor to the increase (3.7 per cent of GDP), reflecting the ageing population and policy to uprate the pension by the highest of CPI inflation, earnings or 2.5 per cent (the 'triple lock'). Together these more than offset rises in the state pension age. Adult social care spending rises by 1.1 per cent of GDP, largely reflecting ageing and the rising costs of care associated with higher demand and steady increases in life expectancies of successive cohorts. But a fall in the relative size of the school-age population reduces education spending by 0.8 per cent of GDP.

Chart 2.4 – Summary results of the OBR's July 2022 projections




Source: OBR Fiscal risks and sustainability report 2022 and Fiscal risks report 2018

- With non-interest receipts remaining flat and spending increasing, the **primary balance** deteriorates steadily from a surplus of 0.2 per cent of GDP at the jumping-off point to a deficit of 11.2 per cent of GDP in 2071-72. The OBR then incorporates financial transactions (mostly related to student loans), which add to the UK Government's cash requirement but not the primary deficit. As the primary deficit mounts, the borrowing to finance it increases the government's debt – as does the borrowing needed simply to finance the rising interest payments on that debt. By the end of the projection, net interest payments are 7.7 per cent of GDP higher than at the jumping-off point at 9.0 per cent and public sector net borrowing 19.2 per cent of GDP higher at 20.3 per cent. **Net debt** reaches 267 per cent of GDP at the end of the projection, compared to 84 per cent at the jumping-off point.

## Assessing fiscal sustainability

Put simply, the fiscal position of a government like the UK's is judged unsustainable if current policy puts the ratios of debt and debt interest to GDP (the size of the economy that can be taxed to service them) on a persistently rising trajectory. At some point, the debt interest burden would become so great that the government would be unable to borrow at reasonable rates (or at all) and would be left with the choice between a politically infeasible budget tightening or a default on its debt.[17]

This is clearly the case in the OBR projection, primarily reflecting the ongoing upward pressures on spending from cost pressures in health and the ageing population. And policy would likely have to adjust well before the 50-year horizon. There are of course many uncertainties around the assumptions that underpin the projections, not least around the scale and duration of the non-demographic cost pressures and the outlook for the population structure. But the diagnosis of unsustainability is robust to most alternative projections.

Various techniques are used to quantify how unsustainable a fiscal position is, most based on the size of the policy adjustment required to restore sustainability. The 'intertemporal budget gap' is the one-off and immediate cut in spending or increases in taxes required to ensure that the present value of all future revenues is sufficient to cover the current debt stock plus the present value of all future spending. This concept appeals to theorists, but is not a particularly practical guide for policy, so the OBR focuses on 'fiscal gap' measures of the adjustment necessary to achieve a plausible debt-to-GDP ratio in a particular year.

Based on the projections described above, the OBR calculates that to achieve a debt-to-GDP ratio of 75 per cent at the forecast horizon – broadly the ratio the UK Government appeared content to aim for prior to the pandemic – would require a permanent increase in taxes and/or cut in spending of 4.2 per cent of GDP (£3,719 per household in today's terms) in 2027-28. Since it is very unlikely that a government would try to offset decades' worth of future demographic and other cost pressures via a single upfront adjustment, a more realistic response would involve a series of tax increases or spending cuts worth an additional 1.5 per cent of GDP (£1,321 per household in today's terms) each decade. This tightening would be in addition to any other measures already announced and incorporated in the medium-term forecast, such as the introduction of the health and social care levy.

[17] Adherents of 'modern monetary theory' (MMT) would argue that there is no limit to the debt and deficit that a government can run if it can print its own money, as long as taxes extract sufficient spending power from the economy to restrain inflation.

## What does this mean for Northern Ireland?

The OBR's projections for the UK public finances include the public finances of NI, although they are not separately identifiable because of the top-down way in which the analysis is constructed. The projections of UK revenues implicitly include the taxes paid by people living in NI (to the Executive and local councils, as well as the UK Government) and the projections of UK spending include the spending on public services undertaken by the Executive and local councils (as well as the welfare spending for which the Executive is formally responsible, but that the UK Government finances). The borrowing undertaken by the UK Government is partly on behalf of people living in NI who then contribute to servicing the resulting debt.

If the OBR's projections are in the right ballpark, some fiscal tightening is going to be required over the coming years at the UK level to address the ongoing pressures they identify (as well as the fiscal costs of any persistent negative shocks that may come along, like the financial crisis, Brexit, the Covid pandemic or the economic consequences of Russia's invasion of Ukraine). This tightening could come in three main forms, the effect of each of which would be felt in NI:

- first, **tax increases** (which would be paid in part by people in NI);
- second, **cuts in UK-wide pension and social security benefit rates and entitlements** (which would reduce the value of those payments to people in NI and the amount of money that the UK Government has to transfer to the Executive to cover the cost); and/or
- third, **cuts in public services spending**. As we describe in greater detail in the next chapter, under the Barnett formula changes in spending per head in England on areas for which the Executive is responsible in NI (most significantly health and education) result in broadly corresponding changes in the Block Grant that the UK Government pays the Executive to finance its own spending in those areas (although the Executive is free to allocate the Block Grant as it wishes between those areas). When the UK Government seeks to achieve fiscal tightening through cuts in public services, it factors in the implications for the Block Grant in doing so.

The first two channels of fiscal tightening at the UK level would not in themselves affect the relative fiscal position of the Executive, because the amount of debt it can accumulate is constrained by legislation and the amount it can borrow each year is limited by agreement with the Treasury. But it would affect the income of NI households. That in itself is something that the Executive might wish to respond to.

As we shall explore in Chapter 5, the key sustainability issues for the Executive are whether increases in the Block Grant genuinely deliver comparable increases in resources when the UK Government increases spending in the rest of the UK, and whether the upward pressures on the cost of delivering a given quality and quantity of public services rise more or less quickly in NI than elsewhere. (Separately there is the question of the starting point: does NI need more resources per head to deliver a quality and quality of services comparable to those in England and does it actually do so?) In the event that the Executive faces stiffer headwinds or a weaker starting position as regards income and/or costs, it has limited scope to raise additional resources through taxation or borrowing.

# 3 Sustainability in Northern Ireland

In thinking about the sustainability of the NI public finances, as it affects the decision-making of the Executive and Assembly, some themes and challenges are common to the analysis at the UK level that we described in the previous chapter. As at the UK level, we are interested in the long-term outlook for income and spending and whether demographic and non-demographic influences might require policy changes. But the consequences of remaining on an unsustainable path are different and so too are the potential responses available to NI policymakers. We argue that given the constraints imposed on the Executive's ability to borrow – and therefore the implausibility of an explosive debt trajectory – sustainability is best interpreted in terms of the sufficiency of the NI Executive's financing to deliver an equivalent quality and quantity of public services to that deliverable in England. This implies a focus on the sufficiency of financing in the short as well as over the longer term, and a need to make the most efficient use of the funding available.

## The Executive's constrained ability to borrow

The public finances of sub-national governments or administrations typically differ from national ones in the areas of spending for which they responsible (which tend to be more limited), their sources of revenue (which also tend to be more limited but include transfers from the national government) and in the legal constraints on their ability to borrow and accumulate debt. Some national governments (like Germany and Switzerland) have constitutional limits on their debt or borrowing, but UK governments are constrained only by self-imposed fiscal rules that they have replaced repeatedly following economic shocks or political decisions to increase spending.

For sub-national jurisdictions that are able to borrow with relative freedom – like the state governments of Australia, for example – a fiscal sustainability analysis can look very like the OBR's for the UK. The long-run projections in the New South Wales Treasury's regular *Intergenerational Report* are a good example, the most recent showing a similar picture to that in the UK with the state's budget deficit and stock of debt on a persistently rising path, thanks both to rising spending and falling receipts as shares of GDP.[18]

We need to think about sustainability differently in NI primarily because the Executive is much more constrained in its legal authority to borrow. As described in our *Guide*, it can borrow to finance capital investment under the Northern Ireland (Loans) Act 1975, but this set a limit of £2 billion on any outstanding debt which was then raised to £3 billion in the Northern Ireland (Miscellaneous Provisions) Act

[18] https://www.treasury.nsw.gov.au/sites/default/files/2021-06/2021-22_nsw_intergenerational_report.pdf

2006.[19] The Executive's debt has remained well below this limit and stood at £1.6 billion in 2020-21 (Chart 6.6).

When the current 'Reform and Reinvestment Initiative' (RRI) borrowing regime was put in place in 2002 to support increased investment in infrastructure, the Executive and the Treasury also agreed a £125 million annual limit on borrowing in 2003-04, rising to £200 million thereafter. This limit was lifted temporarily between 2015-16 and 2018-19 under the Fresh Start Agreement but is now back to £200 million (although the Treasury has occasionally allowed the Executive to borrow more to carry forward undrawn borrowing from previous years). Since 2003-04, RRI borrowing has averaged £135 million a year. Debt-financed projects have included a sports stadium, hospitals, schools and colleges, roads infrastructure and new buses. In years when the NI Budget has been set at Westminster, the UK Government has taken the view that it would be inappropriate to incur long-term debt in the absence of the Executive and has confined borrowing largely to the funding of voluntary exit schemes that the Executive had already agreed.

The Northern Ireland Act 1998 also allows the Executive to borrow for purposes other than capital investment, but only up to £250 million in total. The Treasury's *Statement of Funding Policy* specifies that: *"The sole purpose of these loans is to give the Northern Ireland Executive the ability to borrow over the short-term for cash management purposes, in circumstances where it is necessary to provide a working balance or meet an in-year excess in expenditure over income within the Northern Ireland Consolidated Fund"*.[20] This is, in effect, an overdraft facility and was originally put in place to help smooth cash flow within a given financial year. But no Devolved Administration has yet needed to borrow for this purpose.

Unlike NI's local councils, the Executive can only borrow from the UK Government. Formally, the Secretary of State borrows on its behalf from the National Loans Fund (NLF), with the Debt Management Office then borrowing on the NLF's behalf by issuing gilts as part of its broader financing strategy.

The Executive's borrowing powers are as constrained as they are in large part because its tax raising powers are also very limited – and thus also its ability to raise more revenue if and when debt servicing costs increase. Regional Rates are the Executive's only significant source of tax revenue (but paid for only 4 per cent of its spending in 2019-20). In contrast, the Scottish and Welsh Governments have greater tax raising powers (notably over part of income tax and property transactions taxes). Like local authorities, to fund capital spending they can also borrow from banks or other lenders or by issuing bonds as well as from the UK Government.

Given their greater tax raising powers, it may seem odd that the cumulative capital borrowing limits for the Scottish Government (£3 billion) and the Welsh Government (£1 billion) are smaller per head than the Executive's. But this is because the Executive has some responsibilities that fall to local authorities in the

[19] The Executive can also borrow within-year for cash management purposes unrelated to investment, but its ability to draw on the UK Consolidated Fund as needed day-to-day means that it has never needed to.

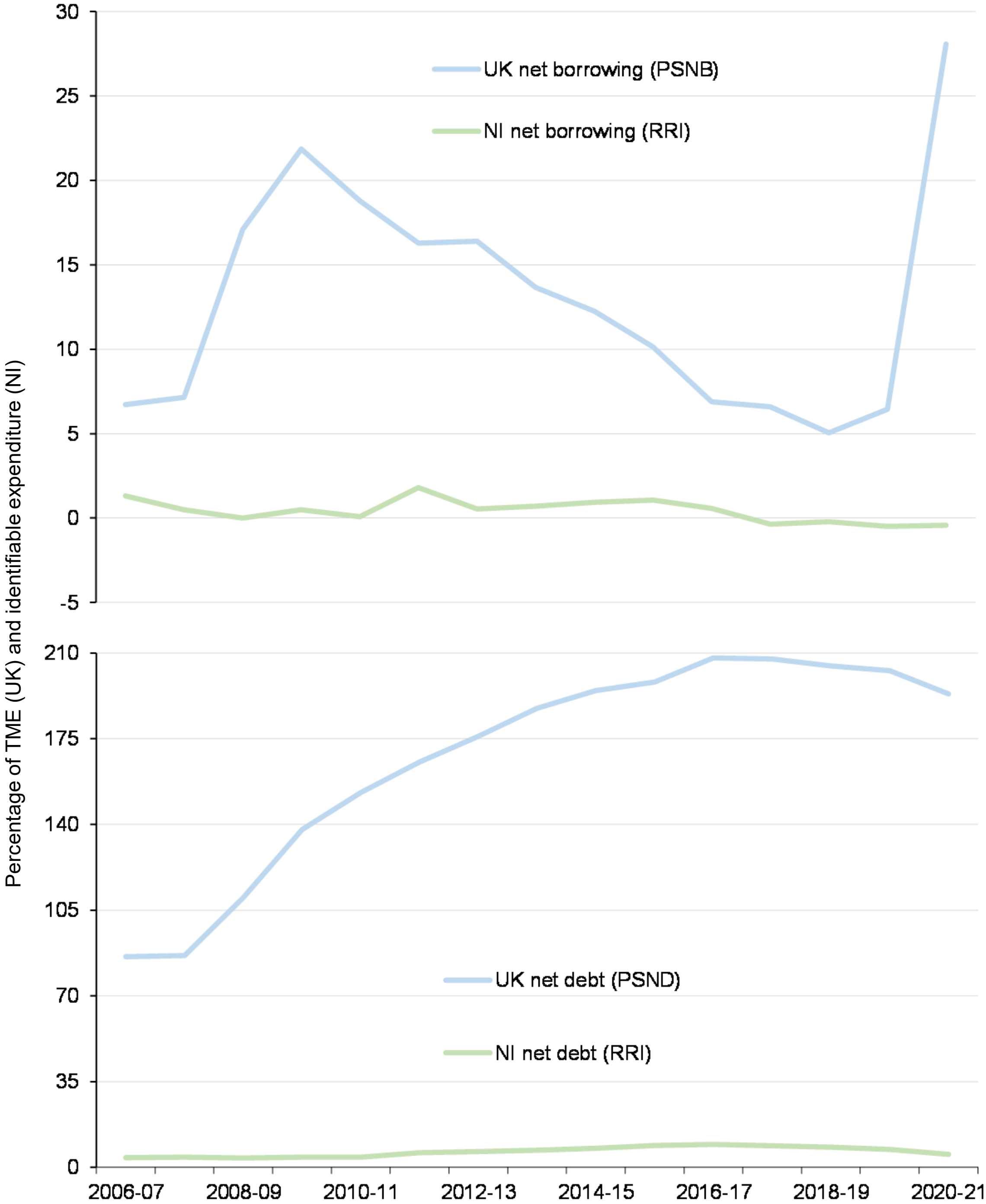
[20] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1030043/Statement_of_Funding_Policy_2021_-_FINAL.pdf

other regions and the Executive therefore needs to undertake some of the borrowing that these authorities would undertake.

Given the Executive's relatively constrained borrowing powers, it comes as no surprise that the amount of borrowing and debt accumulated have been very different at the UK and NI levels, even relative to each Administration's spending. Chart 3.1 shows annual net borrowing and outstanding debt as percentages of Total Managed Expenditure by the UK Government and identifiable spending in NI (around 85 per cent of which is undertaken by the Executive) each year since 2006-07.

It shows that borrowing and debt accumulation by the NI Executive has been much smaller relative to its spending than for the UK Government. Another difference is that the Executive's borrowing has been entirely to finance capital spending whereas just over half of the UK Government's borrowing has been to finance current budget deficits, the gap between revenue and other spending. The NI Executive receives a share of UK Government borrowing as this makes up one of the sources of funding in the Block Grant (and AME funding).

## Chart 3.1 – Borrowing and debt at the UK and NI levels




Sources: Department of Finance, HM Treasury Country and Regional Analysis and ONS UK PSF statistical bulletin

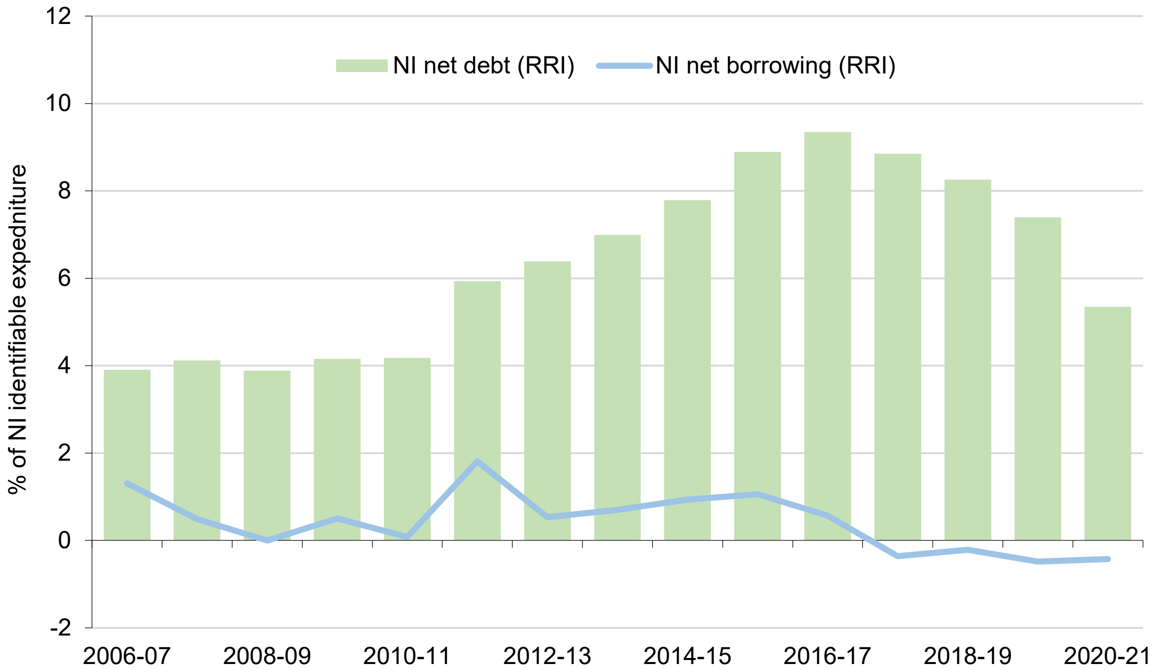
Because the UK Government's borrowing finances its current deficit as well as capital investment, UK borrowing increased a lot during Covid with the total deficit rising from 2.4 per cent of GDP in 2019-20 to 14.8 per cent in 2020-21.[21] This reflected temporarily higher spending on health and support for households and

[21] https://obr.uk/docs/dlm_uploads/Fiscal_risks_and_sustainability_2022-1.pdf (chart 10)

firms, as well as temporarily depressed tax receipts. In contrast the Executive's net borrowing as a proportion of identifiable expenditure was actually negative over the last four years reducing the stock of net debt by 40 per cent (Chart 3.2).

Given the Executive's very limited ability to borrow, we simply could not see the sort of prospective explosive profile for debt or debt interest that signals an unsustainable outlook in the UK or New South Wales. Upward pressure on spending or downward pressure on revenue will ultimately show up in the quality and quantity of public services that the Executive can deliver.

### Chart 3.2 - NI net debt and net borrowing




Sources: Department of Finance, HM Treasury Country and Regional Analysis

## The Executive's spending and income

The NI Assembly and Executive were created in their current forms following the Belfast / Good Friday Agreement in 1998. The Agreement took legislative effect through the Northern Ireland Act 1998. The Act divides the legislative responsibilities that were held by the UK Government prior to 1998 into three categories and gives the Executive responsibility for 'transferred matters' and (where agreed by both communities and the UK Government) 'reserved matters', while the UK Government retains responsibility for 'excepted matters'. The transferred matters are shown in Table 3.1 and they in effect define the scope of the Executive's spending and its Budgets.

## Table 3.1 – Transferred matters under the NI devolution settlement

| Transferred matters | |
|---|---|
| · health and social services | · local government |
| · education | · environmental issues, including planning |
| · employment and skills | · transport |
| · agriculture | · culture and sport |
| · social security | · the NI Civil Service |
| · pensions and child support | · equal opportunities |
| · housing | · policing and criminal justice |
| · economic development | |

Source: Northern Ireland Act 1998 (as amended)

Like the other Devolved Administrations in Scotland and Wales, the Executive is constrained to manage its spending within the framework that the UK Government has put in place to manage the public finances of the UK as a whole. For each Whitehall department and devolved administration, the Treasury divides public spending responsibilities into two categories – those for which it sets 'Departmental Expenditure Limits' (DELs) and those which it treats as 'Annually Managed Expenditure' (AME). DELs cover spending over which the Treasury believes that departments and devolved administrations have reasonable short-term control and the potential to make meaningful plans over the medium term. AME covers spending that is *"demand-led and volatile"* in a way that departments and devolved administrations could not be expected to manage.

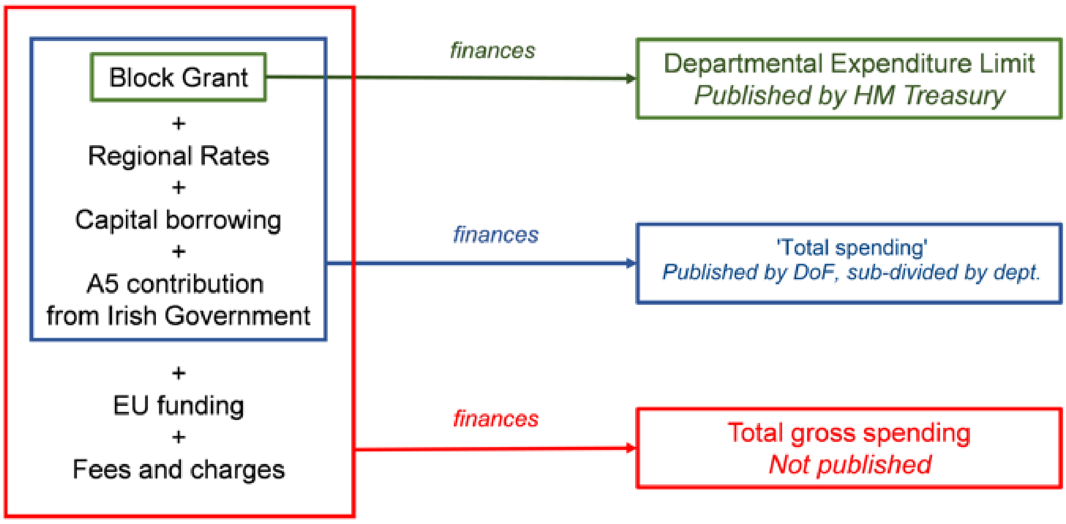
The Executive's AME spending – primarily on state and public sector pensions and social security benefits – is financed fully and automatically by the UK Government. Upward pressures on core AME spending in NI (primarily from the ageing population) thus contribute to the sustainability challenge for the UK Government rather than for the Executive. However, if the Executive makes an AME programme more generous than in England ('super-parity') it then has to meet the additional cost within its DEL. The cost to the Executive of super-parity spending tends to be relatively modest compared to its overall budget and is unlikely to be source of significant future pressures. But it has caused serious political difficulties in the past, in areas like welfare reform and the cost of the Renewable Heat Incentive (RHI) scheme.

The Executive's Budget – and our assessment of sustainability – therefore focuses on the allocation and financing of spending covered by its DEL. Within the total, the Treasury sets three subsidiary cash DELs for the Executive. The Department of Finance mirrors this in the way it lays out separate plans for:

- **Non-ringfenced resource** spending, which covers the day-to-day running costs of public services, administration and grants, plus the payment of debt interest. This is the largest component.
- **Conventional capital** spending, which largely covers investment in physical assets like infrastructure, buildings and machinery.
- **Financial transactions capital (FTC)** spending, which can only be used to make loans to or equity investments in the private sector.

In each category the Executive allocates planned spending department-by-department, with a small proportion held centrally for allocation later. The bulk of DEL spending is financed by the UK Government Block Grant. Indeed, under the UK spending control framework the Treasury sets the Executive's DEL equal to the Block Grant and treats all other financing as 'negative DEL' that creates room for higher gross spending within this net limit (Figure 3.1).

## Figure 3.1 – Financing of the NI Executive's DEL spending




Source: Northern Ireland Fiscal Council

The Department of Finance aims where possible to present both a Draft and a Final Budget. The most recent was the *2022-2025 Draft Budget* published in December 2021.[22] This covered the three financial years 2022-23, 2023-24 and 2024-25 for which the UK Government had announced the NI Block Grant as part of its Spending Review in October 2021.[23] The Executive could not agree on the allocations and so the Draft was published purely for consultation based on the proposals of the Finance Minister. The Department halted the formal consultation on 15 February 2022, following the resignation of the First Minister. Even though the Draft never proceeded further, the plans (favouring Health over other departments) are likely to remain the initial basis for negotiation under a new Executive.

In its presentation of Budget plans, including this recent Draft Budget, the Department of Finance publishes a measure of 'Total Spending' that includes individual DELs for the nine Executive departments with Ministers plus six smaller non-ministerial ones. This is matched by an equivalent figure for 'Total Financing' that, in addition to the Block Grant, includes Regional Rates (which help finance resource spending net of Principal Repayments of previous RRI borrowing) plus new borrowing under RRI and the Irish Government's contribution to the A5 road project (which help finance capital spending). The Block Grant includes a core

[22] https://www.finance-ni.gov.uk/sites/default/files/publications/dfp/Draft%20Budget%20document%202022-25%20accessible.pdf
[23] https://www.nifiscalcouncil.org/publications/fiscal-council-response-2021-spending-review

component based on historic spending, updated using the Barnett formula, plus 'non-Barnett additions'. These include funding linked to political agreements (most recently New Decade, New Approach) plus City and Growth Deals, farm and fisheries funding to replace that provided by the EU, and protocol costs.

But these totals are still net of other sources of finance – mainly income from fees and charges[24] and EU funding – which the Department of Finance treats as negative spending that creates room for additional gross spending within its own totals. The Department does not publish estimates for these – or a 'Total Gross Spending' figure that includes the spending financed by them.

In this context, the key choices the Executive has to make in a Budget are:

- First, when setting a total spending envelope, **how far to 'top up' the Block Grant** that the Executive receives from Westminster through the Regional Rates, fees and charges, and capital borrowing?
- Second, **how to balance the competing demands of different departments** within the total spending envelope?

Under the 1998 Northern Ireland Act,[25] the NI Finance Minister is required formally to state that the Draft Budget can be delivered with the UK Government funding available. Table 3.2 summarises the proposals in the *2022-2025 Draft Budget* and how they would have 'balanced the budget' in this specific sense (i.e. including borrowing within permitted limits):

- As determined by the UK Government at the time of the 2021 Spending Review and subsequent confirmation of financial packages shortly after, the total Block Grant would be £15.3 billion by 2024-25 – 97 per cent of which is the core component determined by using the Barnett formula to update historic spending. Under the Draft Budget, Finance Minister proposed to top this up from other funding sources which together contributed 5 per cent of the total spending envelope in that year of £16,160 million.
- As regards the non-Block Grant financing:
  - The Draft Budget proposed increasing **capital borrowing** to the maximum permitted £200 million a year by 2024-25, at which point it would pay for 10 per cent of conventional capital spending.
  - The proposed **Regional Rate** poundages (frozen at 2020-21 levels) would raise £630 million by 2024-25 (after deducting £122 million of debt principal repayment, which formally has first call on that revenue). This covers 4 per cent of resource spending.
  - The **Irish Government funding for the A5** is part of the New Decade, New Approach agreement.
- Treating **EU funding and income from fees and charges** as 'negative spending' and choosing not to identify in the Draft Budget masks these

[24] Described as 'sales of goods and services' in the National Accounts, including non-domestic water charges and tuition fees. Some of this income is a transfer within the public sector and so would not increase total gross spending.

[25] As amended by s.9 of Northern Ireland (Stormont Agreement and Implementation Plan) Act 2016

components. We showed in our *Guide* that EU funding was still expected to be almost £200 million in 2021-22 (around half its pre-Brexit level) and income from fees and charges had contributed around £700-£800 million a year over the past five years (albeit partly through transfers within the public sector). The largest were non-domestic water charges, health trust receipts and tuition fees.

## Table 3.2 – The financing of the Executive's DEL spending

| | 2021-22 Provisional Outturn | 2022-23 Draft Budget | 2023-24 Draft Budget | £ million 2024-25 Draft Budget |
|---|---|---|---|---|
| **FINANCING** | | | | |
| **Resource** | | | | |
| Block grant: core Barnett | 11,974 | 12,584 | 12,789 | 12,982 |
| Block Grant: specific allocations | 350 | 352 | 367 | 369 |
| Block Grant: political agreements | 1,798 | 58 | 57 | 54 |
| Regional Rates (post debt repayment) | 370 | 577 | 628 | 630 |
| **Capital** | | | | |
| Block Grant: core Barnett | 1,609 | 1,686 | 1,785 | 1,759 |
| Block Grant: agreements and City deals | 170 | 157 | 143 | 79 |
| Capital borrowing (RRI) | 80 | 140 | 194 | 200 |
| Irish Government funding for A5 | - | 7 | 25 | 25 |
| **FTC** | | | | |
| Block Grant: core Barnett | 42 | 163 | 66 | 62 |
| **TOTAL FINANCING** | **16,393** | **15,725** | **16,054** | **16,160** |
| *pays for* | | | | |
| **SPENDING** | | | | |
| **Resource** | | | | |
| Departmental spending | 14,447 | 13,484 | 13,754 | 13,952 |
| Held centrally for later allocation | | 42 | 41 | 38 |
| Debt interest (RRI) | 45 | 46 | 46 | 46 |
| **Capital** | | | | |
| Departmental spending | 1,859 | 1,976 | 2,137 | 2,063 |
| Held centrally for later allocation | | 15 | 10 | - |
| **FTC** | | | | |
| Departmental spending | 42 | 56 | 66 | 62 |
| Held centrally for later allocation | | 107 | - | - |
| **TOTAL SPENDING** | **16,393** | **15,725** | **16,054** | **16,160** |

Notes:

1. Resource financing and spending in this table excludes depreciation.
2. The additions to the Block Grant for political agreements include some Covid support beyond Barnett consequentials
3. The Main Estimates for 2022-23 for the Northern Ireland Office include details of additional block grant financing in 2022-23 for the NI Executive, compared to the Draft Budget plans show n above. The additional block grant financing comes from underspends carried forw ard from 2021-22 into 2022-23 under the Budget Exchange scheme, the Spring Statement, and Main Estimates for UK Government departments. The Main Estimates block grant financing figures are as follow s:

| | 2022-23 |
|---|---|
| Resource | |
| Block grant, Barnett | 12,856 |
| Block grant, non-Barnett | 577 |
| Capital | |
| Block grant, Barnett | 1,691 |
| Block grant, non-Barnett | 150 |
| FTC | |
| Block grant, Barnett | 223 |

4.The Irish Government contribution to the A5 under NDNA is £75 million over the next three years. £7.4 million is expected for 2022-23. Future annual profiles still to be adjusted

Sources: Department of Finance, Draft Budget, NIO Main Estimates 2022-23

Table 3.3 details how the Draft Budget proposed to allocate the total spending shown above between the NI departments. It shows that the Department of Health accounted for 49 per cent the Executive's total resource spending on this measure in

2021-22 (Provisional Outturn), rising to 51 percent of Draft Budget allocations in 2024-25, with Education and Justice the next largest spending departments with resource shares of around 18 and 8 per cent respectively by 2024-25.

## Table 3.3 – Proposed allocations in the 2022-2025 Draft Budget

| | 2021-22 (October) | 2021-22 Provisional Outturn | 2022-23 Draft Budget | 2023-24 Draft Budget | £ million 2024-25 Draft Budget | Share % |
|---|---|---|---|---|---|---|
| **Resource spending[1]** | **14,301** | **14,447** | **13,484** | **13,754** | **13,952** | |
| *Of which:* | | | | | | |
| Health | 6,991 | 7,052 | 6,782 | 6,947 | 7,109 | 51 |
| Education | 2,500 | 2,500 | 2,431 | 2,471 | 2,503 | 18 |
| Justice | 1,179 | 1,180 | 1,118 | 1,129 | 1,122 | 8 |
| Communities | 905 | 957.5 | 839 | 839 | 840 | 6 |
| Economy | 1,166 | 1,098 | 832 | 842 | 841 | 6 |
| Agriculture etc | 568 | 574 | 551 | 567 | 571 | 4 |
| Infrastructure | 485 | 572 | 444 | 448 | 450 | 3 |
| The Executive Office | 139 | 123 | 211 | 231 | 231 | 2 |
| Finance | 261 | 288 | 169 | 172 | 174 | 1 |
| Minor departments | 108 | 102 | 107 | 108 | 109 | 1 |
| **General capital spending** | **1,928** | **1,859** | **1,976** | **2,137** | **2,063** | |
| *Of which:* | | | | | | |
| Health | 353 | 330 | 350 | 370 | 368 | 18 |
| Education | 208 | 209 | 199 | 218 | 204 | 10 |
| Justice | 86 | 73 | 100 | 125 | 129 | 6 |
| Communities | 220 | 236 | 214 | 232 | 185 | 9 |
| Economy | 148 | 122 | 187 | 197 | 198 | 10 |
| Agriculture etc | 99 | 87 | 101 | 116 | 110 | 5 |
| Infrastructure | 753 | 753 | 767 | 822 | 823 | 40 |
| The Executive Office | 14 | 12 | 15 | 15 | 15 | 1 |
| Finance | 41 | 33 | 35 | 40 | 30 | 1 |
| Minor departments | 6 | 4 | 7 | 4 | 2 | 0 |
| **Financial transactions** | **61** | **42** | **56** | **66** | **62** | |
| *Of which:* | | | | | | |
| Health | -1 | -1 | - | - | - | - |
| Communities | 46 | 30 | 52 | 55 | 52 | 84 |
| Economy | -7 | -10 | 4 | 12 | 10 | 16 |
| The Executive Office | 23 | 23 | - | - | - | - |
| **Total departmental spending[1]** | **16,291** | **16,347** | **15,515** | **15,957** | **16,077** | |

Note[1]: Excluding depreciation

Source: Department of Finance

# Sustainability or sufficiency?

As we saw in Chapter 2, the OBR assesses fiscal sustainability at the UK level by choosing a jumping-off point and then projecting revenue and spending from that point on the assumption that current policy is unchanged. The UK Government is assumed to accommodate any demographic and non-demographic pressures on spending and to meet any resulting shortfall between revenue and spending through borrowing. If this puts debt on an unsustainably rising trend relative to GDP, the OBR calculates the policy adjustment needed to achieve an alternative sustainable trajectory.

Under the budget-setting framework for NI, the Executive's spending is legally constrained by the Block Grant income it receives from the UK Government, the amount of borrowing it is permitted to undertake (by UK legislation and agreement with the Treasury), by the amount it receives from external funders (currently the EU and the Irish Government) and by the revenue it chooses to raise from Regional Rates and fees and charges.

At the end of the day, the Executive's limited borrowing powers constrain its potential spending and sustainability could be defined in this way:

> *"Given the outlook for the external funding that it can expect, and its relatively limited ability to top that up through its own policy decisions, could the Executive expect to be able to finance a quality and quantity of public services in NI broadly equivalent to that deliverable in the rest of the UK?"*

Needless to say, judging the quality and quantity of public services relative to other nations/regions is far from straightforward. That said, if prospective future spending envelopes did not look sufficient, the options would be:

- Simply to **accept that the quantity and quantity of services will be lower** than elsewhere in the UK.

- To **cease or reduce the provision of lower priority services.** Previous examples where this has been done include restricting the eligibility for student grants and removing certain medicines from the list of those that can be prescribed, where a low cost alternative is available.

- To try to **increase the efficiency with which public services are delivered**. We will take a detailed look at some examples in the NI health service in our soon-to-be-published accompanying volume, drawing on analysis prepared for us by the Nuffield Trust.

- To make **additional fiscal effort** within the scope of the Executive's existing powers. For example, households in NI pay significantly less in rates than other UK households do in council tax and water charges. This provides a significant cost of living benefit, but also reduces the amount of funding available for public services. This may partly reflect the lower disposable incomes and average earnings in NI, but there is nonetheless scope for the NI Executive to increase the Regional Rates or introduce water charges for domestic customers. However, given the dominance of the Block Grant in the Executive's funding, it would need to raise revenue from these sources by 107 per cent to increase the overall spending envelope by 5 per cent in 2024-25.

- Seek changes to the fiscal framework agreed with the UK Government to **increase the Executive's tax raising and/or borrowing powers**. Interestingly, neither the Scottish nor the Welsh Government have to date used their greater tax-raising powers significantly to raise or lower revenue and spending per head relative to England, but rather to change the structure and re-distributiveness of the tax system.

- To **seek more money from the Treasury, either through political agreements as in the past or, more durably, by seeking changes to the fiscal framework to incorporate an assessment of need in the operation of the Barnett formula**, as the Treasury has agreed to do with the Welsh Government.[26] If a floor was set at the value of the estimated relative need for public spending in NI, it would remove the risk that actual spending allocations would fall below this point. We discuss this mechanism in more detail in Chapter 5.

Given this framing, in subsequent chapters we try to address the following questions before reaching some overarching conclusions:

- First, how do the characteristics of the NI population compare to those in the rest of the UK? And do they imply that the Executive would **need to spend a higher amount per person** on the public services for which it is responsible than the UK Government spends in England to deliver equivalent outcomes?

- Second, will future increases in UK Government spending in England on services for which the Executive is responsible in NI generate proportionate additional funding per person for the Executive through the **Barnett formula**?

- Third, in the event that the Executive suffers a 'Barnett squeeze' on its Block Grant funding that is greater than the change in relative need, what scope does it have to **generate additional financing** through its own policy decisions – on tax, fees and charges and the use of its borrowing powers? And what might the prospects be for additional sources of external funding?

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[26] *"In the Welsh Government's fiscal framework it was agreed that the Welsh Government's block grant would be uplifted by adding a new needs-based factor into the Barnett Formula. This needs-based factor will ultimately be set at 115%, as recommended by the Holtham Commission. However, while relative Welsh Government funding remains above 115%, changes in the Welsh Government's funding will use a transitional factor of 105%".* Para 3.21, Statement of Funding Policy, HM Treasury (October 2021) https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1030043/Statement_of_Funding_Policy_2021_-_FINAL.pdf

# 4 Population characteristics and relative need for public spending

Various studies have been undertaken over the years to assess the relative need for spending on public services per head between the different regions/nations of the UK, based on underlying characteristics of population, geography and economy that evolve relatively slowly over time. In this chapter we summarise some of these for NI and then look more broadly at the size and structure of the population in NI and elsewhere and at socio-economic factors that could affect relative need for public spending.

## Past needs assessments

The first systematic assessment of relative need was conducted in 1978-79. An inter-departmental group, co-ordinated by the Treasury, developed the methodology and then applied it to six public service programmes then intended for devolution to Scotland and Wales: health and personal social services; education and libraries (excluding universities); housing; environmental services; roads and transport (excluding railways); and law, order and protective services (excluding police).[27]

The results were presented by showing the percentage (or proportion) of spending per head of population in England required in each region/nation to deliver the same quantity and quality of service, assuming similar policies. So a relative need indicator of 110 (or 1.10) would imply that a region requires 10 per cent more funding per head to deliver the same services as in England.

The assessment split the main spending programmes into different services with separate need indicators calculated for each (for example for Hospitals & Community Health, Family Practitioner Services and Personal Social Services in the Health programme), with the need indicator for the overall programme calculated as a weighted average.

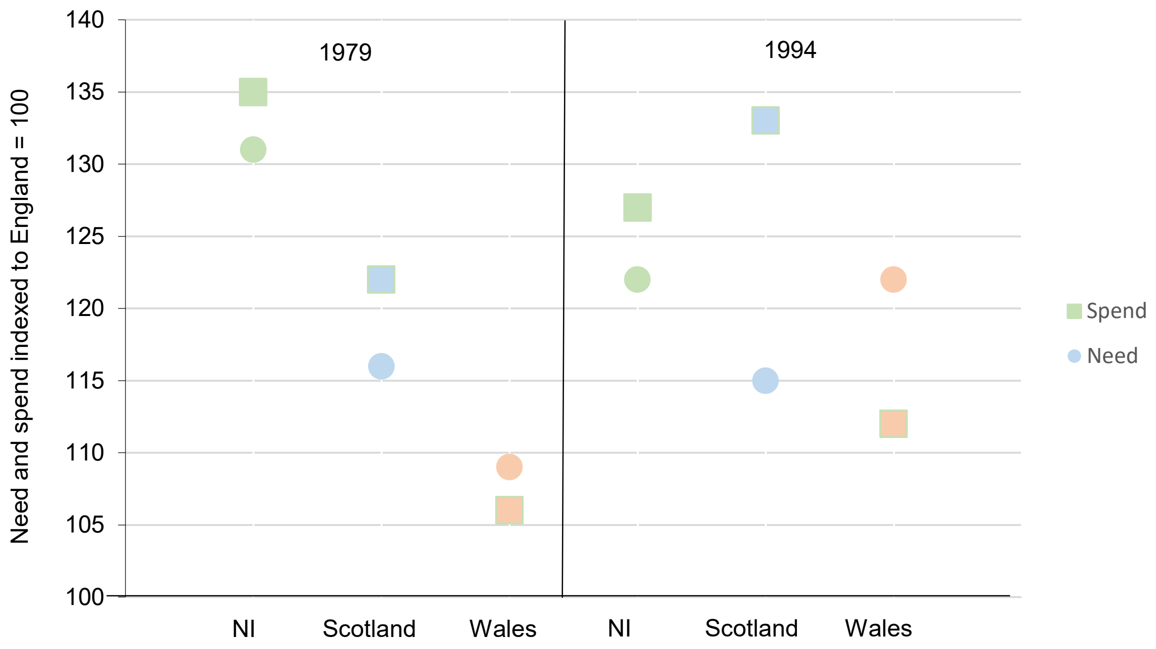
The need indicator for each service was calculated by weighting various factors by the relative importance of each, with different approaches adopted for different services. For Health a weighted population approach was used with adjustment also made for morbidity, deprivation, sparsity and fertility. The indicators used for Health included the Standardised Mortality Ratio, the proportion of the population in receipt of income support and the population in areas with population density below one person per hectare.

Under this exercise, the overall need indicator for NI was estimated as 131, compared with 116 for Scotland and 109 for Wales (Chart 4.1). The Treasury compared this to actual spending in these areas in 1976-77, which it estimated at

[27] https://publications.parliament.uk/pa/ld200809/ldselect/ldbarnett/139/13907.htm#n25 (paragraph 28)

135 for NI, 122 for Scotland and 106 for Wales. So NI had the highest relative need, compared to England, but even higher relative spending. Wales had the lowest relative need, but relative spending was lower still.

## Chart 4.1 – Spending versus estimated relative need from HM Treasury Needs Assessment Studies (NAS)

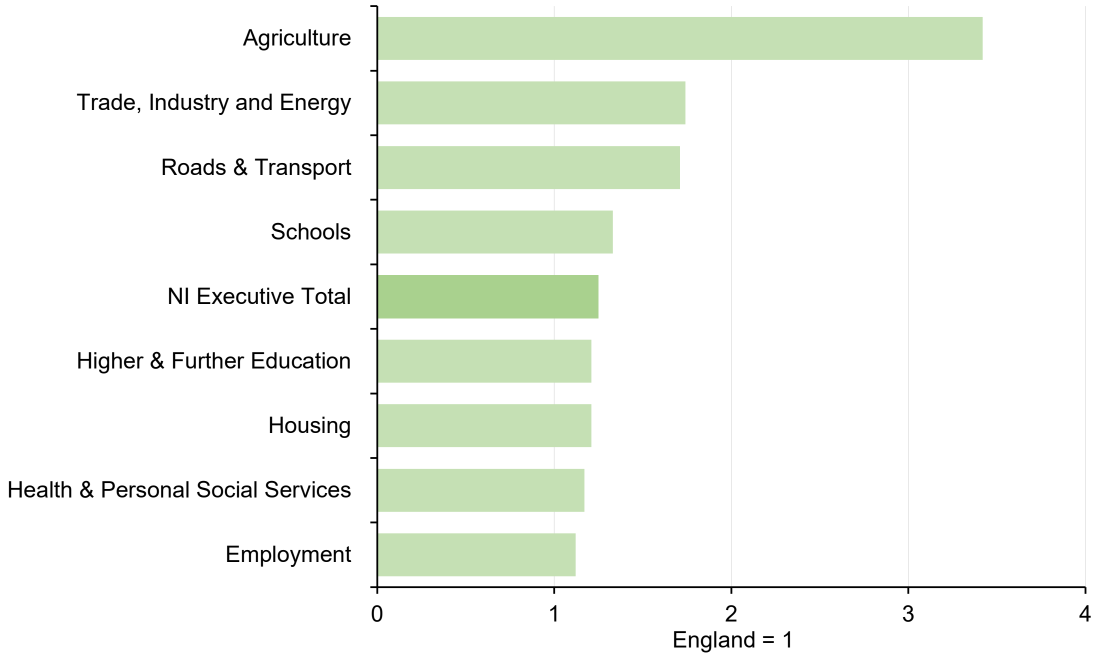



Source: House of Lords Select Committee on the Barnett Formula, First report (Table 5)

The Treasury subsequently updated the analysis, including the methodology, in 1994 in response to bids for additional funding from the Scottish Office. The estimate of relative need for NI fell from 131 to 122, with relative actual spending falling by a similar amount but remaining in excess of estimated need. Relative need fell slightly for Scotland, but over this period relative actual spending had increased sharply until it exceeded that in NI. (This appears to have been due to a delay in updating relative population factors and the scale of allocations made outside the Barnett formula, including to fund public sector wage increases.) Relative need and relative actual spending both increased in Wales, but the shortfall between need and spending was estimated to have increased.

In 2001 and 2002 the NI Executive departments updated and reviewed the Treasury-led methodology as well as extending its coverage to include almost all public spending funded by the Block Grant apart from Justice. This formed part of the Needs and Effectiveness studies (NEEs) launched shortly after the restoration of devolution in 2001 to provide an assessment of the need for key public services in NI and on how effectively resources were being used to meet the objectives for these services. This resulted in a higher overall need indicator for NI of 125 as set out in Chart 4.2, just above the 122 determined in the 1994 analysis.

## Chart 4.2 – Estimated relative need from Needs and Effectiveness Studies




Source: Department of Finance

By far the highest level of relative need was estimated for Agriculture at 342 compared with, for example, 133 for Schools and 117 for Health & Personal Social Services. Analysis produced by the then Department of Finance and Personnel projected that spending per head of population relative to England would fall below the level of relative need in the subsequent 5 years even if there was a substantial increase in the Regional Rates. Not surprisingly NI Ministers indicated their desire for a needs-based element to be introduced to the formula for distributing public expenditure in the UK.[28] But the expectation was that a need indicator would be applied to the entirety of the Block Grant, which might create the risk of large changes in the funding available from relatively minor changes to the estimate of need.

Following the suspension of the NI Assembly between October 2002 and May 2007 and the appointment of Direct Rule Ministers, the 2002 analysis was not taken forward or updated subsequently. The devolution of Policing and Justice powers in 2010 would be expected to result in an increase in the overall NI relative need indicator since this study, but the Treasury might well dispute some of the methodological changes made by the NI Executive departments in 2002. The lack of transparency and independence around these exercises was far from desirable, especially as you would expect the Treasury and the Devolved Administrations to hope for different answers.

The estimates of relative need set out above do not include the impact of region-specific factors such as the ongoing costs of community division in NI. Research by the Ulster University Economic Policy Centre (UUEPC) in 2016 estimated that the cost of a divided society was £400-800 million per annum, compared with £1.5

[28] https://publications.parliament.uk/pa/ld200102/ldselect/ldconst/147/2061007.htm (Para 1130)

billion estimated by the consultants Deloitte in 2007.[29] The UUEPC estimate was equivalent to 3.7-7.7 per cent of the NI Executive Block Grant for 2016-17 with 66-77 per cent of the estimated cost in respect of Policing. The latest PESA figures imply that spending on Public Order & Safety per head of population in NI has subsequently fallen from 57 per cent higher than England in 2016-17 to 37 per cent higher in 2020-21. The *2022-2025 Draft Budget* spending plans for the NI Department of Justice compared with those for the Home Office in England, as set out in Table 5.3, would suggest that the differential will narrow further over the coming years.

In 2009, the House of Lords Select Committee on the Barnett formula recommended that "*Public spending per head of population should be allocated across the UK on the basis of relative need, so that those parts of the UK which have a greater need receive more public funds to help them pay for the additional levels of public services they require as a result.*"[30]

In making its recommendations, the Committee referred to the views of the person after whom the formula was named, the former Chief Secretary to the Treasury, Joel Barnett MP (by then Lord Barnett) that it was intended to operate only, "*for a year or two*" and would not therefore result in convergence in spending per head. While agreeing that a needs-based approach would be a fair system Lord Barnett highlighted the need for flexibility, for example, in respect of Policing in NI. He added that "*...there may be other areas in different devolved areas of the UK deserving special needs.*"[31]

The Committee presented a number of indicators of need, as set out in Table 4.1, and recommended that any assessment should take into account the age structure of the population; low income; ill-health and disability; and economic weakness. The Committee did not calculate an overall need indicator for each administration, but concluded that Scotland had lower needs than Wales and NI when compared with England. At that point NI had the highest scores across the four nations for five of the 12 needs indicators with its relative need highest for the proportion of the working-age population not in work and the number of children in low-income households.

The Treasury responded to the Committee that "*...the Government's view is that the Barnett formula has a number of strengths, among them the merit of allowing the devolved administrations to determine their own assessment of needs and priorities in devolved areas. The Government will continue to keep all aspects of public spending under review, including the operation of the Barnett formula, and welcomes the careful analysis presented in the report.*"[32]

[29] https://www.ulster.ac.uk/__data/assets/pdf_file/0007/86524/Cost-of-Division-Overview-Report.pdf £16.5-£95.0 million estimated cost for Education and £36.1 million estimated cost of division for Health
[30] https://publications.parliament.uk/pa/ld200809/ldselect/ldbarnett/139/13904.htm
[31] https://publications.parliament.uk/pa/ld200809/ldselect/ldbarnett/139/9012804.htm Q57 and Q59
[32] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/228660/7772.pdf

## Table 4.1 - Need Indicators from HoL Select Committee report on Barnett Formula[33]

| Needs Measure (2005 to 2007 average except where stated) | Data source | England | Wales | Scotland | N. Ireland |
|---|---|---|---|---|---|
| The number of under 5s | ONS: Population Trends dataset | 101 | 94 | 91 | 112 |
| The number aged 5 to under 16s | ONS: Population Trends dataset | 100 | 102 | 96 | 116 |
| The number aged over 65 and under 74 | ONS: Population Trends dataset | 99 | 111 | 106 | 91 |
| The number of over 75s | ONS: Population Trends dataset | 100 | 111 | 97 | 82 |
| The number of deaths adjusted for the age profile of the population ('Standardised Mortality Rate') | NISRA: Annual Report 2007 | 98 | 101 | 117 | 106 |
| The number of people with a limiting long-term illness (2001) | 2001 Census | 97 | 126 | 110 | 110 |
| The number of working-age adults with a work-limiting disabiity | Labour Force Survey | 97 | 120 | 109 | 116 |
| The number of working-age adults who are unemployed | Labour Force Survey | 101 | 92 | 101 | 76 |
| The number of working-age adults not in employment | Labour Force Survey | 99 | 108 | 96 | 119 |
| Gross disposable household income per head (inverse) | ONS: Regional Gross Disposable Household Income | 98 | 114 | 106 | 115 |
| The number of adults in households with an income below 60% of the UK median income before housing costs have deducted ('Adult poverty') | DWP: Households Below Average Income 2009 | 99 | 115 | 95 | 107 |
| The number of children in households with an income below 60% of the UK median income before housing costs have deducted ('Child poverty') | DWP: Households Below Average Income 2009 | 101 | 118 | 88 | 119 |

Source: House of Lords - The Barnett Formula - Select Committee on the Barnett Formula (parliament.uk) Appendix 5

In 2010, the Final Report from the Independent Commission on Funding & Finance for Wales (the Holtham Commission) recommended that the Welsh Government seek "*...the introduction of a simple needs-based formula as the means of determining the Welsh block grant*".[34] This was based on a scaled-down needs assessment exercise using a relatively small number of variables – an under-16 dependency ratio, a pensioner dependency ratio, the proportion of the population from an ethnic minority group, the proportion of the population claiming income-related benefits, the proportion of the population with a long-term life-limiting illness and the proportion of people living outside settlements of 10,000 people or more. These were weighted based on the past relationship between these indicators and actual spending. The assessment generated a relative need indicator of 121 for NI compared with 105 for Scotland and 115 for Wales (although the figures were 'only broadly indicative' for Scotland and NI in part because policing and justice had been devolved there but not in Wales). At the time actual relative identifiable spending per head in NI was estimated at 124-127 per cent of that in England.

Relatively slow growth in UK public spending over the past decade has meant that there has been less focus on the level of spending per head in the Devolved Administrations compared with England and therefore the relative need for public spending. As a result, the latest estimates of relative need are now at least 10 years old. However, it is not clear whether the relative position in respect of the individual indictors of need and the overall assessments would have changed significantly,

[33] https://publications.parliament.uk/pa/ld200809/ldselect/ldbarnett/139/13916.htm

[34] https://gov.wales/sites/default/files/publications/2018-10/fairness-and-accountability.pdf Independent Commission on Funding & Finance for Wales *Final report Fairness and accountability: a new funding settlement for Wales* (July 2010) Chapter 3

given the relative stability of some of the relevant factors (population age and structure).

Based on the studies described above, it does not seem unreasonable to assume that the relative need for spending in NI is about 20 per cent above than in England, against which NI identifiable spending per head has averaged around 24 per cent higher than in England between 2016-17 and 2019-20. However, the more appropriate comparator of the spending power of the NI Executive is with the NI Block Grant per head of population which has averaged around 38 per cent above that in England (as measured by UK Government equivalent spending DEL) over that time.

## Characteristics of the NI population

In this section we review some of the characteristics of the population that the Holtham Commission and others have thought important in assessing need:

- **Size and age structure**, in particular relative numbers of older or younger people (who tend to consume more public services);
- The extent of **poverty and social deprivation**, which tend to increase demand for public services;
- **Socio-economic factors**, as identified by the Social Mobility Commission;
- The **health** of the population. Greater numbers of those in ill health will add significantly to the cost of public services, not just directly in health. We cover this in greater detail in our other volume; and
- **Population dispersion**, it tends to cost more per head to supply public services in sparsely populated remote areas than cities.

### Population size and age structure

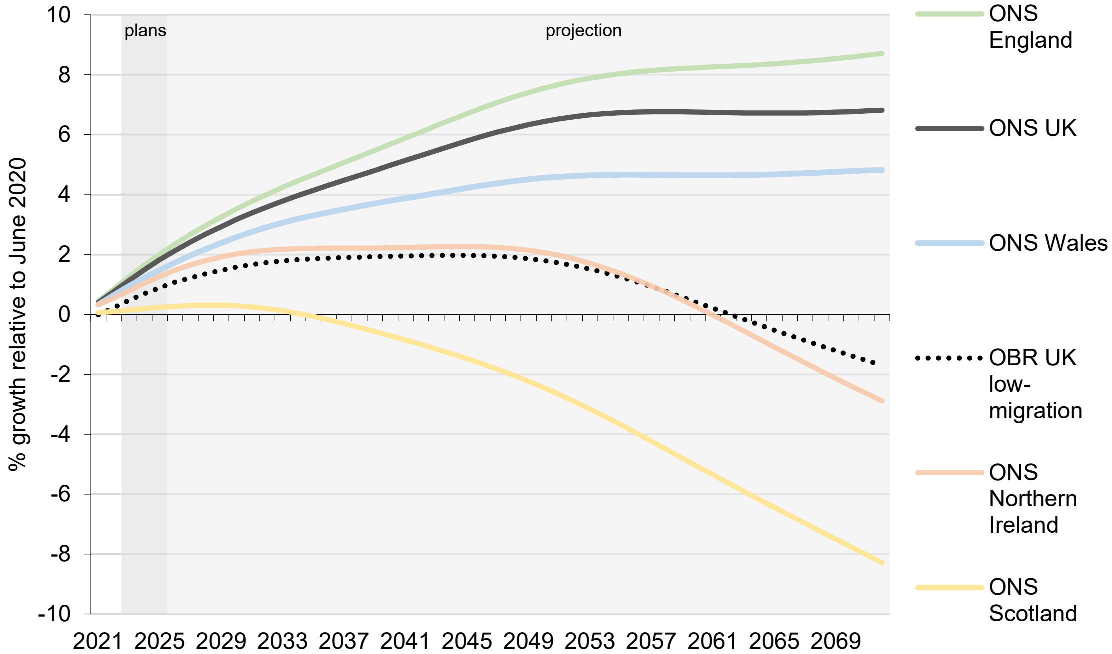
The most recent projections by the ONS in January 2022[35] suggested that NI would have a population of just over 1.9 million in March 2021, 2.8 per cent of the UK population of 67.4 million. The census conducted by the NI Statistics and Research Agency (NISRA) on 21 March 2021 broadly matched this projection, while the England and Wales census conducted by the ONS on the same day found a population 0.6 per cent lower than its projections had assumed. The Scottish census was taken a year later, on 20 March 2022, but results have not yet been published so complete census-based figures for the UK will not be available until next year.

Chart 4.3 shows the latest ONS and OBR projections for population growth in the UK through to 2072, with the ONS projections also divided into the four nations. The ONS projects that the UK population will grow by 6.8 per cent over this period. Within this total, the ONS projects that the NI population will fall by 2.9 per cent by

[35] https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationprojections/bulletins/nationalpopulationprojections/2020basedinterim

2072 compared to growth of 8.7 per cent in England, a 4.8 per cent growth in Wales and an 8.3 per cent decline in Scotland. NI is projected to have moderate population growth over the coming decade, before reaching a plateau and then reducing. As we noted in Chapter 2, the OBR's July 2022 long-term public finance projections assume lower net inward migration as a result of the post-Brexit immigration policy. This suggests an overall fall in the UK population of 1.7 per cent and sees it decline from the late 2040s. The OBR projections are only available at the UK level.

## Chart 4.3 - Projected population growth from 2020 baseline to 2072

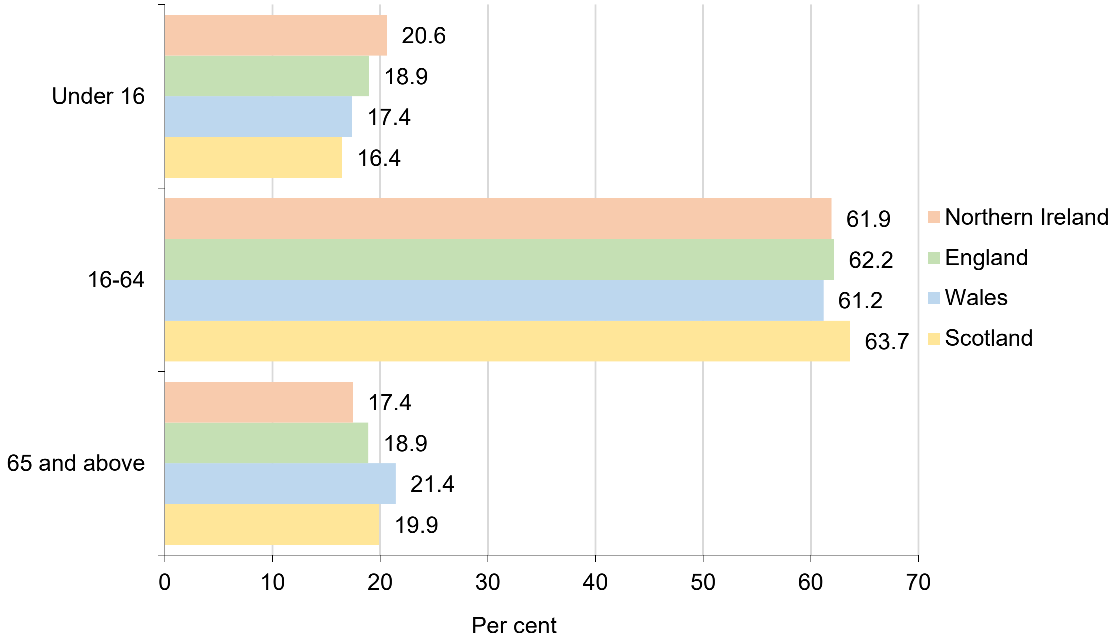



Source: ONS National population projections and OBR Fiscal risks and sustanability report 2022

We saw in Chapter 2 that the age structure of the population affects fiscal sustainability at the UK level because people tend to consume public services most when they are young and (more especially) old, while contributing most tax revenue in their working years. The age profile of tax payments is less relevant to sustainability at the NI level, because of the Executive's modest tax-raising powers, but the profile of public service consumption remains key.

Chart 4.4 shows the proportions of the population aged 65 and above, 16-64 and under 16 in each of the four nations in 2022. It shows that NI has a higher proportion of young people and a smaller proportion of older people than the other parts of the UK. Viewed simplistically, that paints a mixed picture for current need – more need for spending on education and less need for spending on health, social care and other services for the elderly.

## Chart 4.4 - Population age distribution 2022

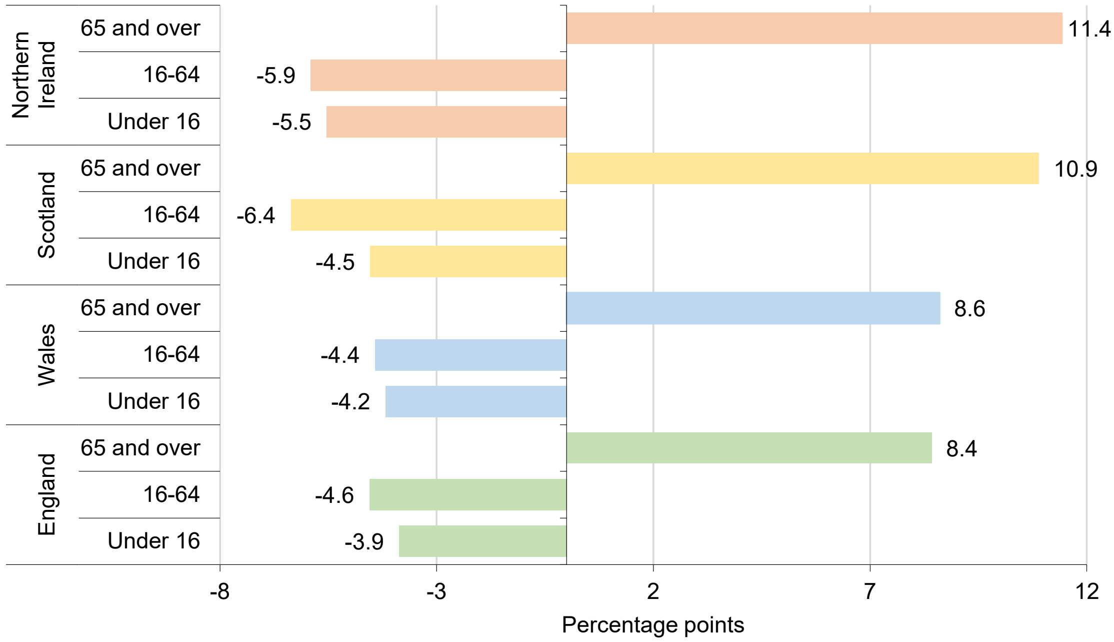



Source: ONS population projections

Looking ahead, the NI population is projected to age more rapidly than the populations of the other UK nations from this relatively youthful starting position. Live births have been on a downward trend for more than a decade, falling from 25,631 in 2008 to 20,815 in 2020. The crude NI birth rate has also dropped from 14.4 to 11.0 per 1,000 population over the same period, this is a 3.4 point decline compared to 2.7 points in England, 2.8 in Wales and 2.9 in Scotland.[36] Average life expectancy continues to rise, unlike in the other nations/regions. [37] Individuals aged 65 and over are predicted to outnumber children under 16 within the next decade (around 2028 according to NISRA[38]). Chart 4.5 shows how the age composition of the nations changes out to 2072. The proportion of younger people in NI falls by 5.5 percentage points while the proportion of older people rises by 11.4 percentage points – in each case the largest figure for any of the four nations.

[36] https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationestimates/datasets/vitalstatisticspopulationandhealthreferencetables
[37] https://www.ons.gov.uk/peoplepopulationandcommunity/birthsdeathsandmarriages/lifeexpectancies/bulletins/nationallifetablesunitedkingdom/2018to2020
[38] https://www.nisra.gov.uk/sites/nisra.gov.uk/files/publications/NI%20IN%20PROFILE_1.pdf

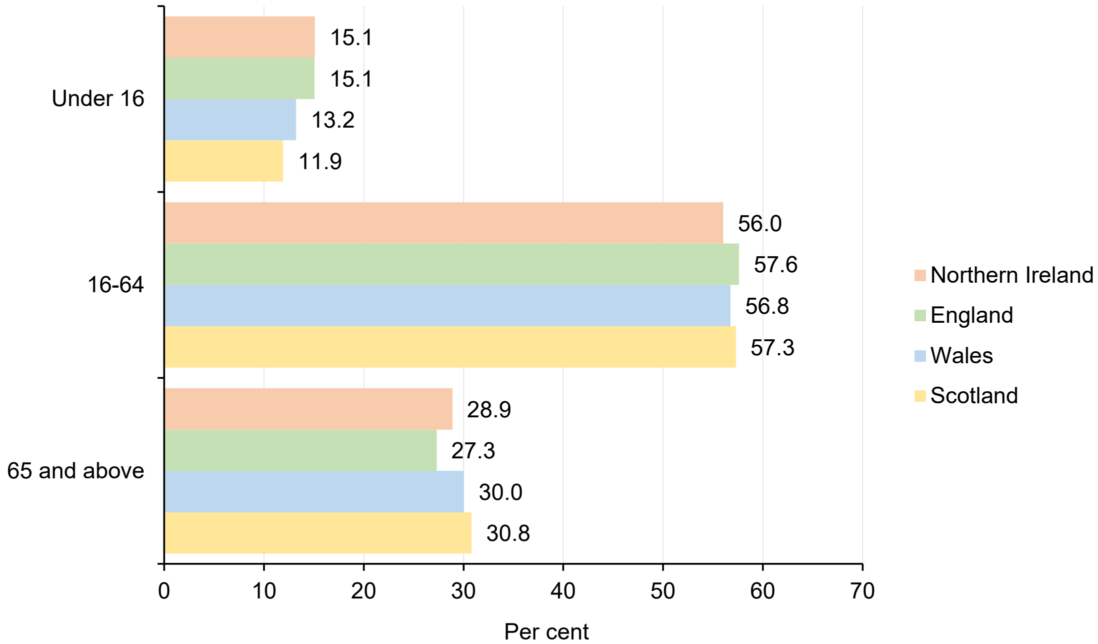
## Chart 4.5 - Changing population age structure in 2020 and 2072




Source: ONS population projections

By 2072 the age distribution in NI shifts towards a lower proportion of working-age and a higher proportion over 65 than in England (Chart 4.6)

## Chart 4.6 - Projected population age distributions by region (2072)




Source: ONS population projections

One widely used way to summarise changes in age structure is to look at dependency ratios, the number of children and/or older people relative to the size of the working-age population. By 2045-46 NI is expected to have the highest dependency ratio across the four nations with 61 dependants per 100 people of working-age compared to 59 in England and Wales and 54 for Scotland (compared to 59, 58 and 54 respectively in 2022-23).[39] NI's working-age population is expected to contract by 3.7 per cent between 2021 and 2045 compared to growth of 1.7 per cent in England, 1.5 per cent in Wales and a contraction of 5.6 per cent in Scotland. That said, dependency ratios are arguably less relevant as an indicator of fiscal sustainability for NI than for the UK or (to a lesser degree) Scotland or Wales. The intuition behind the dependency ratio is the relationship between the number of people who need primarily to be supported by the state compared to the number of people paying taxes to support them. In the case of NI, most of the Executive's income comes from UK taxpayers in general, not from NI taxpayers in particular.

Nevertheless, the ageing of the population will drive changes to the mix of public services required in NI, and the way they are delivered. As the OBR analysis described in Chapter 2 suggested, for the UK Government spending pressures should decline for education as the number of school age children falls (provided school places can be scaled back proportionately) but increase for health and social care as the population ages. At the UK level, the fiscal impact of the latter dominates the former and there is no reason to believe that the story would be different in NI. Indeed, the net pressure from ageing may be greater in NI. We will deal in some detail with the health pressures facing NI in our separate thematic report on that topic. The ageing of the population will also put upward pressure on state pension costs, but as described in Chapter 3 this will add to the sustainability challenge facing the UK Government rather than the Executive, met through AME not DEL.

## Socio-economic factors and poverty

An important goal (primary or subsidiary) of many public services is to support individuals and households detached from the labour market or in poverty or deprivation. Various of these factors can be brought together in 'indices of multiple deprivation', but these are typically used to assess small geographical areas. Each of the UK nations compiles and maintains its own indices, so it is not currently possible to compare them directly at the level of nations or to compile a composite UK-wide measure.[40]

But we can look at some component factors included in them.[41] For example:

- NISRA reported in 2019 that NI had had the highest rate of **working-age economic inactivity** in the UK for the past 30 years.[42] Seasonally adjusted, 28.3 per cent of NI's working-age population were economically inactive between April and June 2022, compared to 21.4 per cent for the UK as a

[39] https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationprojections/datasets/2014basednationalpopulationprojectionstableofcontents
[40] https://www.nisra.gov.uk/sites/nisra.gov.uk/files/publications/UK_Measures_of_Multiple_Deprivation.pdf
[41] It is also possible that some of these measures may indicate a failure in economic performance or failure of previous policy.
[42] https://www.nisra.gov.uk/sites/nisra.gov.uk/files/publications/Economic%20Inactivity%20in%20Northern%20Ireland.pdf

whole.[43] The difference between the NI and UK economic inactivity rates has increased by 1.4 percentage points over the past 10 years. Almost 40 per cent of the economically inactive in NI reported being so primarily because they were long-term sick or disabled, compared to 29 per cent for the UK as a whole.

- The **unemployment** rate in NI was 2.7 per cent for April to June 2022, below the UK average of 3.8 per cent, and the second lowest of the 12 UK regions. However, 42 per cent of those unemployed in NI were 'long-term' unemployed.

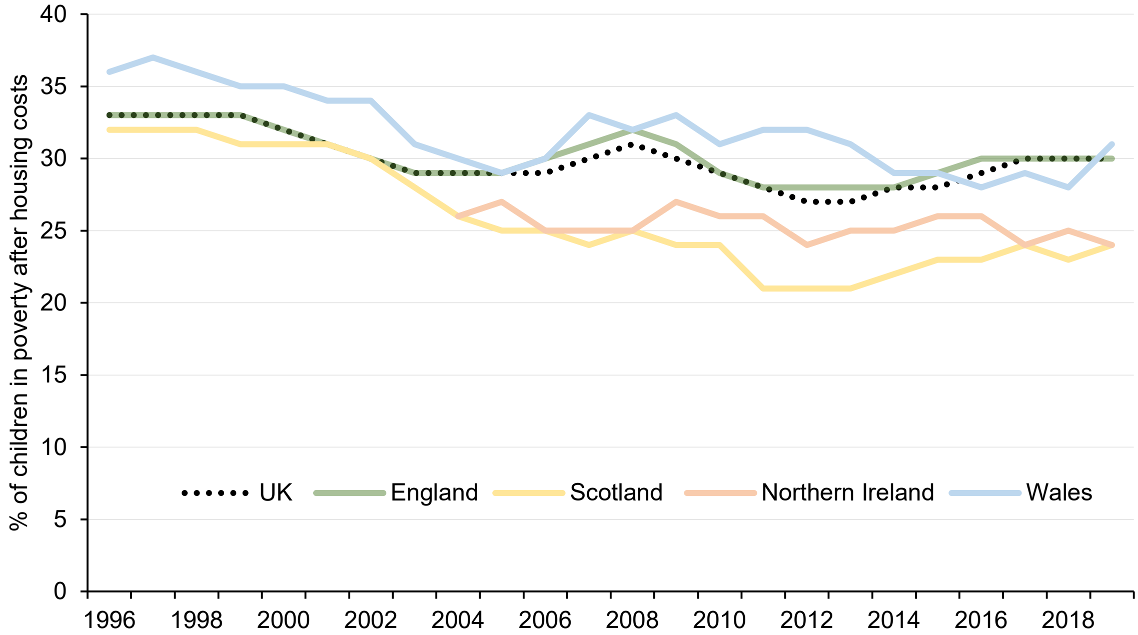
- The relative proportion of people in **poverty** between NI and the other nations or regions depends crucially on the treatment of housing costs, which are lower on average in NI than elsewhere. Measuring poverty as the proportion of people living in households with disposable household income below 60 per cent of that region's median in that year, NI had the same proportion as the UK average before taking account of housing costs (17 per cent), but the lowest of the UK nations and regions after taking account of housing costs (18 per cent versus a UK average 22 per cent and as high as 27 per cent in London).[44] [45]

- An individual is defined as being in **persistent low income** if they have been in relative low income for at least three out of the past four years. For this measure, NI again is equal to the UK average (at 9 per cent) before counting housing costs, and joint lowest among the UK nations and regions with the South-East of England (again 9 per cent) after. NI has relatively low rates of persistent low income on this basis for children, working-age adults and pensioners.

- As with the overall poverty figures, NI has a rate of **child poverty** broadly in line with the UK average before housing costs and one of the lowest among the UK nations and regions after housing costs. Only NI and the South-East of England experienced a decrease in child poverty rate after housing costs between 2014-15 and 2019-20 and there were no local authority areas in NI where the rate had risen during the period. Although the proportion is low relative to the other UK nations, child poverty still affects one in four in NI.

[43] https://www.nisra.gov.uk/system/files/statistics/Labour-Market-Report-August-2022.pdf
[44] https://ifs.org.uk/uploads/R194-Living-standards-poverty-and-inequality-in-the-UK-2021.pdf
[45] https://researchbriefings.files.parliament.uk/documents/SN07096/SN07096.pdf

## Chart 4.7 - Relative child poverty rates (after housing costs)




Note: NI data series starts in 2004
Source: Department of Work and Pensions, Households Below Average Income, 2021

## Economic performance, wages and living standards

The *State of the nation 2021* publication from the Social Mobility Commission[46] reported that qualification levels, wages, the proportion of high-paid jobs, the rate of job creation and new start-up growth are all lower in NI than the UK average and that 25 per cent of jobs pay less than the 'real living wage'[47] of £9.30. In addition, it found that NI's unique post-conflict circumstances have exacerbated social deprivation. The report found that:

- **NI's economy is heavily reliant on the agri-food, retail and hospitality sectors** which have been hard hit by Covid-19 and face an uncertain recovery. It also relies heavily on public sector employment.
- Reliance on **lower-paid and lower-skilled employment** and a lack of high-growth firms **restrict opportunity**.
- **NI has the lowest median wage** of the UK nations – 9.7 per cent lower than the UK median.
- **NI has fewer people with third-level qualifications and more with no qualifications** than the UK as a whole: 35 per cent of the workforce are qualified to degree level in NI compared to 39 per cent UK-wide, and 11 per cent have no qualifications compared with 8 per cent.

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[46] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1003977/State_of_the_nation_2021_-_Social_mobility_and_the_pandemic.pdf
[47] The Real Living Wage is a wage rate paid by employers based on a calculation by the Resolution Foundation and overseen by the Living Wage Commission, as opposed to the statutory National Living Wage and Minimum Wage https://www.livingwage.org.uk/

- The growth rate of **'new' business creation is considerably higher than in Wales but trails far behind England and Scotland.**
- Between 2012 and 2018, not only did NI have the **lowest job creation** of all 12 UK regions but less than half of all jobs created were in 'professional and managerial' occupations, in comparison to three-quarters across the UK as a whole.
- **NI's proportion of professional jobs is lower than UK's** (42 against 49 per cent). Conversely, NI has one of the highest rates of working-class jobs when compared to the UK as a whole (33 against and 29 per cent). An individual from a working-class background in NI has a lower chance of being in a professional job than in any other nation/region.

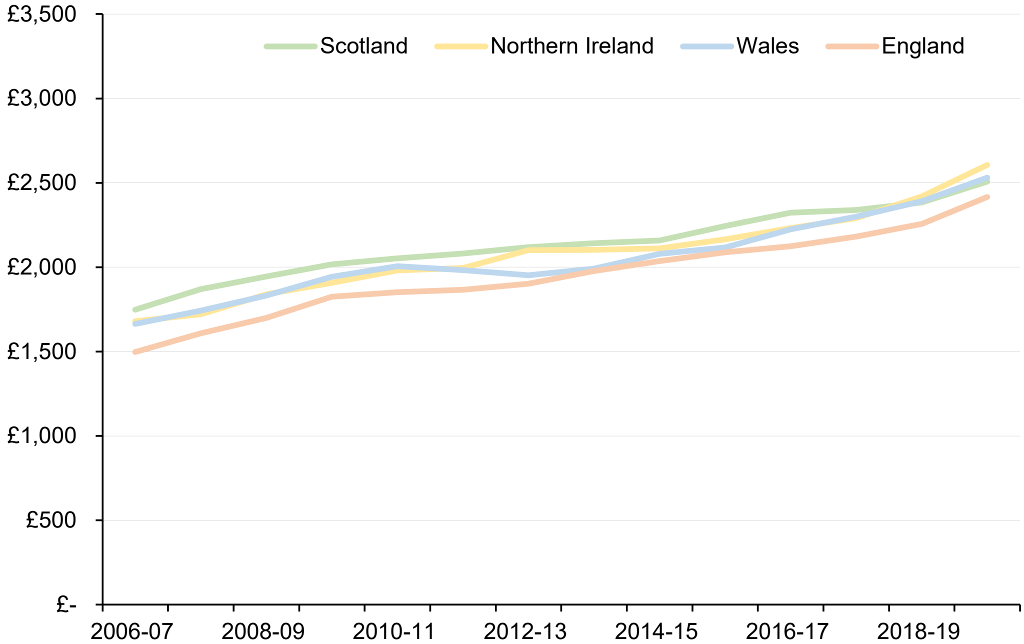
## Health

In our soon-to-be-published accompanying volume, we will consider the relative health of the NI population in detail. Health status is lower than in England across most but not all relevant indicators, perhaps implying higher need for spending. Some NI health indicators are lower and some higher than in Scotland and Wales.

Real per capita health spending has increased by 54 per cent across the whole of the UK since 2002-03, with spending per head in NI in 2019-20 almost 7 per cent (£181) higher than in England. As shown in Chart 4.8, growth in health spending broadly aligns with three distinct phases of government at the UK level with more rapid increases during the Blair/Brown era, slower growth under Cameron, and then speeding up again under May/Johnson.

NI spend per capita has been higher than in England for at least the last two decades, but not always higher than in Wales or Scotland. Funding for recent political agreements (Confidence & Supply, and New Decade, New Approach), ring-fenced monies for health services and transformation. This may have been only temporary, but history suggests future packages cannot be ruled out. The plans set out in the Department of Finance's *2022-25 Draft Budget* (which as noted earlier the outgoing Executive never signed off) imply that NI spending per head has fallen below England for the first time in 2022-23, reflecting a smaller increase in the NI Block Grant than in the equivalent UK Government spending in England. We shall discuss this in the next chapter.

## Chart 4.8 - Per capita spending on health




Source: HM Treasury PESA, Country and Regional Analysis and ONS

### Population dispersion

The **geographical dispersion of the population** can influence the cost of providing (and indeed consuming) public services. Delivery in smaller rural centres typically result in additional costs, in part because of the need to transport people and physical items longer distances and because it becomes more difficult to exploit economies of scale.

Rurality is not defined in an identical way across the UK nations, but in 2020 the House of Lords Library reported that in England 21 per cent of the population live in local authorities defined as predominantly rural, compared to 17 per cent in Scotland, 33 per cent in Wales and 36 per cent in NI.[48]

An illustration of the impact of rurality is that although NI has invested heavily and has extremely fast relative broadband speeds, and amongst the highest coverage of full fibre and full and partial fibre in the UK, because of the proportion of people living in rural areas NI still has the lowest proportion of people able to access 30Mbps and by far the highest proportion of people with less than 2Mbps download speeds.[49]

There are additional costs to maintaining public services such as schools and hospitals within a reasonable distance of the population in rural areas, and to the typically smaller scale of these services in those areas. For example, a 2019 report by the Nuffield Trust, *Rural health care: A rapid review of the impact of rurality on the costs of delivering health care*,[50] identified a number of ways in which healthcare

[48] https://lordslibrary.parliament.uk/fact-file-rural-economy/

[49] https://www.thinkbroadband.com/news/8978-april-2021-update-on-broadband-availability-across-the-uk-nations-and-regions data at April 2021

[50] https://www.nuffieldtrust.org.uk/files/2019-01/rural-health-care-report-web3.pdf

costs may be higher in rural areas due to difficulties in staff recruitment and retention, higher travel costs and unproductive staff time when travelling, and difficulties in realising economies of scale while adequately serving sparsely populated areas.

The dispersal of the population from larger urban areas also contributes to the much higher numbers of properties in NI that are heated using oil, rather than gas, which will pose additional challenges, and likely costs, for the NI Executive in its target to achieve net zero carbon.

## Conclusion

Several studies have been undertaken to estimate the relative need for spending per head in the different parts of the UK to deliver equivalent levels of public service quality and outcomes, based on different characteristics of each nation/region's demography, economy and geography. All involve a considerable degree of judgement, notably around the weight to be placed on different indicators in reaching an aggregate measure.

Unfortunately, most of these studies are relatively old – the most recent coming from the Holtham Commission in 2010. But these studies are attempting to reflect underlying relative characteristics rather than ones that would be expected to change significantly over short time horizons. Looking at the range of estimates presented, it seems reasonable to use 20 per cent as a broad measure of the relative need for spending per head in NI versus England to deliver equivalent services.

Given a particular estimate for relative need in NI, it would be useful to know if this was likely to rise or fall over time because of changes in demand for particular kinds of service or because the cost of providing different types of service is likely to rise more or less quickly in NI than elsewhere. We noted above that the NI population is relatively young and set to age relatively quickly. This has offsetting effects, implying that demand for services for older people (dominated by health and social care) might rise more quickly than elsewhere, but that the demand for education might rise more slowly as the proportion of the population of school age falls more quickly. At the UK level, the ageing population pushes up health spending more than it reduces education spending so it would seem more likely that faster ageing would intensify overall pressures in NI than reduce them. As regards the relative speed of increase in the cost of providing services, this would need to be examined on a service-by-service basis, but there is no obvious reason to expect either pay (especially where there are national agreements) or input costs (e.g. the cost of medicines for the health system) to rise systematically more quickly or slowly in NI than in the rest of the UK. In health it could be argued that hospitals in England are generally larger and so better placed to achieve economies of scale, so any inefficiency gap could grow over time.

# 5 Is the Block Grant being squeezed?

The Block Grant paid by the UK Government to the NI Executive (and the other Devolved Administrations) is by far the largest source of funding for the Executive's spending on public services, administration and capital investment. As shown earlier in Table 3.2, it is planned to provide £15.5 billion of the £16.2 billion spent on items covered by the Executive's DEL in 2022-23. This includes some earmarked funding for the likes of City and Growth Deals and political agreements, but £14.8 billion of it is core Block Grant funding determined by the Barnett formula.

The Barnett formula was first implemented in Scotland and NI in 1979, and then in Wales in 1980.[51] As noted in Chapter 2, put simply it ensures that when the UK Government increases spending in the rest of the UK on services for which the Executive is responsible in NI, the Block Grant increases by an equivalent sum in pounds per head.[52] This means that when the UK Government spends tax revenue that it has collected from UK taxpayers on services provided by Whitehall departments in England, taxpayers elsewhere do not lose out. The Barnett formula has no statutory basis, and there have been calls for it to be replaced by the Calman Commission in 2009, the Holtham Commission in 2010 and by parliamentary committees.[53] The principles on which it operates are set out in the *Statement of Funding Policy* first published by the Treasury in 1999 and normally updated as part of each UK Spending Review.[54]

The Barnett formula has important implications for the financial sustainability of the devolved administrations in the sense that we interpret it, because spending per head starts higher in the devolved administrations than in England. So increasing the funding for such spending by the same amount in pounds per head in each nation/region means a smaller percentage increase in the devolved administrations and a gradual convergence over time in spending per head of population compared with England. (If England spends £100 per head and NI spends £200, increasing spending by £10 in both will deliver a 10 per cent increase in England but only 5 per cent in NI and NI spending will fall from 200 per cent of England's to 191 per cent.)

If (as seems plausible) the Executive needs to spend a given percentage more than England to deliver equivalent services (rather than a given cash sum more) – because of characteristics of the population like those discussed in the previous chapter – then this 'Barnett squeeze' will put pressure on fiscal sustainability in NI in the sense that we defined it in Chapter 3: the Executive having resources sufficient to deliver services equivalent to those in England.

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[51] https://publications.parliament.uk/pa/ld200809/ldselect/ldbarnett/139/13907.htm#a8 House of Lords Select Committee on the Barnett Formula - First Report Paragraph 26

[52] https://www.nifiscalcouncil.org/files/nifiscalcouncil/documents/2021-11/the-public-finances-in-northern-ireland-final-version_0.pdf

[53] https://researchbriefings.files.parliament.uk/documents/CBP-7386/CBP-7386.pdf (Paragraph 2.2)

[54] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1030043/Statement_of_Funding_Policy_2021_-_FINAL.pdf Paragraph 2.6

In this chapter we provide a more fully worked out illustration of the Barnett squeeze before considering how it has operated to date and how it might over the period covered by the latest UK Spending Review and the longer term.

## An illustrative example of the 'Barnett squeeze'

The impact of changes in UK Government spending on funding allocations through the Barnett formula differs depending on the Whitehall department whose spending is changing, as well as the baseline level of spending on the respective service in each Devolved Administration. We use education to illustrate the usual impact.

The UK Government has responsibility for schools, further education colleges and universities in England, but this has been devolved in Scotland, Wales and NI. Table 5.1 shows that spending on education in NI (thus defined) was 16 per cent higher than in England in 2019-20, but lower than in Scotland. This reflects the proportions of the population that are of school age in each, as well as differences in policies towards the funding of university education.

### Table 5.1 - Expenditure on Education (2019-20)

| | Spend (£m) | Population (m) | Spend per head (£) | Spend per head (England = 100) |
|---|---|---|---|---|
| England | 74,088 | 56.3 | 1,316 | 100 |
| Northern Ireland | 2,888 | 1.9 | 1,525 | 116 |
| Scotland | 9,258 | 5.5 | 1,695 | 129 |
| Wales | 4,386 | 3.2 | 1,391 | 106 |

Source: HM Treasury PESA 2022, Northern Ireland Fiscal Council calculations

The worked example below (Figure 5.1) shows the impact on funding for education in NI of a 10 per cent increase in education spending in England (£7.4 billion), assuming for simplicity that that the Executive spends all the associated increase in the Block Grant (known as the 'Barnett consequentials' of the change in English spending) on education, which it is not obliged to do.

A £7.4 billion increase in English education spending would be expected to result in £243 million of additional education funding for the NI Executive as calculated below. You take the increase in the budget for the UK education department, multiply it by a 'comparability factor' that captures the proportion of its spending that would be undertaken by the Executive in NI (which in this case is 100 per cent), then multiply it by the NI population as a proportion of the English population (so that the consequentials reflect spending per head). Finally you apply a Value Added Tax (VAT) abatement factor, reflecting the fact that the NI Executive, unlike UK Government departments and the Scottish and Welsh Governments, has many of the responsibilities of local authorities in the rest of the UK so has its VAT refunded by HMRC as they do.

Figure 5.1 - Illustrative example of Barnett formula calculation

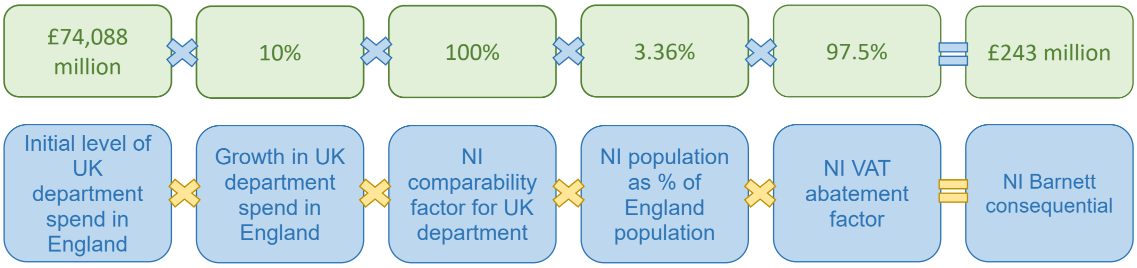



Table 5.2 compares the impact of the rise in education spending in NI with the other Devolved Administrations. As discussed further below, an additional 5 per cent needs-based uplift is provided for Wales to reflect the transitional arrangements agreed in response to the recommendations from the Holtham Commission.

Due to the higher baseline level of expenditure on education per head of population in NI, the Barnett consequentials of the 10 per cent increase in England finance only an 8.4 per cent increase in NI. However, given percentage increases in expenditure on public services in England often have a direct read across to NI. For example, in many sectors NI is obliged to deliver the same percentage pay settlement in response to the recommendations of a UK-wide Pay Review Body. In this example, the growth in funding to the NI Executive would be insufficient to match the 10 per cent increase in England.

The NI Executive would need to find £46 million from other sources in order to achieve the same 10 per cent rate of growth in education spending.

Pressures of this sort have not been too great a challenge for the Executive to date, while the Block Grant per head of population advantage compared with England funding has been greater than estimated relative need, as discussed in Chapter 4. This means that the impact of lower-than-required Barnett consequentials for a high priority service could be offset by the reallocation of funding from other services. Whether the NI Executive will continue to have this funding buffer in the medium to longer term is considered below.

Table 5.2 – The impact of 10% growth in English education spending in the Devolved Administrations (DA)

| | | | £ million |
|---|---|---|---|
| | Northern Ireland | Scotland | Wales |
| Baseline DA Education | 2,888 | 9,258 | 4,386 |
| Baseline DA per capita (England = 100) | 116 | 129 | 106 |
| **Barnett formula inputs** | | | |
| Increase in England Education | 7,409 | 7,409 | 7,409 |
| Comparability factor - DE | 100% | 100% | 100% |
| DA population as % of England | 3.4% | 9.7% | 5.6% |
| VAT abatement factor | 97.5% | 100% | 100% |
| Additional Needs Adjustment | 100% | 100% | 105% |
| **DA Barnett consequentials** | **243** | **719** | **436** |
| Implied growth in DA Education funding | 8.4% | 7.8% | 9.9% |
| Implied funding gap | 46 | 207 | 3 |
| Final DA per capita (England =100) | 114 | 126 | 106 |

Source: HM Treasury PESA 2022, Northern Ireland Fiscal Council calculations

Table 5.2 also highlights the fact that the higher the baseline funding position, the slower the percentage growth in funding delivered by the Barnett formula. So Scotland sees slower growth in education funding (7.8 per cent) than NI. As a consequence, Scotland would see a 2.6 percentage point drop in its spend per head advantage with England, compared to 1.7 percentage points for NI. The lower baseline position for Wales (as well as its additional uplift) means that it experiences almost the same rate of growth in spending as in England. While its spend per head advantage falls by only 0.1 percentage points, it would fall by 0.5 percentage points if there were no additional uplift.

When the Block Grant has been determined at the two most recent Spending Reviews, the calculation is made bottom-up, looking at separate comparability factors for individual programmes within the Whitehall departments (although the comparability factors for programmes within the Department for Education are all 100 per cent so the example above is not too much of an over-simplification). The process is simplified somewhat for spending changes between Reviews. The Treasury now publishes a regular *Block Grant Transparency* publication which explains in detail how the overall Block Grant has been determined.[55]

## The historic impact of the Barnett formula

Chart 5.1 shows how the Barnett formula has contributed to a reduction in total identifiable spending per head in NI relative to England over the last 35 years. In the late 1980s the identifiable spending per head advantage in NI was on average 55 per cent. This fell to fell to 38 per cent in the 1990s, 31 per cent in the 2000s and 25 per cent in the 2010s. The change in Scotland and Wales is less dramatic, reflecting the fact that when the Barnett formula was first implemented the initial gap in spending per head with England was much smaller. The rate of decline is greater at times

[55] https://www.gov.uk/government/publications/block-grant-transparency-december-2021

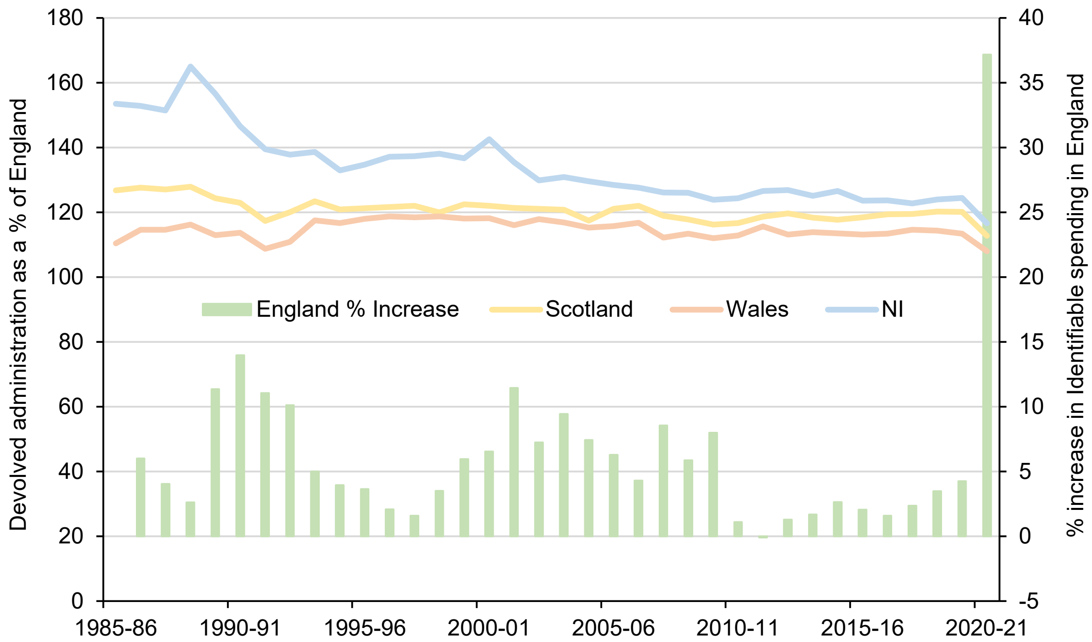
when spending is growing more quickly in England, because more expenditure is being allocated though the formula.

The relationship in Chart 5.1 is noisy from year to year, reflecting the fact that spending here is measured as total identifiable spending (i.e. on everything that directly benefits the people living in each region/nation) not a measure that reflects only spending that has been devolved. The Block Grant financed 54 per cent of total identifiable spending in NI between 2010-11 and 2020-21. In addition, there are allocations to the Block Grant other than through the Barnett formula, reflecting technical adjustments and political agreements, with the latter tending to be time-limited. This also helps explain why the Barnett squeeze does not show up very obviously for Wales in this chart.

We have data from the same source for this period, but in analysis for the Northern Ireland Economic Council (NIEC) Professor David Heald estimated that identifiable spending per head in NI was around 50 per cent higher than the UK average when the Barnett formula was first implemented in 1978-79, broadly the level shown here for the mid-1980s.[56] The premium had risen sharply from 21 per cent in 1973-74, following the abolition of the NI Parliament in 1973, the introduction of Direct Rule from Westminster and the response to the deteriorating security situation.

Professor Heald also referred to earlier data suggesting that spending per head had been 1 per cent below the UK average in NI in 1960-61. In those days the NI Parliament received additional funding (subventions) if it matched changes to taxes and expenditure in the rest of the UK. But Professor Heald said that "*these principles were implemented in an ungenerous manner, with the inevitable result that public services in NI continued to lag behind those in Great Britain.*"

## Chart 5.1 - Identifiable public spending per head




Source: HM Treasury PESA 2000-2022

[56] Funding The Northern Ireland Assembly: Assessing The Options Professor David Heald with A Statement by the Economic Council, NIEC (March 2003) https://www.davidheald.com/publications/Healdfinalpaper2.pdf

## The squeeze over the 2021 Spending Review period

So how might the Barnett formula and other factors affect spending per head over the period for which the UK Government initially determined the Block Grant in the 2021 Spending Review, i.e. from 2022-23 through to 2024-25?

The *Autumn Budget and Spending Review 2021: A Stronger Economy for the British People*[57] indicates that the NI Executive Block Grant is set to increase by 1.3 per cent per annum in real terms between 2019-20 and 2024-25 compared with 3.8 per cent for the Total DEL (excluding depreciation) for all UK Government departments, including 2.9 per cent for Wales and 2.6 per cent for Scotland. This uses a forecast for inflation that now looks too low implying lower real terms growth, with the OBR forecast for the Consumer Prices Index (CPI) measure of inflation in 2022 rising from 3.3 per cent in October 2021 to 8.7 per cent in the forecast made in March 2022.[58] The nominal increases in Total DEL are 3.6, 6.0, 5.1 and 4.9 per cent a year respectively.

Chart 5.2 below shows that this would see the NI Executive Block Grant continuing to fall relative to UK Government equivalent spending per head in the coming years, from 38 per cent higher in 2017-18 to around 25 per cent higher by 2024-25. Note that the NI Block Grant premium per head over English spending shown in this chart is significantly higher than the spending premium shown in the previous chart, because NI has a lower advantage in the areas of identifiable spending not funded by the Block Grant.

If the 5 per cent Welsh needs adjustment uplift had applied to NI, the Barnett consequentials for 2024-25 from the 2021 Spending Review would have been £89 million higher. This would have meant that the Block Grant per head of population would have fallen from the baseline level of 30 per cent of UK Government equivalent spending in 2021-22 to 26 per cent of UK in 2024-25, rather than 25 per cent. The NI Executive would still have needed to make difficult decisions on spending and revenue generation, but the adjustment would have made the fiscal position slightly more manageable.

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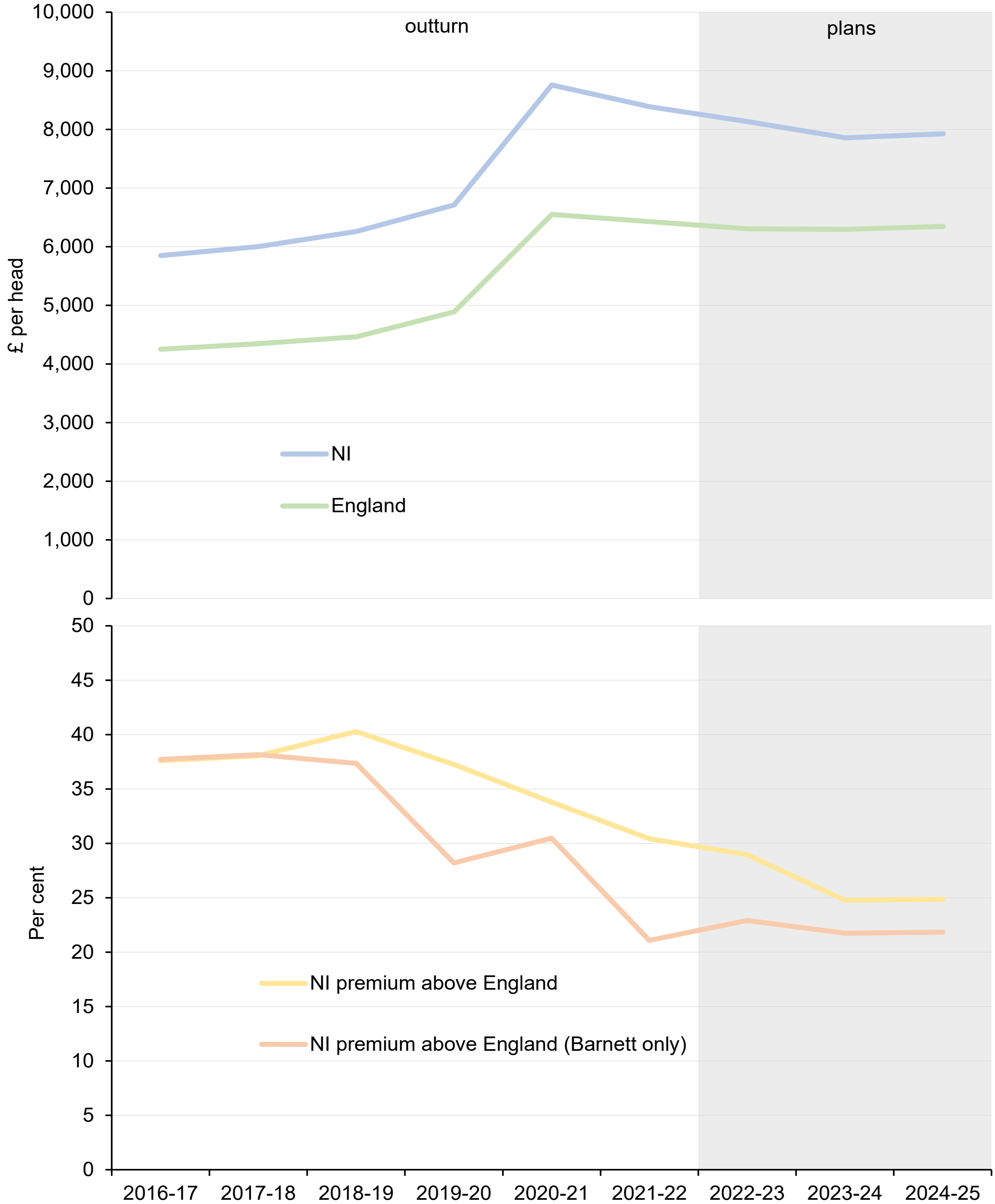
[57] https://www.gov.uk/government/publications/autumn-budget-and-spending-review-2021-documents

[58] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1083817/Forecomp_June_2022.1_Final.pdf Forecasts for the UK economy: a comparison of independent forecasts, HM Treasury (June 2022) Table 2

## Chart 5.2 – NI Block Grant and comparable UK spending per head




Note 1: 2016-17 data from PESA 2021 (Table 1.10)
Note 2: 2017-18 to 2024-25 data from PESA 2022 (Table 1.10)
Note 3: Comparability adjusted UK Government equivalent spending DEL based on applying NI Comparability Factors from 2021 Statement of Funding Policy to outturn and spending plans for UK Government departments from PESA. Calculations exclude Business rates, Reserves, Levelling up Fund and Allowance for Shortfall from UK Government spending
Note 4: Barnett only includes SR Settlement, Baseline and Barnett source of funding from HMT Block Grant Transparency data. Funding relates to allocations rather than outturn. Includes additional allocations at Main Estimates 2022-23 and Spring Statement 2022

Source: HM Treasury and Northern Ireland Fiscal Council calculations

The impact of the Barnett formula in reducing the Block Grant premium over equivalent UK departmental spending has at times been offset by the 'non-Barnett additions' to the Block Grant we described in Chapter 3. This can be seen in the chart, where the Block Grant per head of population increased from 38 per cent higher than equivalent UK Government spending in 2017-18 to 40 per cent higher in 2018-19. This was because the NI Executive received £410 million in non-Barnett funding under the 2017 Confidence and Supply Agreement between the Conservative Party and the Democratic Unionist Party (DUP). Without it, the premium would have fallen to 35 per cent.

Several packages of non-Barnett funding, or other forms of financial support, have been negotiated between the NI Executive and the UK Government, including as part of the St Andrews Agreement (2006), Hillsborough Castle Agreement (2010), Fresh Start Agreement (2015) and New Decade, New Approach (2020). But they are typically one-off or time-limited, which means that the reduction in the Block Grant per head relative to UK Government equivalent spending is steeper when they are subsequently removed. They simply delay the point at which NI's overall spending advantage is reduced – unless of course they are simply replaced by future packages that provide a succession of 'temporary' boosts.

The non-Barnett additions agreed for the 2021 Spending Review largely comprise the UK Government's promised replacement of EU farm funding (£310-330 million per annum), as well as additional security funding. This increases the Block Grant per head from 22 per cent of UK Government equivalent spending to 25 per cent in 2024-25. Further non-Barnett additions for 2022-23 have been made subsequent to the 2021 Spending Review including the formal allocation of funding agreed as part of previous political agreements.

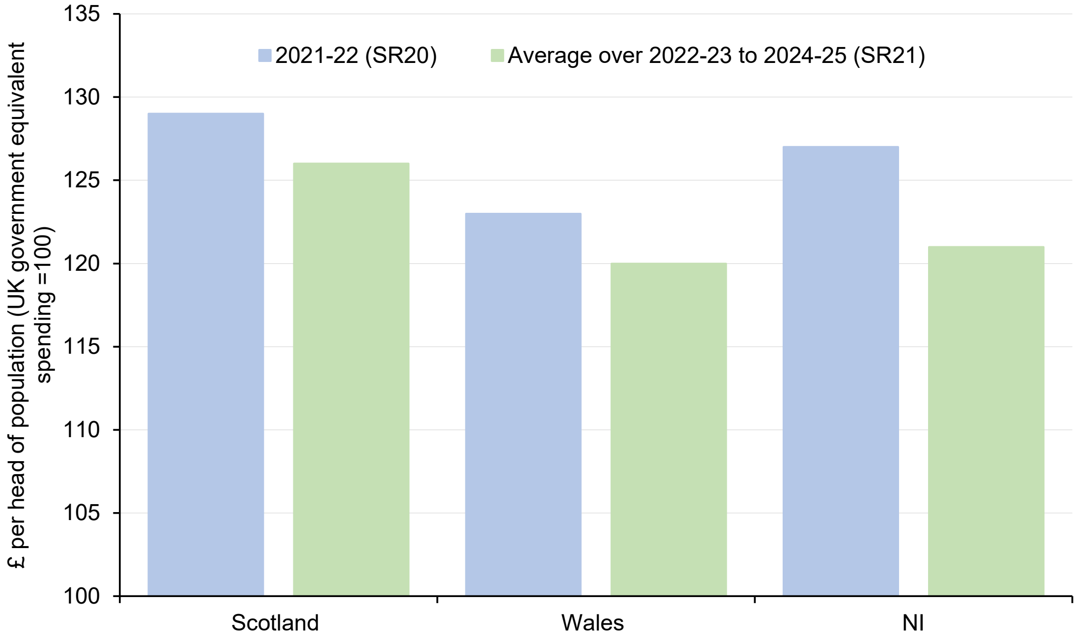
The comparisons in the Treasury *Block Grant Transparency* publications imply that the NI Block Grant premium, excluding non-Barnett additions, would fall by 6 percentage points (from 27 to 21 per cent) between Spending Review 2020 (2020-21) and Spending Review 2021 (2022-23 to 2024-25), as shown in Chart 5.3. This compares with a 3 percentage points reduction for both the Scottish (129 to 126 per cent) and Welsh Governments (123 to 120 per cent), again assuming that no further agreements are negotiated.[59] (These calculations incorporate some additional adjustments for Business Rates that are not included in Chart 5.2.) It is noteworthy that the reduction for the NI Executive is double that for the Scottish Government in spite of the latter having a higher starting position. This is possibly due to the greater scale of previous temporary allocations that have now been removed and the different rates of population growth between NI and Scotland.

The inclusion of time-limited one-year Barnett consequentials for Covid-19 spending in 2020-21, as well as the support for Energy Bills in 2022-23, means that we do not see the smooth trend of asymptotic convergence in the "NI as a % of England (Barnett only)" line in Chart 5.2 that you would expect from the application

[59]https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1040846/BGT_Explanatory_note__HMT_template_.pdf December 2021 (Table 4.C) and https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/995939/Block_Grant_Transparency_2021_Explanatory_Note_.pdf (June 2021)

of the Barnett formula alone. This can be seen in Chart 5.4, which does not include any additional time limited allocations.

Chart 5.3 – Block Grant per head of population compared with UK Government equivalent (England) spending




Source: HM Treasury

If the 2021 Spending Review plans left NI's overall funding advantage at 38 per cent, rather than prospectively reducing it to 25 per cent, the Block Grant would be £1.5 billion higher in 2024-25 (in 2020-21 prices). This reduction in relative spending advantage is equivalent to approximately £2,000 per household and confronts the Executive with a significant near-term sustainability challenge in terms of delivering equivalent quality and quantity of services as England. The rapid pace of the adjustment is a challenge in itself, particularly when there is pressure to increase support to households, businesses and public sector workers in response to the recent rapid rise in inflation. In the absence of a planned and coordinated approach, departments and public service providers could end up taking actions to contain costs in an ad hoc and piecemeal manner that would exacerbate the impact on the public.

In terms of where the adjustment falls, it is important to remember that the Executive is not obliged to allocate Barnett consequentials to the same areas of spending that generated them in England – although its room for manoeuvre in making different choices is limited in practice. Table 5.3 compares the increases in spending allocations for NI departments in the Department of Finance's Draft Budget last year with the closest equivalent increases in allocations for Whitehall departments at the 2021 Spending Review. Health, Education, Justice and Economy, the four departments taking the largest shares of the Block Grant, all face significantly lower growth (or in the case of Economy, a reduction) than their nearest Whitehall counterpart department. The slower growth in funding for most NI departments compared with their nearest UK Government equivalent highlights the challenge faced by the next NI Executive in seeking to prioritise spending on Health and Social Care, as all parties have indicated they wish to do.

### Table 5.3 - Resource DEL plans for NI departments compared with nearest UKG equivalent

| | Outturn[1] | Plan[1] | % change | £ million |
|---|---|---|---|---|
| | 2019-20 | 2024-25 | NI Department | Nearest equivalent UKG Department |
| Agriculture etc | 206.0 (1.7%) | 571.2 (4.1%) | 177.3 | 109.6 |
| Communities | 790.7 (6.6%) | 840.4 (6.0%) | 6.3 | 5.5 |
| Economy | 1,009.0 (8.4%) | 841.3 (6.0%) | -16.6 | 3.4 |
| Education | 2,148.3 (18.0%) | 2,503.2 (17.9%) | 16.5 | 27.0 |
| Finance | 167.6 (1.4%) | 174.1 (1.2%) | 3.9 | -24.9 |
| Health | 5,990.8 (50.1%) | 7,109.2 (51.0%) | 18.7 | 32.9 |
| Infrastructure | 405.4 (3.4%) | 450.4 (3,2%) | 11.1 | 40.1 |
| Justice | 1,083.3 (9.1%) | 1,122.0 (8.0%) | 3.6 | 33.5 |
| The Executive Office | 73.1 (0.6%) | 230.7 (1.7%) | 215.6 | -18.9 |
| Other | 85.7 (0.7%) | 108.9 (0.8%) | 27.1 | N/A |
| **Total** | **11,959.9** | **13,951.4** | **16.7** | **30.4** |
| Notes: | | | | |
| DAERA excluding farm funding | 206.0 | 241.8 | 17.4 | |
| TEO excluding victims/abuse etc. | 73.1 | 84.5 | 15.6 | |

Note[1]: Share of total spend in parenthesis

Source: Department of Finance, Draft Budget 2022-25, HM Treasury PESA 2022

## The Barnett squeeze over the longer term

Over the medium to longer term the repeated application of the Barnett formula to the funding allocations for UK Government departments each year would be expected to result in further reductions in the Block Grant per head of population relative to equivalent UK Government spending in England.

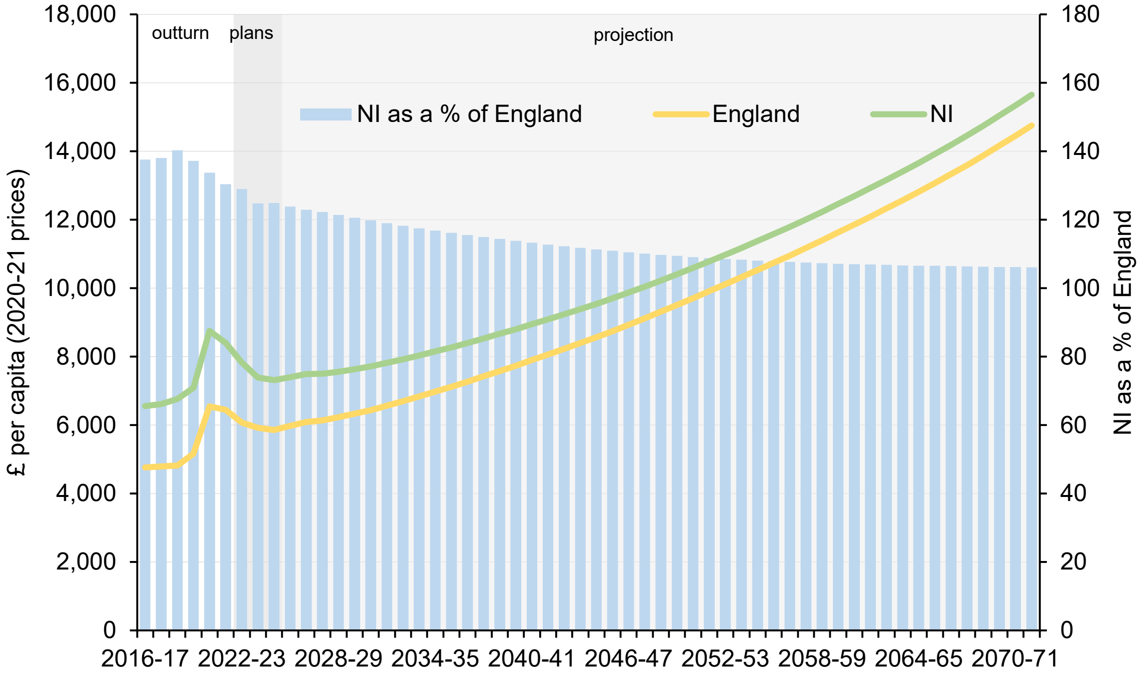
Chart 5.4 sets out some illustrative projections for the NI Block Grant, equivalent UK Government spending and the premium of the former over the latter for the next 50 years, based on the OBR projections for the UK from the 2022 *Fiscal risks and sustainability report* (FRSR). The OBR baseline projections for the main UK spending programmes as a percentage of GDP were multiplied by the OBR's projections for nominal GDP to derive cash spending and then the projected annual percentage increase in cash spending for each programme. This was applied to the total planned 2024-25 DEL for Whitehall departments to help calculate the implied NI population share of the changes in UK Government equivalent spending between 2025-26 and 2070-71, with further adjustments for comparability and VAT abatement in line with the Barnett formula.[60] The UK Government equivalent spending in Chart 5.4 is calculated as the sum of the projected spending for Whitehall departments each year with adjustment for comparability to allow like-for-like comparison with the NI Block Grant.

The projections 'jump off' from the end of Chart 5.2, which shows a Block Grant per head premium over equivalent spending of 25 per cent in 2024-25. No adjustment is made to the size of the non-Barnett allocations in the 2024-25 Block Grant, as they are assumed for simplicity to be either replaced or permanently included. As the Block Grant gradually converges on equivalent UK spending through the operation of the Barnett formula, the premium steadily declines reaching 20 per cent in 2030-31, 10 per cent in the late 2040s and ending the projection at 6 per cent in the early 2070s. To offset the reduction in relative funding per capita, and maintain the 25 per cent premium, the NI Executive would require an additional £5 billion in funding or £2,800 per head (in 2020-21 prices) each year by 2071-72.

The projected slower growth in the NI population compared with England over the long term means that the projected Block Grant of £29 billion in 2071-72 is £1.7 billion lower than if there were no change in the relative size of the NI population between 2024-25 and 2071-72. However, this is more than offset by the impact of slower population growth on funding per capita. This would be projected to be only 1 per cent higher in NI than England in the early 2070s if there were assumed to be no change in population levels, compared with the 6 per cent premium in Chart 5.4. This shows the impact that relative population dynamics can have on Barnett convergence.

[60] The population share used was NI as a percentage of England for most Whitehall departments. The exceptions were Home Office, Justice, Work & Pensions and the Law Officer's Department where services are also provided for Wales with the associated comparability factor for Wales below 2 per cent. For these departments, the NI population as a percentage of that for England and Wales was used instead.

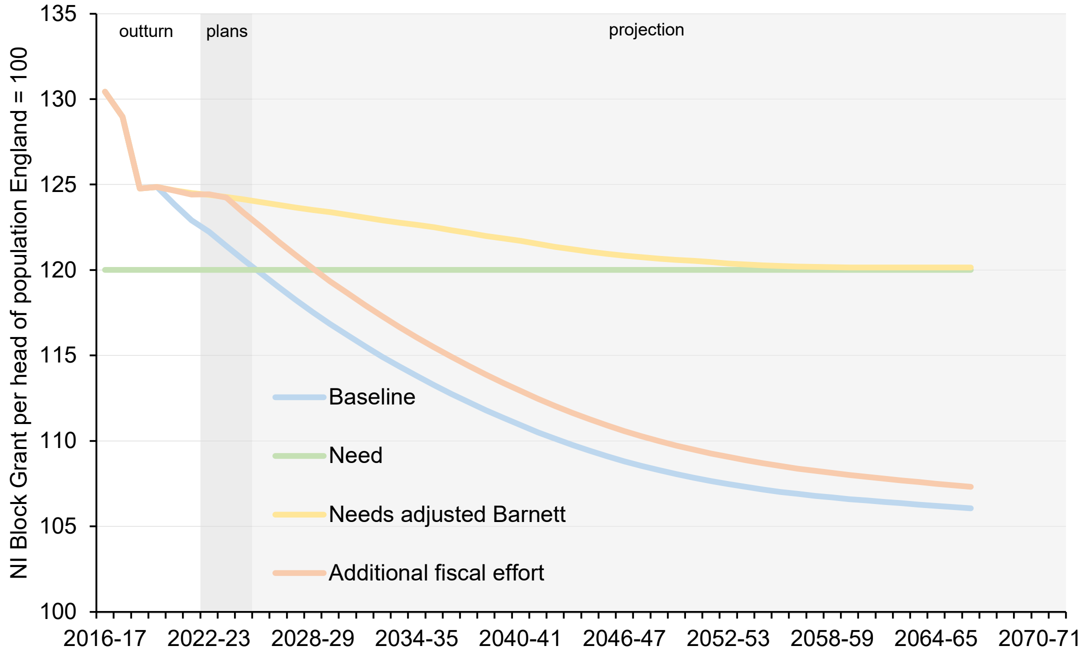
## Chart 5.4 – Long-term projections of the NI Block Grant and equivalent UK Government spending per head in real terms




Source: HM Treasury, OBR and Northern Ireland Fiscal Council calculations

We discussed in the previous chapter how various characteristics of NI's demography, geography and economy suggest the Executive may need to spend more per head on the public services for which it is responsible than the UK Government does in England to deliver an equivalent quality and quantity of service. Based on existing studies, we concluded that 20 per cent was a reasonable ballpark figure and on this basis the Block Grant premium would fall below this figure in 2030-31.

## Chart 5.5 – NI Block Grant projections and relative need




Source: HM Treasury PESA 2021, Northern Ireland Fiscal Council calculations

As we noted in Chapter 3, there is no adjustment for relative need when applying the Barnett formula to the NI Block Grant, but there is for Wales. At the 2015 Spending Review the UK Government implemented a funding floor in Wales, specifically a guarantee that the Welsh Government's block grant funding per head would not fall below 115 per cent of equivalent funding per head in England, reflecting the relative need estimated by the Holtham Commission.[61] This guarantee was for what was then the current Parliament, after which the floor would be reset. But, as part of a new fiscal framework, the two governments then agreed in 2016 to implement a new funding mechanism from 2018-19 (as recommended by the Holtham Commission).[62] By adding an extra 5 per cent uplift to future Barnett consequentials, the agreement slowed the prospective decline in the Welsh Block Grant premium, while the new the framework maintained the 115 per cent floor agreed in the previous year (rather than allowing relative funding to fall to 100 per cent as in NI). There would clearly be potential to put a similar floor in place for NI.

In Chart 5.5, the 'needs adjusted Barnett' line shows the path of the Block Grant with a 20 per cent uplift to the projected Barnett consequentials (reduced over time to offset the impact of the projected slower population growth in NI) to reflect the judgment on relative need in Chapter 4. The scope to begin with a lower rate of uplift in line with Wales, is less for NI given that the Block Grant per head of population, excluding non-Barnett additions, is already planned to be within 2 percentage points of relative need by 2024-25.

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[61] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/479749/52229_Blue_Book_PU1865_Web_Accessible.pdf

[62] https://www.gov.uk/government/publications/the-agreement-between-the-welsh-government-and-the-united-kingdom-government-on-the-welsh-governments-fiscal-framework

Even if the NI Executive increased its fiscal effort by £400 million by 2028-29 – for example by increasing the Regional Rates element of rates bills by around 50 per cent - this would only delay the Block Grant premium falling below relative need by four years to 2034-35 (Chart 5.5).

## The impact of further fiscal devolution in NI

The Final Report from the Independent Fiscal Commission for Northern Ireland was published in May 2022.[63] This recommended the partial devolution of income tax to the NI Executive and Assembly as well as the full devolution of stamp duty land tax, landfill tax and air passenger duty. But the Commission did not recommend whether additional tax-raising powers should be used to raise or lower the overall level of taxation or spending.

In terms of the financial implications for the NI Executive, a baseline adjustment would likely be made to the Block Grant to reflect the revenue foregone by the UK Government in respect of the devolved tax. This would be revised in subsequent years, most likely based on the planned growth in the revenue from the devolved tax in the rest of the UK. In return, the NI Executive would receive a new income stream from the devolved tax, with both this and the Block Grant adjustment subject to adjustments to reflect the difference between plans and outturn.

The Commission discussed the potential risks and rewards in detail. It is sufficient to note here that that in addition to giving the Executive greater policy choices, further fiscal devolution to NI would inevitably introduce additional uncertainty around the size of the Block Grant as well as the revenue from the devolved tax. This could further impede a future Executive's ability to deliver multi-annual budgets, as it could compound the existing difficulties which have prevented past Executives from developing multi-year plans. It would also likely prompt fresh consideration of the Executive's borrowing powers and the relative merits of the Executive having access to the Treasury's Budget Exchange Scheme to carry forward underspends (as now) or allowing it to run a reserve like the Scottish and Welsh Governments.

## Conclusion

By ensuring that it increases by the same <u>cash</u> amount per head as equivalent UK Government spending, rather than the same <u>percentage</u> amount, the Barnett formula squeezes the Block Grant over time as a percentage of equivalent UK Government spending. Spending per head was considerably higher in NI than England when the Barnett formula was introduced and the gap has narrowed as a result of it, albeit with the squeeze loosened from time to time by funding for political agreements and other non-Barnett additions.

It has historically been the case that NI has had higher estimated relative need than England, and also than the other Devolved Administrations. However, we estimate

[63] https://www.fiscalcommissionni.org/evidence/fcni-final-report-more-fiscal-devolution-northern-ireland

that the Block Grant will be around 25 per cent above the equivalent UK Government spending by the end of the current Spending Review period in 2024-25 (or 22 per cent excluding non-Barnett additions). If 20 per cent is a reasonable estimate of NI's additional need for spending per head, then our projections suggest that this threshold might be passed in around 2030-31. This has implications in terms of the quality and quantity of public service provision in NI compared to England and the choices facing the NI Executive.

The UK and Welsh Governments agreed in 2016 that the Welsh Block Grant should fall more slowly that the raw Barnett formula suggested and that it should not drop below the Holtham Commission's estimate that Wales needs a 15 per cent spending premium to reflect greater need. It would clearly be possible to put a similar arrangement in place for NI, perhaps with a more up-date needs assessment to help secure agreement around the chosen level.

# 6 Topping up the Block Grant

In the previous chapter, for simplicity we compared the level of the Block Grant per head to estimates of the relative need for spending in NI and England. But, as we noted at the beginning of the chapter and in Chapter 4, the NI Executive has some other (relatively modest) sources of financing for its spending. One of the key decisions that the Executive has to make in setting the NI Budget is how far to use these to top up the Block Grant, in part to pay for any 'super-parity' decisions it takes explicitly to provide more generous access to services or entitlement to benefits than offered in England.

Table 6.1 summarises the contribution that non-Block Grant finance made to the total proposed spending in the Department of Finance's *2022-2025 Draft Budget* (and that non-Barnett additions made within the Block Grant). It shows that even in 2024-25 (when revenue is no longer depressed by Covid-related concessions), Regional Rates are assumed to generate only £630 million (net of £122 million in debt principal repayments, which have first call on this revenue), alongside capital borrowing of £200 million and the Irish Government contribution to the A5 project of £25 million. Together these pay for only a little over 5 per cent of the total planned spend of £16,160 million.

## Table 6.1 - The financing of the Executive's DEL spending

| | 2021-22 Provisional Outturn | 2022-23 Draft Budget | 2023-24 Draft Budget | £ million 2024-25 Draft Budget |
|---|---|---|---|---|
| **FINANCING** | | | | |
| **Resource** | | | | |
| Block grant: core Barnett | 11,974 | 12,584 | 12,789 | 12,982 |
| Block Grant: specific allocations | 350 | 352 | 367 | 369 |
| Block Grant: political agreements | 1,798 | 58 | 57 | 54 |
| Regional Rates (post debt repayment) | 370 | 577 | 628 | 630 |
| **Capital** | | | | |
| Block Grant: core Barnett | 1,609 | 1,686 | 1,785 | 1,759 |
| Block Grant: agreements and City deals | 170 | 157 | 143 | 79 |
| Capital borrowing (RRI) | 80 | 140 | 194 | 200 |
| Irish Government funding for A5 | - | 7 | 25 | 25 |
| **FTC** | | | | |
| Block Grant: core Barnett | 42 | 163 | 66 | 62 |
| **TOTAL FINANCING** | **16,393** | **15,725** | **16,054** | **16,160** |

Notes:

1. Resource financing and spending in this table excludes depreciation.
2. The additions to the Block Grant for political agreements include some Covid support beyond Barnett consequentials
3. The Main Estimates for 2022-23 for the Northern Ireland Office include details of additional block grant financing in 2022-23 for the NI Executive, compared to the Draft Budget plans show n above. See Fottnote 3 to Table 3.2 above for the details of the Mains Estimates bock grant financing figures.
4. The Irish Government contribution to the A5 under NDNA is £75 million over the next three years. £7.4 million is expected for 2022-23. Future annual profiles still to be adjusted.

Sources: Department of Finance, Draft Budget, NIO Main Estimates 2022-23

One source of additional financing not included in the Draft Budget presentation is 'fees and charges' (formally referred to as 'sales of goods and services' in the National Accounts). The Department of Finance treats these as negative spending that allows the departments that raise them to spend more in gross terms than the net budget allocation they are given. These totalled around £700 million in 2020-21, but some of them are flows within the NI public sector so their net contribution is impossible to identify precisely.

The Department of Finance applies the same treatment to EU funding (some of which continues after Brexit). This too is treated as negative spending by the recipient department and thus allows additional gross spending within the net budget allocation. EU funding totalled £136 million in 2020-21 and £180 million in 2021-22. In our *Comprehensive Guide*, we explained that EU funding was lower in 2020-21 principally as a result of the reduction generally in activities due to Covid-19, which hampered the drawdown of funding for EU programmes and capital spending.

In this chapter we look at the Executive's sources of non-Block Grant income and what contribution they might make to long-term sustainability.

## Regional Rates

The Regional Rate is the Executive's largest single source of financing to top up the Block Grant. It is levied on domestic and non-domestic properties in NI at a poundage (i.e. rate per pound) determined by the NI Executive. Each rates bill also includes a District Rate element set by each of the 11 local councils, which contributes to the financing of their spending. The Executive has raised the Regional Rate more slowly than the rate of inflation in the past two decades, most recently freezing it for 3 consecutive years, but councils have continued to raise the District Rates year on year. The Rates Order requires the Executive to '*take into consideration estimates of the amounts required to be raised by means of district rates*' before setting the Regional Rates (Article 7(4)). This does not prevent the Executive from raising the Regional Rate if District Rates rise, but it is another political consideration that may influence the Executive.

The rates system in NI works broadly as follows:

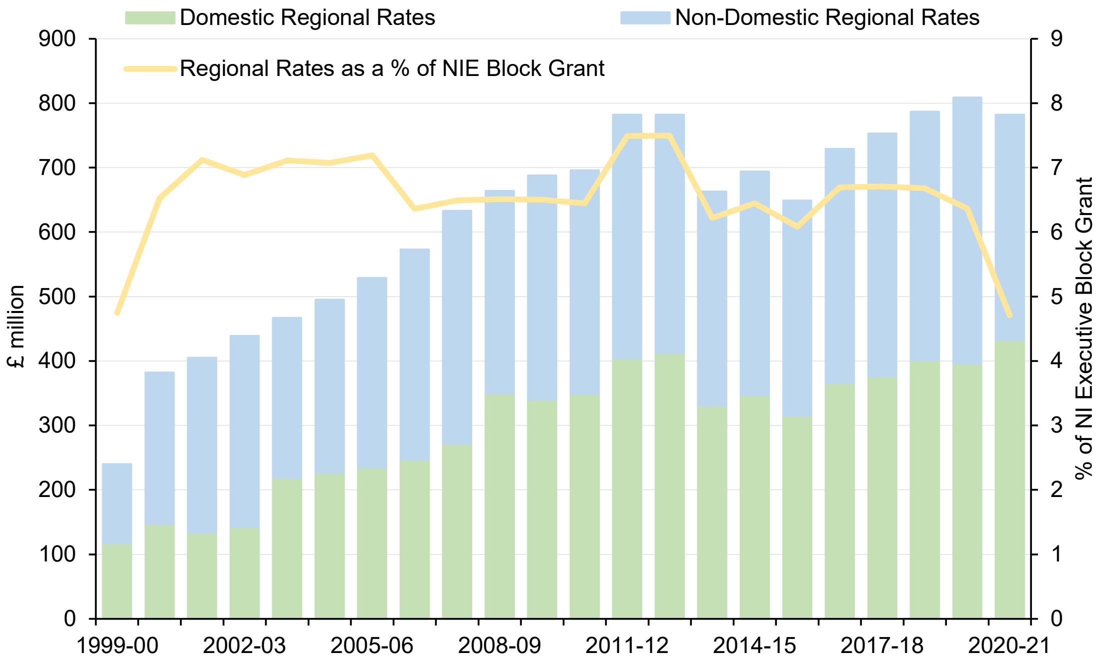
- The rates payable on a **non-domestic property** are calculated by adding the Regional and District poundages set by the Executive and the local council and then multiplying the total by the 'Net Annual Value' (NAV) of the property. The NAV is an assessment of the annual rent that the property could reasonably be expected to have realised on the open market. The current valuation list for non-domestic properties came into operation on 1 April 2020 and is based on rental values at 1 April 2018.

- The rates payable on a **domestic property** are calculated by adding the Regional and District Rates poundages set by the Executive and the local council and then multiplying the total by the 'Rateable Capital

Value' of the property. This is what it is considered to have been worth if it had been sold (as a freehold property) on the open market on 1 January 2005. In 2008 a Maximum Capital Value (CV) was set at £400,000, which means any house in NI with an assessed CV of £400,000 or over will only pay rates based on a £400,000 value. This 'disregard' means revenue is forgone by the Executive and councils on all CVs over the cap, with losses mainly concentrated in Belfast and North Down. The current valuation list for domestic properties came into operation on 1 April 2007 and is based on capital values as at 1 January 2005.

- There are a range of **rate reliefs, allowances and exemptions** available for both domestic and non-domestic ratepayers that have been developed over many years depending on different policies and priorities of the Executive at various points in time. For example, some empty properties receive 100 per cent relief and there are partial rebates for lone pensioners, disabled people and Universal Credit recipients. These rate reliefs are administered by Land & Property Services (LPS) in the Department of Finance.

Chart 6.1 – Regional Rate revenue in NI, 1999-00 to 2020-21[64]



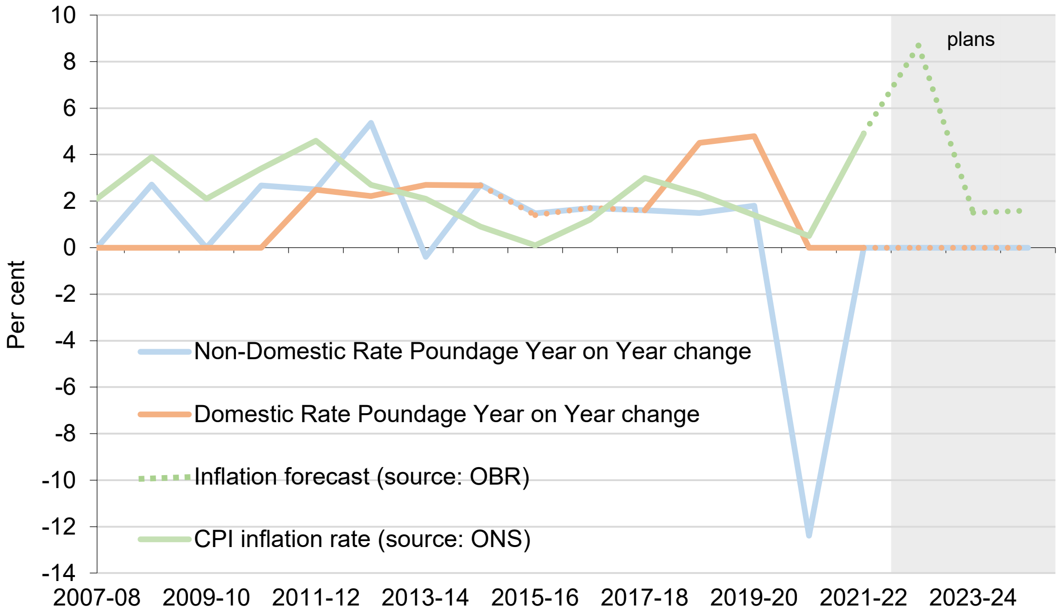

Source: HM Treasury, ONS

Changes in Regional Rate revenue reflect the flow of properties onto and off the Valuation Lists as well as changes to the rate poundage. Chart 6.1 shows Regional Rate income in recent years, in cash terms and as a percentage of the

[64] Data published in Country and Regional Public Sector Finances (2022). We have been unable to reconcile this to DoF data.

Block Grant. The Chart shows that rates revenue increased rapidly in the 2000s before growing at a significantly slower rate over the past decade. From 2007 the restored NI Executive decided to minimise the increase in the Regional Rate poundage, especially for domestic payers (Chart 6.2). Regional Rate revenue fell only marginally as a percentage of the Block Grant over this period, although this also reflected slow growth in UK public spending. Responding to current inflationary pressures and the legacy impact of Covid on some household and business finances, the Draft Budget proposed to maintain the low rates increase policy and continue in the short term with both domestic and non-domestic poundages frozen in cash terms for 2022-23 to 2024-25.[65]

## Chart 6.2 – Annual change in Regional Rate poundages




Note: Non-domestic rate poundage adjusted for effect of revaluations in 2015 and 2020
Source: Department of Finance, OBR EFO March 2022), ONS

Table 6.2 shows that the average domestic household rates bill in NI is significantly lower than the average council tax bill in the rest of the UK. It is estimated that the NI Executive could raise up to an additional £300 million in funding for public services if it increased domestic Regional Rates so that total rates bills in NI (including the District Rate element) matched those in England on average or up to £120 million if there were parity with Scotland. This would ease the Executive's sustainability challenge, but only very modestly given the scale of the Barnett squeeze set out above. Even if a floor were placed on the Block Grant so that it did not fall below relative need, it would not be sufficient for the Executive to match England in terms of Regional Rate revenue in order to deliver the same level of public services. Instead, Regional

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[65] https://www.finance-ni.gov.uk/sites/default/files/publications/dfp/Draft%20Budget%20document%202022-25%20accessible.pdf (Paragraph 3.51)

Rate revenue per household would need to be around 20 per cent higher in line with the estimate of the relative need for spending on public services.

However, it is also worth bearing in mind that house prices in NI are 45 per cent lower than in England, 22 per cent lower than in Wales and 12 per cent lower than in Scotland.[66] In addition, although public sector earnings are 4 per cent higher in NI than the UK average, those in the private sector are 14 per cent lower.[67] Overall, NI taxpayers pay significantly less Income Tax and National Insurance Contributions because of lower incomes and the progressive structure of the taxes, so it is questionable whether NI households should pay equivalent amounts of council tax. This highlights the paradox in respect of fiscal effort that while this needs to be greater in NI to reflect the relative need for public services, the lower level of house prices and average earnings locally would suggest that increasing the fiscal effort to the full extent required might be seen as placing an unfair burden on NI households.

### Table 6.2 – NI domestic rates and GB council tax bills (2021-22)

| | | | £ |
|---|---|---|---|
| | Average bill (Council tax or rates) | Water and sewage | Total household bill |
| Northern Ireland | 1,036 | - | 1,036 |
| England | 1,428 | 408 | 1,836 |
| Wales | 1,544 | 408 | 1,952 |
| Scotland | 1,198 | 383 | 1,581 |

Source: Ulster University Economic Policy Centre

Looking to the future, NISRA projects[68] that the number of households in NI will increase by 9.3 per cent between 2021 and 2041, or 0.4 per cent per annum (slowing from 0.6 per cent in 2021 to 0.2 per cent in 2041). Average household size is projected to fall from 2.52 to 2.42 over the same period. The slow rate of growth in the number of domestic households does not suggest significant growth in the Regional Rate tax base over this period. But the tax base depends not only on the number of properties but also the value of each property.

LPS has provided us with an updated projection of Regional Rate revenue for the next 50 years. These are very broad-brush projections with LPS taking the level of forecast revenue in 2022-23 and projected that this would grow in line with:

- a 2 per cent per annum increase in **rates poundages** for domestic properties and no increase for non-domestic properties. The increase in rates poundages for domestic properties assumed by LPS is higher than in recent years while that for non-domestic properties is lower.

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[66] https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/housepriceindex/may2022
[67] https://www.nisra.gov.uk/system/files/statistics/Employee-earnings-NI-2021.pdf
[68] https://www.nisra.gov.uk/publications/northern-ireland-household-projections-2016-based

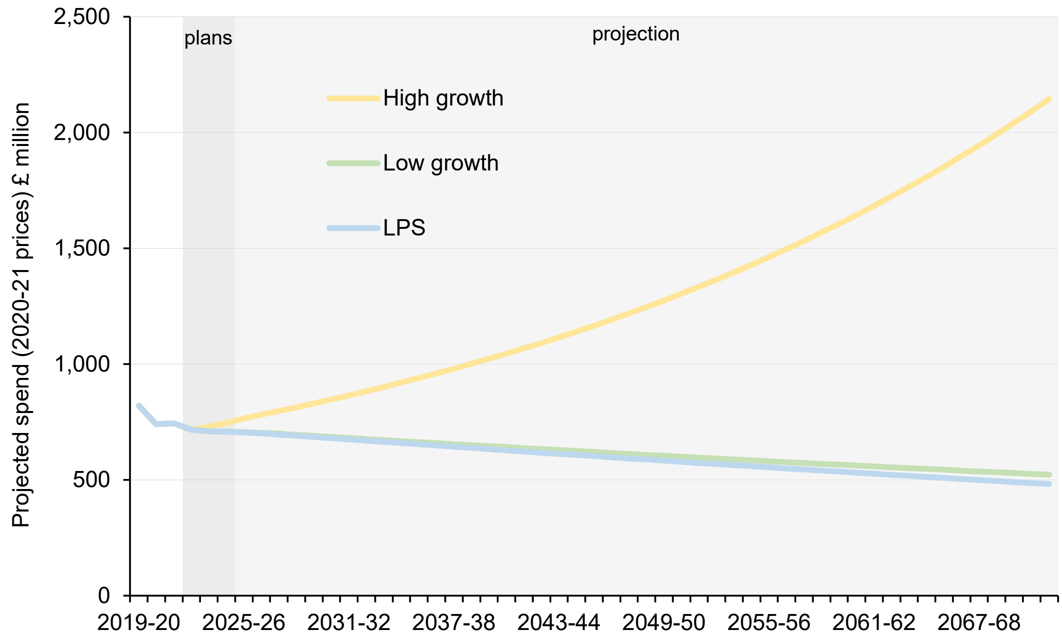
- a 1 per cent per annum increase in the **tax base** for domestic properties and no increase for non-domestic properties. The increase in the tax base for domestic properties is lower than that experienced in recent years and reflects slower projected growth in the number of households. The increase in the NAVs of non-domestic properties in recent years is mainly due to revaluations, which LPS excluded because they are intended to be revenue neutral.

LPS also applied the relevant assumed growth rate for gross revenue to Regional Rate reliefs (e.g. Small Business Rate Relief) and discharges (e.g. vacant properties) which cost £54 million and £41 million respectively in 2021-22.
Chart 6.3 shows that the LPS projections imply that revenue would fall in real terms over the next 50 years to approximately £480 million (in 2020-21 prices). We show this alongside two alternative projections of our own:

- Under the **low-growth scenario** it is assumed that Regional Rate income grows in line with the average between 2009-10 and 2019-20 (1.5 per cent per annum for domestic properties and 1.7 per cent for non-domestic). On this basis revenue would fall to £520 million.

- Under the **high-growth scenario** it is assumed that Regional Rate income grows in line with the longer-term rates of growth between 2000-01 and 2019-20 (5.4 per cent for domestic and 3.0 per cent for non-domestic). On this basis revenue would rise to £2,145 million.

## Chart 6.3 – Long-term projections of NI Regional Rate revenue (2020-21 prices)

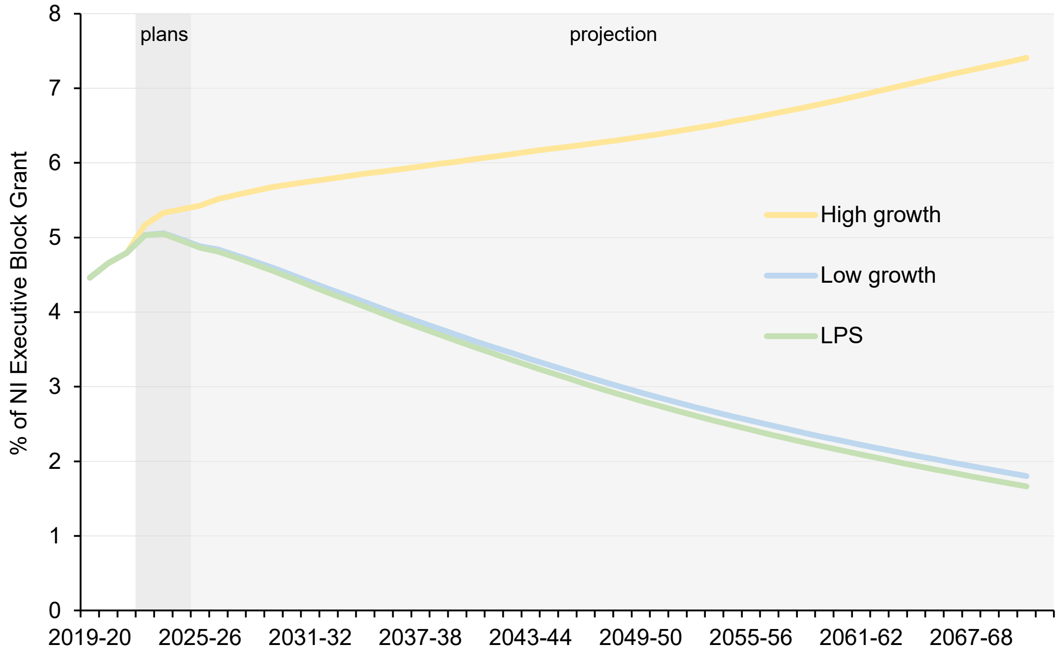



Source: Land & Property Services, ONS and Northern Ireland Fiscal Council calculations

Chart 6.4 compares the Regional Rate revenue projections to the projected level of the NI Executive Block Grant calculated in the previous chapter (Chart

5.4). Under the LPS projections and low-growth scenario Regional Rate revenue would fall further as a percentage of the Block Grant. Under the high-growth scenario revenue would increase as a percentage of the NI Block Grant with the increase from 2024-25 equivalent to £0.6 billion in additional funding in 2071-72 in 2020-21 prices. But as the Barnett squeeze on the Block Grant continues to tighten (to £3.8-£8.7 billion on our projections in 2071-72[69]), the Executive may feel itself under pressure to move further on poundages – especially given the comparatively low level of household charges in NI against the rest of the UK.

## Chart 6.4 – Regional Rate revenue as a percentage of the NI Block Grant




Source: Land & Property Services, ONS and Northern Ireland Fiscal Council calculations

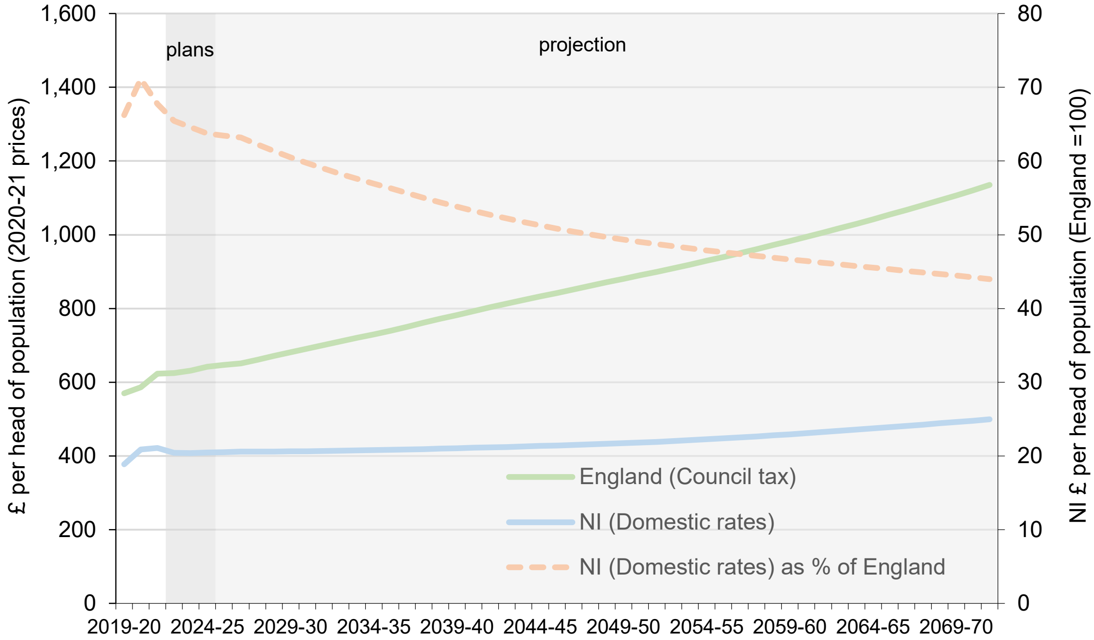
Chart 6.5 shows that the gap between NI domestic rates and council tax in England, as set out in Table 6.2, is projected to increase further in the coming decades based on the LPS projections. The NI domestic rates in the Chart assume that the District Rate rises in line with the LPS projections for the Regional Rate plus 2 per cent each year to reflect the higher rate of growth in District Rate revenue over the past twenty years. The projected levels of council tax revenue in England are based on the OBR projections that assume council tax remains a constant proportion of GDP (1.6 per cent) between 2026-27 and 2071-72. While NI domestic rates will increase by 18 per cent in real terms between 2022-23 and 2071-72 under the LPS projections, council tax income will almost double in England under the OBR projections. Although the District Rate element of domestic rates was one fifth smaller than the Regional Rate element in 2019-20, the assumed faster rate of growth means

69 Increase in NI Executive Block Grant required to maintain premium per head of population at 20 per cent and 38 per cent higher than UK Government equivalent spending.

that it is projected to be greater than the Regional Rate element by 2030-31 and more than double by 2065-66.

NI domestic rates per head of population are projected to fall from 68 per cent of council tax in England in 2021-22 to 44 per cent in 2071-72. If the Executive and District Councils maintained NI domestic rates at 68 per cent of council tax in England per head of population, then they would receive up to £120 million (in 2020-21 prices) in additional income in 2031-32 compared with that implied by the LPS projections, £330 million more in 2051-52 and £500 million more in 2071-72.[70]

### Chart 6.5 - NI domestic rates and England council tax revenue




Source: Land & Property Services, ONS, OBR and Northern Ireland Fiscal Council Calculations

## Capital borrowing

As described in Chapter 3, the NI Executive can borrow to finance capital investment under the Northern Ireland (Loans) Act 1975, but this set a limit of £2 billion on any outstanding debt which was then raised to £3 billion in the Northern Ireland (Miscellaneous Provisions) Act 2006.[71]

When the current 'Reform and Reinvestment Initiative' (RRI) borrowing regime was put in place in 2002, consistent with the 1975 Act, the Executive

[70] It should be noted that these projections are not directly comparable with the Regional Rate revenue projections in Charts 6.3 and 6.4 which include non-domestic Regional Rates but exclude District Rates. However, the high growth scenario for Regional Rates in Charts 6.3 and 6.4 implies average annual real terms growth in revenue of 2.1 per cent between 2021-22 and 2071-72 compared with the OBR projections for council tax which imply growth of 1.4 per cent, in line with the OBR projections for GDP growth.

[71] The Executive can also borrow within-year for cash management purposes unrelated to investment, but its ability to draw on the UK Consolidated Fund as needed day-to-day means that it has never needed to.

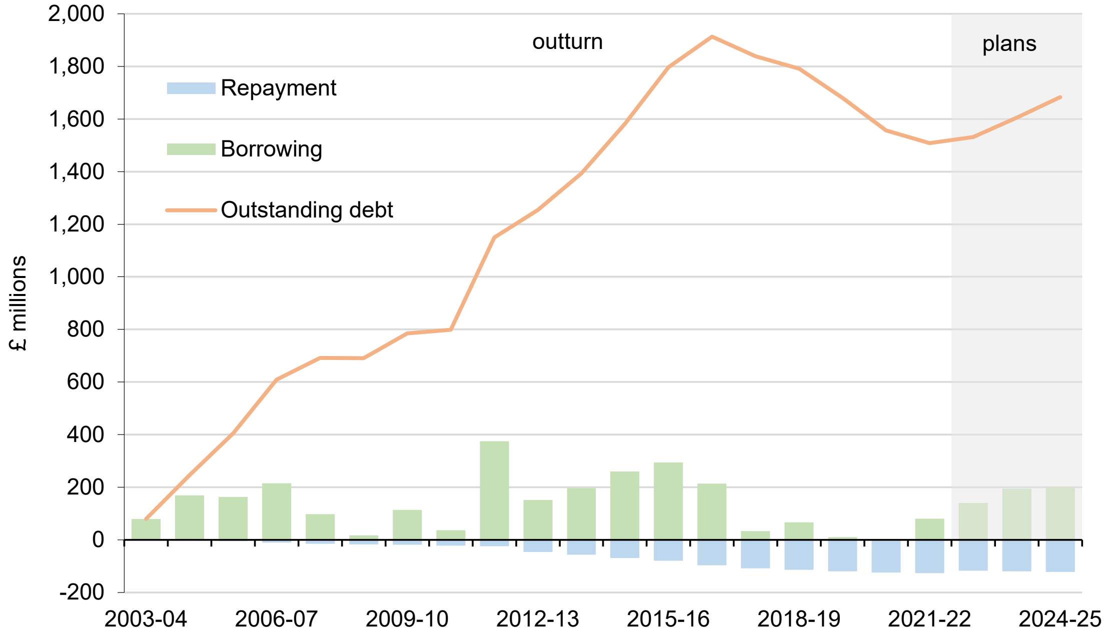
and the Treasury also agreed a £125 million annual limit on borrowing in 2003-04, rising to £200 million thereafter. This was lifted temporarily under the Fresh Start Agreement between 2015-16 and 2018-19 but is now back to £200 million (although the Treasury has occasionally allowed the Executive to borrow more to carry forward undrawn borrowing from previous years).

Unlike the Scottish and Welsh Governments, and local authorities throughout the UK, the NI Executive can only borrow from the UK Government. More precisely, the Secretary of State for NI borrows on the Executive's behalf from the National Loans Fund, which itself is financed by the Debt Management Office. Loans are normally repaid over a 15-to-25-year period. Principal and interest repayments are made twice yearly from the NI Consolidated Fund.

(The Northern Ireland Act 1998 also allows the Executive to borrow for purposes other than capital investment, but only up to £250 million in total. This is, in effect, an overdraft facility and was originally put in place to help smooth cash flow within a given financial year. The Executive has never used this facility, given its ability to draw down agreed funding from the UK Government Consolidated Fund on a day-by-day basis as needed.)

In the *2022-2025 Draft Budget*, the Department of Finance proposed that the Executive would borrow £140 million under the RRI in 2022-23 followed by £195 million in 2023-24 and £200 million in 2024-25. The RRI borrowing would pay for 10 per cent of conventional capital spending (and barely 1 per cent of total spending) by NI departments in 2024-25. After a period in which borrowing was very low while the UK Government was setting the NI Budget in the absence of a functioning Executive and Assembly, this would take the overall level of RRI borrowing undertaken since 2003-04 to £3.1 billion with the level of outstanding debt standing at around £1.7 billion (Chart 6.6).

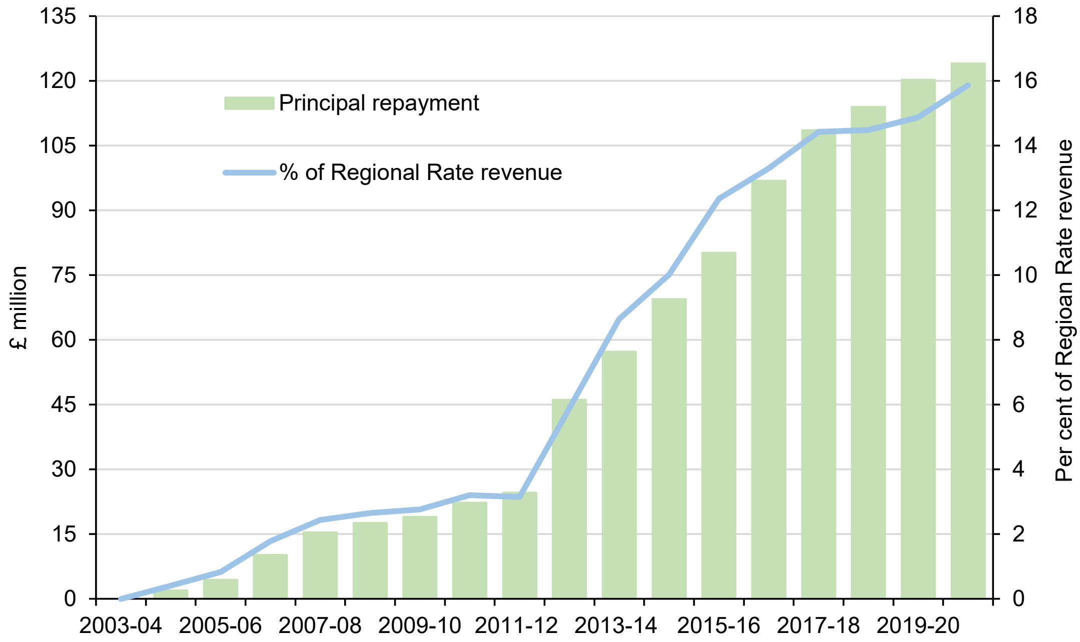
## Chart 6.6 – Capital borrowing and outstanding debt




Source: Department of Finance

Interest payments under the RRI are a cost to the Executive's Resource DEL, forecast at around £40 million in 2024-25. As noted above, principal repayments are a first call on the Regional Rate, reducing the income that can be used to help fund departmental spending. Chart 6.7 shows that principal repayments have risen from 3 per cent of Regional Rate revenue in 2010-11 to 16 per cent in 2020-21. If the additional RRI borrowing had been constrained so that the repayments had remained at the same proportion of Regional Rate revenue as in 2010-11, then the Executive would have had approximately £100 million more funding available for current expenditure in 2020-21, but less capital investment in the intervening years with consequences for the quality and quantity of services further out. Although interest payments on RRI borrowing are a direct call on the Block Grant, the low interest rate for RRI borrowing means that they are much lower than the principal repayments.

## Chart 6.7 – Principal repayments from RRI capital borrowing



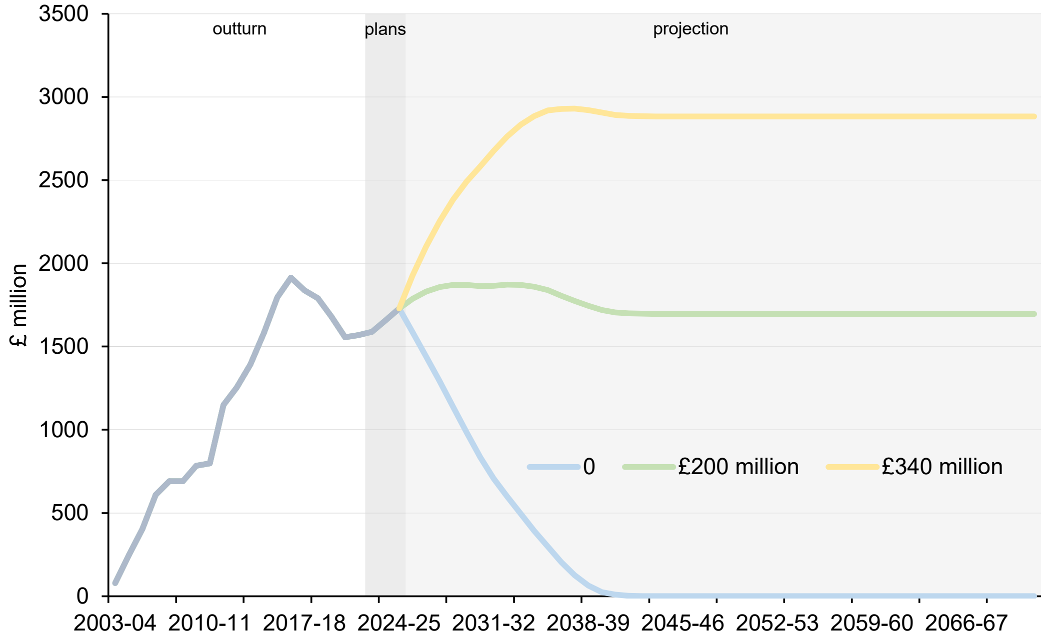

Source: Department of Finance, ONS

The Draft Budget includes illustrative long-term projections that assume borrowing increases as proposed to 2024-25, reaching £200 million in that year, but then (implausibly) ceases thereafter. As Charts 6.8b and 6.8c illustrate, on this basis principal repayments would increase until 2028-29 before falling almost to zero by 2049-50. Interest payments would follow the same trajectory.

Alternatively, if we assume that new borrowing remains at £200 million a year with an average term of 15 years, then the outstanding debt would remain below £2 billion, as the principal repayments on historic borrowing offset the new borrowing. If the Executive continues to be able to borrow at the 2.6 per cent or so interest rate at which it has done so recently, then debt interest would not change significantly at around £44 million per annum. The principal repayment would consume about one-quarter of the revenue from Regional Rates by the mid-2030s, falling to around one-eighth by 2071-72.

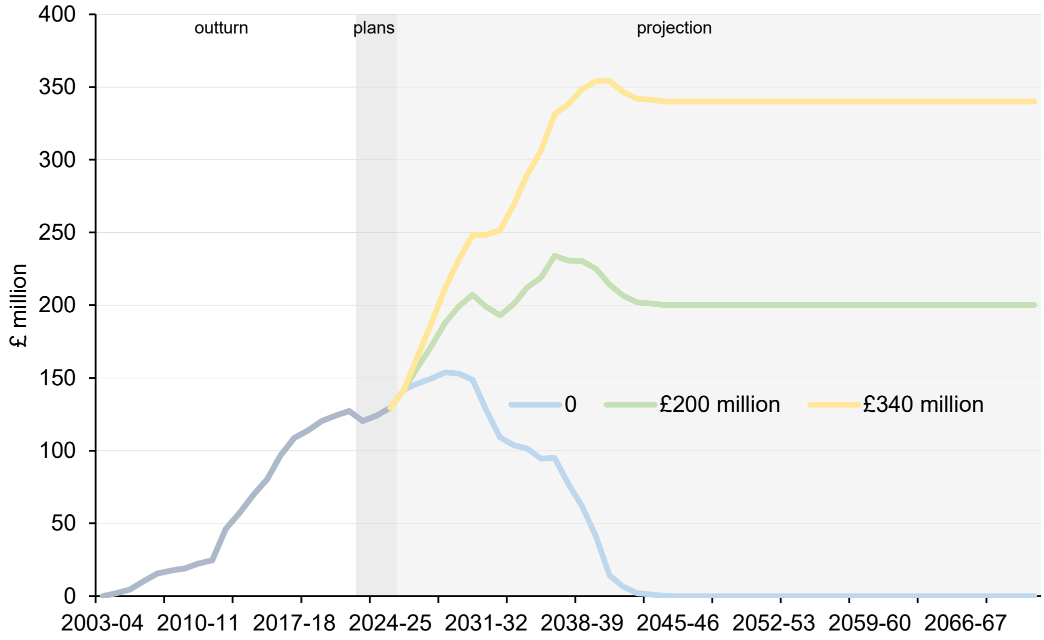
If the Executive wished to increase its annual borrowing from £200 million (and the Treasury agreed), then it could move to £340 million a year without breaching the £3 billion statutory limit. Under this scenario debt interest payments would peak at just under £80 million per annum in the mid-2030s at current borrowing rates, but if the borrowing rate rose to 5 per cent then they would peak at £155 million. The interest bill would be significantly higher than the £40 million projected for 2024-25 in *2022-2025 Draft Budget*, but still relatively modest compared to the projected Block Grant.

## Chart 6.8a – Outstanding debt by level of borrowing 2024-25 to 2071-72



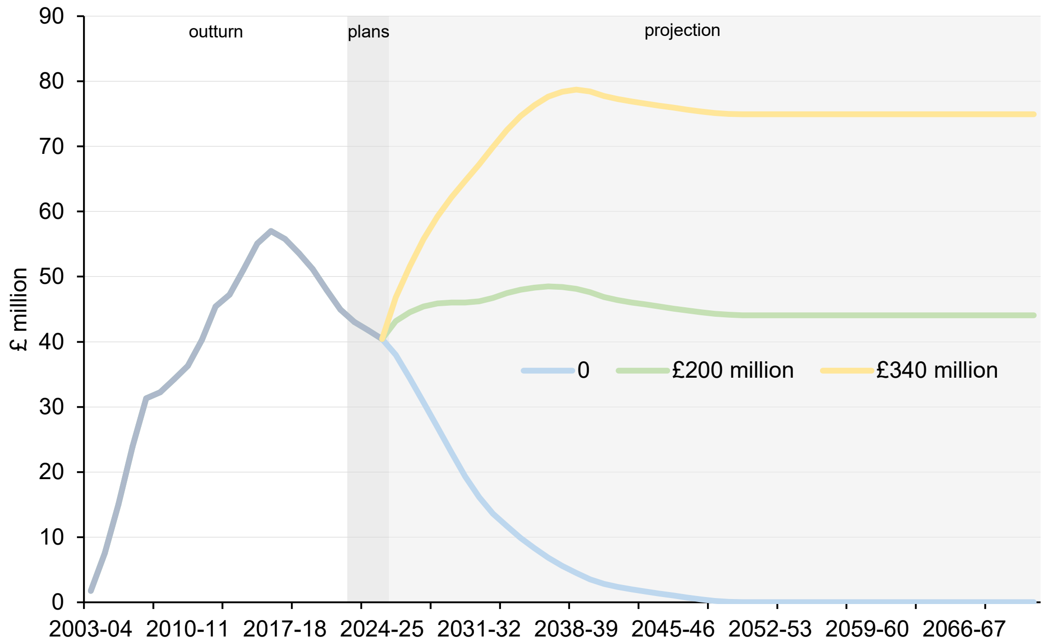

Source: Department of Finance, Northern Ireland Fiscal Council calculations

## Chart 6.8b - Principal Repayments by level of borrowing 2024-25 to 2071-72




Source: Department of Finance, Northern Ireland Fiscal Council calculations

## Chart 6.8c - Interest Payments by level of borrowing 2024-25 to 2071-72




Source: Department of Finance, Northern Ireland Fiscal Council calculations

Given the levels of borrowing seen in recent years, there has been little active discussion of raising the annual borrowing limit – and the Treasury might well be reluctant to consider this unless greater tax powers were devolved to the Executive to give it scope to address upward shocks to interest payments.

Over the longer term, there would of course also be nothing to prevent the UK Parliament legislating a further increase in the £3 billion limit on the Executive's outstanding debt, which you might intuitively expect to show some link over time over the Executive's broader income and spending. But this limit has not yet proved a binding constraint, which presumably explains why it took more than 30 years to be increased from £2 to £3 billion and has remained at that higher level without serious discussion for the last 16 years.

The relative tight constraints on the Executive's borrowing mean that greater use of the existing borrowing powers could make only a modest difference to the Executive's overall spending envelope, although a more significant difference to the potential for capital spending (which affects the quality and quantity of public services over the longer term). The limits on borrowing also mean that increases in borrowing costs are unlikely to impose a significant squeeze on the Executive's resource position via higher servicing costs.

## Fees and charges

Income from fees and charges (which encompasses all income classified as 'sales of goods and services' in the National Accounts) is a modest but far from insignificant source of financing to top up the Block Grant, worth in total around £700 million in 2020-21. As noted above, they are not identified explicitly as a source of income in the Draft Budget. Rather they are treated as negative income for the department that levies them, allowing it to undertake additional gross spending within the net sum allocated to it in the Budget.

Fees and charges include a large number of very different items (as shown in Table 6.3, taken from our *Guide* to the NI public finances). The biggest revenue raisers are non-domestic water charges, Health Trust receipts and tuition fees. Income from fees and charges includes some receipts from within the public sector, where one part of government is paying another for specific goods and services delivered at market rates. (This is true where payments "*are related to specific volumes or values of output under arms-length contracts and are not paid if that output is not delivered*"). So it is not clear yet exactly what contribution they make overall to the Executive's spending power.

## Table 6.3 – Income from fees and charges

| Department | Description | £'000 2021-21 | % of total |
|---|---|---|---|
| DfI | Non domestic water charges and roads drainage | -91,559 | 13.3% |
| DoH | Health Trusts receipts | -73,071 | 10.6% |
| | *of which: hospital services receipts* | *-54,073* | *7.8%* |
| | *social care receipts* | *-18,998* | *2.8%* |
| DfE | Further Education tuition fees and charges, contracts and other operating income | -55,041 | 8.0% |
| DoH | Medical and Dental training course fees | -36,793 | 5.3% |
| DoF | Land & Property Services including land registers, registry of deeds, statutory charges registry, and mapping services provided | -30,994 | 4.5% |
| DoH | Health and Social Care Board receipts | -29,451 | 4.3% |
| | *of which: hospital services receipts* | *-21,793* | *3.2%* |
| | *social care receipts* | *-7,658* | *1.1%* |
| DOJ | NI Courts and Tribunals fees and charges and recovery of costs from other departments | -26,055 | 3.8% |
| DfC | Recharge income for Child Maintenance services delivered by the Department for Work & Pensions (DWP) in Great Britain (GB) | -25,915 | 3.8% |
| DfC | Recharge income for benefit delivery services delivered by the Department for GB DWP | -19,762 | 2.9% |
| DoF | NI Statistics & Research Agency income for General Registry Office services including the provision of life certificates and recovery of out-posted staff costs. | -17,811 | 2.6% |
| DoH | NI Blood Transfusion Service receipts (generated from Trusts) | -17,603 | 2.6% |
| DoF | ITAssist income for provision of IT equipment, server hosting and Internet Protocol Telephony tariff provided to NICS and other public sector organisations. | -16,075 | 2.3% |
| DoF | Central Procurement Directorate income in relation to professional procurement services to the NICS and other public sector bodies. | -14,873 | 2.2% |
| DfC | Income from HMRC for recovery of costs associated with administration of National Insurance fund benefits | -13,935 | 2.0% |
| DfC | Recharge income for benefit delivery services delivered by the Department for GB DWP | -13,728 | 2.0% |
| DoF | HR Connect income for the receipt of HR Connect services | -11,119 | 1.6% |
| DOJ | Forensic Science NI recovery of costs for forensic science services | -10,305 | 1.5% |
| DOJ | PSNI fees and charges | -10,123 | 1.5% |
| NIAUR | Utility Regulator licence fees | -9,560 | 1.4% |

Source: Department of Finance Provisional Outturn

Given the variety of items involved, it would be hard to produce a meaningful long-term projection in a bottom-up way, based on current policy. Plausible arguments might be made for projecting the total in line with inflation, average earnings or the total spending of the Executive.

There are restrictions to what departments could do locally in order to raise additional funding. For example, the retention of income from licences and levies or fines and penalties is subject to Treasury agreement. And some changes would require legislation by the Executive.

The most frequently cited potential change is of course charging for domestic water supply. Water supply and sewerage is in the public sector in NI, delivered through the government-owned company NI Water. The company does not charge domestic customers for its services, unlike the private sector water suppliers in England, the not-for-profit supplier in Wales and the publicly-owned supplier in Scotland. In lieu of charges, the Department for Infrastructure provides a budget to NI Water of around £215 million for capital and £130 million for resource spending in 2021- 22. This is paid out of the Executive's income and might roughly approximate the cost to the Executive of choosing not to impose domestic water charges. It is sometimes argued that water is charged for implicitly in NI through domestic rates, although formal hypothecation ended in the 1990s. However, the significant levels of direct funding from the Executive to NI Water, mentioned above, as well as comparisons with other regions, clearly show the disparity between the cost of the service and the funding raised from households.

As noted above, NI households paid an average of £1,036 a year in rates in 2021-22, compared to an average £1,836 in council tax and water charges in England. Closing this gap would raise an extra £615 million, which would be sufficient to increase total Executive spending by 4 per cent but no doubt at the cost of significant political controversy.

## Other external funding

In addition to the core Barnett-based component of the Block Grant, the Executive has three main sources of external funding: the non-Barnett additions included in the Block Grant (identified in the Draft Budget), EU funding (not mentioned in the Draft Budget but treated as negative spending by recipient departments) and the Irish Government's contribution to the A5 road project (mentioned in the Draft Budget). None is likely to be big enough and predictable enough as a source of long-term future financing to top up the Block Grant and ease sustainability more than they do now.

### Non-Barnett additions to the Block Grant

As we noted in the previous chapter, the Executive has over time received a variety of 'non-Barnett additions' to its Block Grant from the UK Government. As shown in Table 6.1, these were worth £2,318 million in 2021-22 and were projected to average £545 million a year over the three years of the Draft Budget to 2024-25.

Some are received by all Devolved Administrations and some solely by the Executive. They are typically one-off or time-limited and earmarked for particular purposes, which makes it hard to project them into the future (although history certainly suggests they are still likely to arise).

The main current Block Grant additions common to all Devolved Administrations are:

- Ringfenced contributions to **City and Growth Deals**. These are agreements between the UK Government, Devolved Administrations, local councils and other local partners, designed to boost economic growth. As of April 2021, the UK Government had committed £617 million over 15-20 years to four deals in Belfast City Region, Derry City & Strabane, Mid South West NI and Causeway Coast & Glens.

- Post-Brexit funding to replace EU support for **farming and fisheries**. The UK Government has promised "*to maintain the funding available to farmers and land managers*" and "*to maintain fisheries funding across the UK's nations*", but only over this Parliament. Spending Review 2020 committed £316 million in farm support for the Executive in 2021-22 (excluding £14.4 million in residual EU support from a programme agreed pre-Brexit). This funding was extended by Spending Review 2021. For this and the next two years £3 million was provided for Fisheries. Farm funding rises from £313 million for 2022-23 to £327 million for 2023-24 and £329 million for 2024-25.

The main non-Barnett additions specific to the Executive have accompanied political agreements with the UK and Republic of Ireland. Most importantly:

- The **New Decade, New Approach** (NDNA) deal that paved the way for the restoration of the Assembly and Executive in January 2020 was accompanied by what the UK Government referred to as a "*£2 billion injection of financial support to the new NI Executive*" by 2024-25. As discussed in our *Comprehensive Guide*,[72] half of this sum was in effect a guarantee that the Executive would receive at least £1 billion in Barnett consequentials to finance spending over those five years (which it did) or that the Treasury would make up the difference. It is currently estimated that £508 million was spent under NDNA in 2020-21 and that £162 million was spent in 2021-22, with more than £150m more due to be spent by the end of 2024-25. The Irish Government's contribution to the A5 road project was part of this agreement. It is worth £75 million over three years, with £7.4 million anticipated in 2022-23 – the first year this will be drawn down.

- The **Confidence and Supply Agreement** between the Conservative Party and the DUP in 2017 was accompanied by a financial annex agreed between the UK Government and the Executive promising an extra £1 billion for the Executive over the five-year parliament.

- The Executive received funding under the **Fresh Start Agreement** of 2015, to sustain the Assembly and Executive by addressing various issues left unresolved by the Belfast and St Andrews agreements. Funding has totalled £259 million over the past five years and the 2021-22 Budget included £31 million for security and £28.4 million for shared education and housing.

[72] https://www.nifiscalcouncil.org/files/nifiscalcouncil/documents/2021-11/the-public-finances-in-northern-ireland-final-version_0.pdf

We argued in our *Guide* that:

> *"Given the number of occasions on which the UK Government has provided financial support packages to help sustain or restore NI's power-sharing institutions, it would hardly be surprising if politicians at Stormont were tempted from time to time to exploit this potential source of finance to loosen the 'budget constraint' they face… At face value, securing additional resources for NI via this route is beneficial to the regional economy and society: more public funding and hence more public services. But a considerable body of economic commentary suggests that 'moral hazard' or the ability to tap a reliable stream of public money from the Treasury may distort public and private sector behaviour in NI with implications that are ultimately undesirable. Decision making under soft budget constraints may not be optimal and high levels of subsidy for the private sector may have contributed to comparatively low productivity and competitiveness."*

It would be a brave person who bet that NDNA will be the last package agreed to help restore or sustain the Stormont institutions. But whether they contribute to fiscal sustainability in an underlying sense is perhaps debateable, not least as the funding is typically time-limited and earmarked for specific purposes. As we have shown, these non-recurrent funding packages do delay the impact of the Barnett squeeze, but as soon as they are removed, the full impact of the Barnett squeeze is then felt.

## EU funding

The Executive received funding from various European Union programmes while the UK was a member and continues to receive smaller amounts after Brexit – in most cases because previously-agreed funding streams have yet to run their course and in others because financial support for peace in NI will be renewed via a new cross-border PEACE PLUS Programme. The main sources have been:

- Common Agricultural Policy (CAP) Pillar 1 – Direct Farm Payments
- CAP Pillar 2 – Rural Development Programme
- Common Market Organisation (CMO) Funding
- Peace IV Programme
- Interreg VA Programme
- Structural Funds (European Regional Development Fund (ERDF) and European Social Fund (ESF))
- European Maritime Fisheries Fund (EMFF)
- Competitive Funds, including Horizon Europe, Erasmus Plus, Connecting Europe Facility and a number of smaller programmes.

EU income in 2019-20 was £466.5 million, but in 2020-21 it dropped to £135.7 million. The reduction of £330.8 million is due to the fact that the CAP payments have halted, although as noted the majority of payments previously made have been replaced by a domestic non-Barnett Block Grant addition.

Under the Withdrawal Agreement, the UK continues to participate in programmes and draw down funds which were committed within the 2014-

2020 Multiannual Financial Framework (MFF). The Executive can continue to draw down tails of funding from the EU until December 2023 or until the relevant project completes under the 'n+3' arrangements. This is not new funding, it relates to expenses incurred and accrued in the 2014-2020 period.

The Executive will also benefit from the PEACE PLUS programme at least until 2027. The original PEACE Programme was agreed in 1995 *"to support peace and reconciliation ... in NI and the border region of Ireland [i.e. Cavan, Donegal, Leitrim, Louth, Monaghan and Sligo]".*[73] The PEACE IV programme ran from 2014 to 2020 with expenditure allowable until the end of 2023. Similarly, PEACE PLUS will run to 2027 with expenditure complete by 2030. The UK Government confirmed a contribution of around £730 million to PEACE PLUS in September 2021, around 75 per cent of the total funding. The remainder will be provided by the EU, the Irish Government and the Executive. It is not clear whether there will be a successor to PEACE PLUS beyond 2027, but there is no reason to expect a significant rise in funding of this sort.

In our response to the 2021 Spending Review[74] we highlighted the impact of EU structural funds replacement funding being paid directly by the UK Government rather than to the Executive and then passed on to eligible recipients. The UK Internal Market Act 2020 has been used by the UK Government to deliver funding in NI directly from Whitehall bypassing the Block Grant. As well as EU replacement funding, this has extended into devolved areas for which NI would previously have received Barnett consequentials, such as the new Levelling Up Fund. There remains a risk that NI receives less of this sort of funding than it would have received from the EU, and projects may not align as well with the Executive's priorities.

## Conclusion

Compared to the core Block Grant funding determined by the Barnett formula, the Executive's other sources of financing are relatively modest. On current policy, none of them of them is likely to offset the Barnett squeeze on the core Block Grant to a significant degree – Regional Rates have a relatively unbuoyant tax base and the Treasury current caps annual borrowing (which can only be used to finance capital spending) at a level well below that which would see outstanding debt rise to the limit set out in legislation.

That said, there remains scope for some increased fiscal effort on the part of the Executive via the Regional Rates, domestic water charges and other charges, plus some scope to borrow more within current limits and to make more efficient use of its funding. This might be worthwhile not only for the relatively modest sums of money that it would raise directly, but because it might make the UK Government more willing to increase the generosity of its

[73] https://www.europarl.europa.eu/factsheets/en/sheet/102/northern-ireland-peace-programme

[74] https://www.nifiscalcouncil.org/files/nifiscalcouncil/documents/2021-11/nifc-response-to-2021-spending-review.pdf

own financial support either through the application of the Barnett formula or other targeted financial support.

# 7 Conclusion

We have argued in this report that when thinking about the sustainability of the NI Executive's finances, we need to take a different approach than when assessing fiscal sustainability for the UK Government or a sub-national administration with significant borrowing and tax-raising powers.

Conventional sustainability analyses assume that governments accommodate demographic and non-demographic pressures on spending, and they ring the alarm bell when this implies an explosive trajectory for borrowing and debt. On this basis, the OBR has concluded that the UK Government's finances are on an unsustainable path over the long-term, primarily because of an ageing population and other cost pressures in health. At some point, this will require a fiscal tightening at the UK level that will affect people living in NI via the taxes they pay and funding for the Executive. It could also impact pensions and social security payments that are met directly by the UK Government through AME.

But because the Executive's ability to borrow is tightly constrained by legislation and agreement with the Treasury, it cannot suffer a sovereign debt crisis in the same way that the UK Government could. With most of its income coming from the UK Government in the Block Grant, and limited ability to top it up from taxes and charges, an unsustainable position seems best interpreted as one in which the Executive cannot finance the same quality and quantity of services that the UK Government is able to deliver in England.

Public spending has long been higher per head in NI (and the other Devolved Administrations) than in England, which the UK Government recognises as an appropriate reflection of greater need in order to deliver equivalent services. Several relative 'needs assessments' have been undertaken over the years, drawing on indicators such as population structure, dispersion and deprivation. None is particularly recent, but they suggest that spending per head may need to be around 20 per cent higher than in England.

The level of spending per head delivered by the Block Grant was around 40 per cent above equivalent UK Government spending per head of population as recently as 2018-19, albeit including time-limited support for political agreements. But the Block Grant settlement set out in last year's Spending Review was bigger than expected and partly as a result will see the spending premium fall sharply to around 25 per cent by the end of the Spending Review period in 2024-25. Under the Barnett formula, the Block Grant per head rises in line with equivalent spending by the UK Government, but in cash rather than percentage terms, gradually reducing the percentage spending premium.

As a result of this 'Barnett squeeze', we project that the Block Grant would fall below the estimated 20 per cent needs threshold in the early 2030s and below 10 per cent in the late 2040s. The convergence effect intrinsic to the Barnett formula does not seem to have been intended by its originator and would seem to work contrary to the UK Government's current 'levelling up' agenda.

The UK and Welsh Governments agreed in 2015 that the Welsh Block Grant would not fall below the 15 per cent needs premium estimated by the Holtham Commission, but no comparable mechanism has been put in place to put a limit to the Barnett squeeze in NI. This has not been a pressing issue until now because the NI Block Grant per head of population had been so much higher than the previous estimates of the needs premium for NI.

The NI Executive has various sources of financing with which to top up the Barnett component of the Block Grant, but on current policy none looks likely to offset the Barnett squeeze in a significant and predictable way. The tax base for Regional Rates is not particularly buoyant and capital borrowing is currently restricted to £200 million a year. But there remains potential for Executive to show greater fiscal effort, for example by increasing Regional Rates and/or increasing charges for services (most obviously domestic water charges) where household charges are currently relatively low. This would not only raise money directly (albeit in relatively modest amounts) but might also encourage the UK Government to provide more generous support. That said, it would clearly be fraught with domestic political difficulty.

Given the prospective need to strengthen the public finances at the UK level identified by the OBR, the Barnett squeeze on the Block Grant and the relatively limited ability of the Executive to top it up from other sources of financing, the need for Executive departments to pursue greater efficiency in their delivery of public services is clear and seems widely accepted, in principle.

In addition to the squeeze on the Block Grant relative to equivalent UK spending, current levels of inflation create a near-term sustainability issue for the Executive's finances and the budgets of NI Civil Service departments, causing a significant reduction in anticipated spending power. Like the rest of the UK, NI is a net importer of energy, and this, as well as rising food and consumer goods prices, is contributing to a cost of living crisis as well as affecting the budgets of bodies delivering public services.[75] [76] In addition, the effective reduction in real-terms pay for many public sector workers (including health and social care staff) is likely to increase the existing workforce shortages present in the public sector.[77] This is a pressure on the sufficiency of spending at the UK level and if the UK Government were to respond by increasing spending (paid for by higher taxes or borrowing) then this would increase the NI Block Grant but intensify the Barnett squeeze.

Recommendations from the UK-wide Pay Review Bodies could contribute to the inflationary spike in the current financial year. In addition, if a significant increase in salary scales were implemented for a large public sector staff group such as healthcare workers, this would present significant sustainability implications for the NI Executive. To afford the same level of pay settlement (i.e. to achieve the same percentage uplift), the Barnett

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[75] https://www.ons.gov.uk/economy/inflationandpriceindices/articles/priceseconomicanalysisquarterly/march2022

[76] There is a question as to whether the inflationary crisis is likely to have a greater relative impact in NI than GB. Conclusive evidence either way appears lacking at this stage.

[77] https://www.health.org.uk/news-and-comment/charts-and-infographics/spring-statement-2022

consequentials from the increased spending in England would need to be supplemented by the Executive by taking funding from other services.