

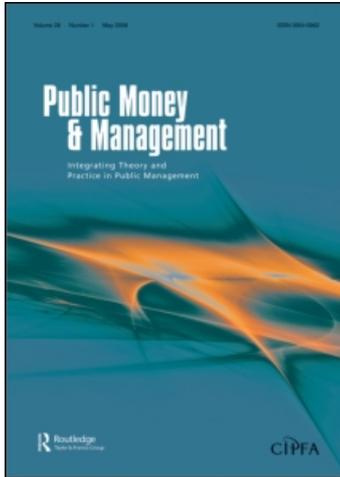
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### The Primacy of Politics: Intergovernmental Fiscal Relations in the UK and Australia

David Pickernell <sup>a</sup>; Gillian Bristow <sup>b</sup>; Adrian Kay <sup>c</sup>; Neal Ryan <sup>d</sup>

<sup>a</sup> Reader in the Welsh Enterprise Institute, University of Glamorgan Business School, <sup>b</sup> Senior lecturer the Department of City and Regional Policy, Cardiff University, <sup>c</sup> Senior lecturer in the Department of Politics & Public Policy, Griffith University Business School, <sup>d</sup> Executive Dean, Faculty of Business, Southern Cross University, New South Wales

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# The Primacy of Politics: Intergovernmental Fiscal Relations in the UK and Australia

**David Pickernell, Gillian Bristow, Adrian Kay and Neal Ryan**

*Interest in Barnett formula reform is on the rise again, particularly because of changes in the parties in power in the devolved governments of Scotland and Wales, and the tighter public spending heralded by the recent Comprehensive Spending Review. This article looks at whether, and to what extent, the introduction of an alternative fiscal allocation system would remove the primacy of politics from the UK's resultant intergovernmental fiscal relations, through examination of the Australian experience, especially the role of Special Purpose Payments.*

The Barnett formula has proved to be a remarkably durable mechanism for allocating public expenditure across the constituent parts of the UK, particularly given the fact that it appears to have been a temporary measure introduced in 1978 prior to (ultimately unsuccessful) Scottish devolution, to replace collective negotiations on individual public expenditure programmes (Twigger, 1998).

Under this system, extended to Wales in 1980, the budget size (known as the block grant) for Northern Ireland, Scotland and Wales is determined predominantly by the size of that budget in the previous year. The annual changes in overall funding are then calculated as a simple per capita proportion of the actual changes in expenditure in England in relevant spending areas (for example health and education). Once this overall budget has been determined, however, spending within the non-English nations of the UK can then be determined according to their own spending priorities i.e. the spend in specific areas (for example health) does not need to be in the same proportions as in England (for a fuller explanation see Midwinter, 2004). The Barnett formula survived the post-1997 transition from administrative to democratic devolution in Scotland, Wales and Northern Ireland largely intact. It has come under scrutiny and sharp criticism, not least because of its failure to relate expenditure allocations to measured levels of public expenditure need or capacities to deliver public services in UK regions (see, for example, Bristow, 2001; Bell and Christie, 2001; Morgan, 2001; McLean and McMillan, 2003; MacKay and Williams, 2005). Despite this, political interest in Barnett reform has been waning

since 2001. There are two main reasons for this:

- Since 2000 the Labour government has significantly increased public expenditure such that total public spending has increased from 37% of national income in 1999–2000 to a forecast 42.8% in 2007–08 (the last year for which we have firm and fixed spending plans). This has also tended to hide the impact of the so-called 'Barnett squeeze' where the strict operation of the formula should lead to public expenditure levels in the devolved regions converging on levels in England. This is brought about by the fact that although spending per capita in the devolved regions is increased annually by the same monetary amount as in England, as a proportion of the baseline that they were getting before the extra is less than in England (ap Gwilym, 2006). This has doused Barnett formula debates and grievances in the regions inasmuch as quibbling about one's share of overall public spending is less pertinent when everyone is doing better (see Midwinter, 2004).
- Since devolution, and until recently, the same political party (Labour) has held power in both UK central government and the devolved administrations in Scotland and Wales. England accounts for around 85% of the UK's population and a similar proportion of the nation's wealth (see Johnson, 2002). The decisions made with respect to expenditure in England inevitably dominate the situation in the rest of the UK. This means that while in theory the devolved administrations are able to exercise complete autonomy over their budgets, in practice

*David Pickernell is a reader in the Welsh Enterprise Institute, University of Glamorgan Business School.*

*Gillian Bristow is a senior lecturer the Department of City and Regional Policy, Cardiff University.*

*Adrian Kay is a senior lecturer in the Department of Politics & Public Policy, Griffith University Business School.*

*Professor Neal Ryan is Executive Dean, Faculty of Business at Southern Cross University in New South Wales.*

they are under considerable pressure to mirror decisions taken in England concerning the major areas of expenditure, namely health and education (Adams and Robinson, 2002). With the same political parties in control however, priorities have largely coincided, thereby reducing the potential for conflict.

This situation is, however, changing such that political debate about the suitability, relevance and equity of the Barnett formula is destined to become centre stage once again. There are three principal factors behind this shift. First, Midwinter (2004) argues that the real test of the Barnett formula's durability under democratic devolution will occur when different parties are in power in London and Edinburgh (or Cardiff). This has now come to pass, with a minority Scottish National Party Administration in Edinburgh and a Labour-Plaid Cymru coalition in power in Cardiff. At a UK level declining political support for the Labour party and the revived electoral prospects of the Conservative party also increase the likelihood of future, sustained divided government, with consequent disagreement over fiscal resourcing and no systematic or transparent system for resolving such disputes. The Barnett formula instead relies, rather pragmatically, on the existence of intergovernmental goodwill.

Second, the Conservative party, which has traditionally supported the Union of the United Kingdom, has signalled a shift away from this position and has outlined plans to introduce an English Parliament should it be elected to power. This would require that the allocation of funding for the territories be decoupled from decisions over spending in England, thereby necessitating the removal of the Barnett formula and the implementation of a new mechanism for distributing finances territorially.

Third, and most immediately, changing economic circumstances mean the UK is moving rapidly into an era of fiscal restraint, and the imperative to place firm control on public expenditure growth will significantly heighten squabbles over relative shares across regions and territories. The most recent Comprehensive Spending Review (2007–2011) indicates that public expenditure will rise by only 2.1% in real terms, indicating the likelihood of a fall as a percentage of national income (Treasury, 2007).

These changing circumstances make renewed discussion about reform of the formula and possible alternative systems inevitable. The

formula has been politically expedient inasmuch as it has avoided the need for extensive annual bargaining between central government and the devolved administrations. The system has also provided scope for the territories to negotiate for additional resources, as and when circumstances require—for example when Wales required additional funding in support of its European Objective One programme commitments (see Bristow and Blewitt, 2001). Thus, there is scope for the formula to be bypassed when there is a clear political will or argument for doing so. The future viability of the formula is thus very much contingent on changing political variables. A key question is whether, and to what extent, the introduction of an alternative fiscal allocation system would remove the primacy of politics from the UK's intergovernmental fiscal relations.

This article takes a fresh look at the merits of the fiscal arrangements deployed in the relatively mature federal system of Australia and draws lessons for the UK. The Australian system is attracting academic and political interest from the UK (see, for example, McGovern *et al.*, 2002; Pickernell and McGovern, 2002; McLean, 2004; Kay *et al.*, 2005), for least three reasons:

- The commitment to horizontal fiscal equalization and the independent assessment of public expenditure needs in Australia provides potentially useful insights into whether formula design and institutional reform remove the scope for political manipulation in the allocation of fiscal resources across territories.
- Australia has experience of contested governance between national and state levels of government (Kelly, 2006).
- Australia has a well-developed and transparent system of specific purpose payments (SPPs) that are given by the federal government to the states for specifically designated programmes and expenditures, particularly in health and education. These provide a transparent mechanism for dealing with payments to address particular public expenditure needs and thus might offer lessons to the UK in respect of its current and rather *ad hoc* system of formula bypass.

### The Australian Experience

The three levels of elected government in Australia are the local tier, state government tier, and the federal level Australian Commonwealth government tier. They all have

community and regional development significance, both individually and collectively. They retain primary responsibilities for education, health, transport and much else, and have a general predisposition towards regional development issues. So they parallel the recent UK situation in a number of ways. The commonwealth government of Australia, as for the UK government, also has dominance in the fiscal system via a high degree of vertical fiscal imbalance (see McLean, 2004), with economic development policy fluctuating between being strongly centralist and more federally devolved to the states.

The Australian fiscal system of distribution has a number of interesting facets which may become of relevance to the UK situation. Indeed, Mathews (1994, p. 16) stated that 'Australia has developed the most comprehensive, effective, and equitable system of fiscal equalization in the world'. Pickernell and McGovern (2002), McLean (2004), and Kay *et al.* (2005), among others, have previously outlined the system by which Australia funds its states. In short, horizontal fiscal equalization (HFE) between the Australian states is carried out by an independent Commonwealth Grants Commission (CGC); the various states also having local grants commissions to equalize funding at the local level within the states (Dollery and Worthington, 1996). The basic principle is that each Australian state and territory should have the financial capacity to provide a range and standard of government services comparable to the other states and territories, subject to a comparable revenue-raising effort and an average level of operational efficiency. The General Purpose Payments (GPPs) then calculated are unconditional (untied) in that the states can use them for any purposes they think fit. The process for calculating GPPs is essentially as follows (McClure, 1994):

- An equal per capita grant.
- An adjustment for above or below average per capita receipts of most recurrent commonwealth conditional grants to the states. These SPPs are given to the states by the federal government for specific programmes and expenditures.
- Adjustment for revenue-raising capacity (obtained from average tax rates).
- Adjustment for demand and cost of service provision.

Each year the CGC goes through these steps to calculate state revenue sharing

relativities for distributing the GPP pool among the states according to HFE. Data problems have bedevilled the Commission over the years. Its acknowledged independence and the quality of approach taken, however, have produced general acceptance of the outcomes produced. The relativities are then applied to state populations to determine a weighted population for each state. The commonwealth government then uses the weighted populations to distribute the GPP pool. In 2000 a Goods and Services Tax (GST) was introduced to fund the large majority of states' GPPs. The 1999 Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations (Parliament of Australia, 1999) established that this 'GST pool' was to be distributed among the states on the basis of HFE.

According to the federal government's budget statements, from 2004–05 onwards each state and territory will receive in excess of what they would have received from previous GPPs, and state taxes will be abolished under the tax reform that brought GST into being. This does mean, however, that the CGC calculates relativities that both cover the allocation of the GST revenues and also the revenue foregone under the new tax system of Financial Assistance Grants (FAGs) (see table 1).

### **The Increasing Use of SPPs**

The GST has grown more quickly than expected and certainly at a faster rate than the growth rate of the economy and is therefore effectively a parallel to the UK situation of fiscal spending growth. The federal government has, however, increasingly tried to control state activities, particularly in health and education (but also key infrastructure investments in road and water for example), via its use of SPPs, tied grants that must be used for the purposes specified by the federal government. Some, but not all SPPs, are accounted for in calculating GPPs, and effectively set minimum funding levels for these services (particularly in the areas of health and education) in terms of current spending. This is important because there have been suggestions by the commonwealth government in the past, that some States substituted commonwealth funding for their own, reducing the total amounts expended on these services in particular. Although decisions about CPPs are made independently of CGC procedures, they are subsequently influential in the CGC procedure for GPP determination because they affect state relativities (the calculations for the Health Care

**Table 1. Weightings applied to Australian state and territory spending allocations 2004–05 and 2005–06.**

Type	New South Wales (NSW)	Victoria	Queensland	Western Australia	South Australia	Tasmania	Australian Capital Territory (ACT)	Northern Territory
<i>GST</i>								
<i>relativities</i>								
2004–05	0.86750	0.86534	1.05504	1.03054	1.20407	1.55939	1.12930	4.26538
2005–06	0.86846	0.87552	1.04389	1.02500	1.20325	1.55299	1.14300	4.26682
<i>FAG</i>								
<i>relativities</i>								
2004–05	0.80363	0.83480	1.10104	1.00781	1.30402	1.74908	1.16529	5.22707
2005–06	0.80494	0.84699	1.08397	0.99807	1.30342	1.75127	1.17714	5.30427

Note: A weighting of 1 would indicate a simple per capita weighting.

Source: CGC (2005).

Grants, now explicitly being calculated using CGC relativities). The use of SPPs has grown markedly since 1970, both in total and more specifically in the areas of education and health. Dollery *et al.* (2000), for example, calculated that between 1970 and 1995, total SPPs rose from 12.6% to 20.8% of state and local government expenditure on services, but the corresponding increases for education and health SPPs were 13.7% to 32.8%, and 3.7% to 39.5% respectively. This also has the knock-on effect of reducing the states' entitlements to GPPs, tied (SPPs) and untied (GPPs) grants consequently becoming relatively similar in size over the past 20 years or so.

SPPs are not free from potential political bias in the same way that CGC grants are (Dollery and Worthington, 1996). Because the obvious benefits of grants go to the recipient not the donor, donors are more likely to try to gain indirect benefit through controlling where the money is spent, hence the historic rise in SPPs grants relative to CGC grants highlighted earlier. The move to greater transparency, including agreement on objectives and performance requirements (important for state

and territory commitment) required by SPPs, should improve accountability. This, however, also reduces explicitly devolved fiscal autonomy (and must also be seen as a distinct possibility in any similar alteration to a Barnett-based system). This is of particular interest to the UK debate, because the use of these SPPs can be seen in some ways as a response to political differences between state and federal levels of government.

This situation continues, although the introduction of GST has increased the perceived size of the GPPs (because it substitutes for revenue that would previously have been generated from state, as opposed to deferral, taxes) as table 2 illustrates.

The rise in GST revenues (faster than SPPs), are softening, but not removing, the disagreements between the states and federal government over SPPs. The commonwealth policy traditionally involved more stick than carrot, as highlighted by Pickernell and McGovern (2002) where the relationship was encapsulated by the phrase 'where begging bowl [the states] meets baseball bat' (the commonwealth government). The commonwealth has preferred SPPs to achieve

**Table 2. Estimated GST revenue provisions and SPPs to the state/local sector 2004–05 and 2005–06 (A\$M).**

Type	NSW	Victoria	Queensland	Western Australia	South Australia	Tasmania	ACT	Northern Territory	Total
<i>GST Revenue</i>									
2004–5	9907.5	7374.4	7374.2	3643.6	3307.6	1441.3	683.2	1743.2	35505.0
2005–6	10426.7	7854.5	7721.1	3822.1	3449.0	1601.4	722.6	1832.7	37340.0
<i>SPPs (total)</i>									
2004–5	8212.9	5758.9	4663.0	2847.8	1063.8	603.7	412.0	396.9	24859.0
2005–6	8640.4	6277.7	4916.0	3071.4	2111.2	660.3	423.4	430.5	26630.9

Source: CGC (2005).

**Table 3. Health SPPs 2005–06 (by state and total) to 2007–08 (totals) (in A\$M).**

Type (see Note)	NSW	Victoria	Queensland	Western	South Australia	Tasmania Australia	ACT	Northern Territory	Total 2005–06	Total 2006–07	Total 2007–08
Hepatitis C settlement fund	2.4	0	0	0.1	0.2	0.1	0.2	0.03	3.0	3.0	2.0
Health Programme Grants	0	1.1	0	0	0	0	0	0.7	1.8	1.8	1.9
Health care grants	2.8	2024.7	1622.1	822.7	698.2	186.2	109.9	103.9	8366.6	8811.2	9268.9
Highly specialized drugs	0.2	139.2	91.3	42.4	39.3	9.7	8.4	5.0	521.5	571.7	627.8
Youth Health Services	0.8	0.6	0.4	0.2	0.2	0.1	0.1	0.1	2.5	2.5	2.6
National Public Health	80.4	55.6	42.5	20.9	17.9	5.9	3.4	3.1	229.8	233.3	236.9
Essential vaccines	37.1	27.7	22.3	10.3	8.5	2.8	1.7	1.3	111.7	121.4	121.6
Repatriation general hospitals	3.5	2.0	0	0	1.2	0.7	0	0	7.3	7.3	7.4
Supporting Western Sydney	1.0	0	0	0	0	0	0	0	1.0	1.1	1.2
Royal Darwin Hospital	0	0	0	0	0	0	0	21.0	21.0	13.2	13.5
Health total	3110.4	2251.0	1778.6	896.6	765.5	205.3	123.8	135.1	9266.1	9766.5	10283.5
SPP total	8515.6	6183.2	4835.0	3017.8	2079.4	631.6	445.5	382.9	26091	27513.7	28096.7
Health as % of SPP total	36.5	36.4	36.8	29.7	36.8	32.5	27.8	35.3	35.5	35.5	36.6

Note: The Hepatitis C Settlement Fund provides financial assistance to people infected with Hepatitis C via blood transfusions. Health Programme Grants provide alternative funding to Medicare benefits with the aim of improving access to approved health services and/or reimbursing service costs to state governments. Health care grants are governed by Australia Health Care Agreements and assist with the provision of public hospital services free of charge to eligible people. Highly specialized drugs are those that cannot be provided through community pharmacies and have to be supplied by hospitals. Youth Health Services contribute to primary health care services for homeless and at risk youth. National Public Health subsidies are for health promotion and disease prevention. Repatriation general hospitals are veterans' hospitals in receipt of non-treatment funds (for example staff costs). Supporting Western Sydney: this is a special fund for the purchase and running of a positron emission tomography scanner. The Royal Darwin Hospital receives funding for its national critical care and trauma response centre.

Source: CGC (2005), Appendix B.

its policy objectives. The states and territories preferred the freedom of GPPs which, of course, did not guarantee that the commonwealth would achieve its policies.

According to the federal government this will generate an additional (GPP) revenue to the states (over what would have occurred before the reform) of A\$1.6 billion in 2004–05, to over A\$2.9 billion in 2007–08. The ratio of GST related GPPs to SPPs was estimated to rise from 1.43 in 2004–05 to 1.47 in 2007–08, indicating the more rapid predicted rise of GST (16%) revenue relative to the SPPs (13%). Many of the SPPs, however, are due for renegotiation after 2007–08 (Australian Budget Paper No 3 2005, Canberra). The treatment of the GST as a states and territories' tax has made a significant difference to commonwealth/state financial relationships. It has delivered to the states and territories significant financial independence. Conversely, however, there is now much greater pressure on SPPs if the commonwealth wants to achieve specific policy objectives.

The situation for health is particularly illustrative in the light of the walkout on 29

August 2003 by all premiers from their meeting with the Prime Minister. Disagreement was over 'shortfalls' in the planned five-year SPP funding allocations for health; as well as the need for a review of the whole health system. The main SPP for health, the Health Care Grant, is calculated according to the principles of HFE because it is so large and included with GST in official analysis of the impact of HFE. Currently, however, the commonwealth government has a number of health-related SPPs, not just the (largest) Health Care Grants. These are split into a number of different areas (see table 3), do not include capital funding (unlike other areas, in particular, education), but are instead focused on current spending areas.

According to the federal government's budget papers in 2004–05 there will be over 90 different SPPs covering a broad range of policy areas such as education, health, social security, housing and transport, with health by far the most important SPP paid to (as opposed to through) the states. Table 3 indicates that in the 2005–08 period health will account for around 36% of the total value of SPPs. The

Australian federal government also states that it: 'is seeking greater accountability in SPP agreements to improve policy outcomes and deliver better value for money. All new and renegotiated SPP agreements will include statements of key objectives and the respective responsibilities of the Australian government and the states, combined with agreed reporting of financial information and detailed performance indicators' (Australian Government, 2004). If states do not meet the terms of the agreement then their funding can be reduced.

Garnaut and Fitzgerald (2002) proposed that the federal government should provide two broad SPPs in health (and aged) care, and education (and training), over which the states would have responsibility for service delivery, while commonwealth and state ministers 'jointly' determine objectives and performance measures. Funding, they said, could be allocated according to primarily demographic factors, with no general or systematic compensation for cost disabilities. The federal government would thus have effective power over these areas, through its direct funding, without responsibility for delivering the services or requirement for compensating high-cost regions. Kay *et al.* (2005) perceived that the recommendations of the Garnaut and Fitzgerald (2002) report (rejected by the states that would lose out under the system and thus never enacted) would not be seen unfavourably by the federal level of government because of the increased power it would enjoy over health and education. This would thus have represented a Barnett-style system, but with a more direct ability for the 'federal' level of government to direct where spending occurs.

### Discussion

The Australian experience has some important pointers for the UK:

- It is possible to develop an alternative to the Barnett formula that takes explicit account of need.
- That any federal grant giving system opens up temptations by the grant giver to try to control where the grant is spent.
- A federal-state government arrangement can be particularly prone to attempting to direct where resources go if the federal government is responsible for substantial proportions of a state's expenditure through grants.
- That SPPs (and their associated agreements) represent an explicit, transparent, but complex, manifestation of this process.

In one way the present UK system overcomes the problems that appear to currently exist in Australia, because the UK government is also a *de facto* 'state' government for England. So it has an incentive to properly fund services such as health and education, given that the majority of the electorate live in England and the UK level of government will be judged on activity in this area. This does open up the issue, however, of the UK government's attitude to services in Wales and Scotland.

There is no easy, practical, and 'clean' solution to these issues. Full examination of regional need within a HFE system that devolves full power and responsibility for spending (allocative function) to the 'local' level (as advocated by Musgrave and Musgrave, 1989), has all the analytical problems of scale and need highlighted by Midwinter (1999). Alternatively, the UK government bringing control of funding and spending allocations for key areas such as health and education back to the UK level (to go with distribution and stabilization), but with devolved responsibility for delivery (such as that proposed by Garnaut and Fitzgerald for Australia) would partly bypass the regional tier of government, but would not remove contested governance. Neither would full control over spending and delivery for health and education be likely in reality for the UK, given the size of the budget grant (and thus policy area) that health and education represent for the Scottish and Welsh governments. Instead, some version of the concurrence of roles and responsibilities evident in the current Australian system is more likely.

### Conclusions

The choice in the UK is unlikely to be straightforwardly between a simple per capita Barnett-type system and an independent CGC formulae-based system of HFE. In practice, both these systems provide 'rough justice' for some, while the 'beneficiaries' will do all that is legitimately possible to maximize their positions. The true choice is between sets of institutions for governing lobbying and deal making in determining budgets, and the openness of these arrangements. Most importantly of all, it is clear that while the formula design and system constructed around it may affect the form and nature of the politics of intergovernmental fiscal relations, they do not remove politics altogether. Any CGC-type formula-based system, however independent the committee calculating it and however sophisticated the estimates of need and cost relativities, is subject to lobbying (see also Midwinter, 1999).

In Australia the use of SPPs, and the continued debate over their role, is an important potential development that may impact on the UK system in the future, possibly regardless of whether a CGC system is introduced. The creation of the devolved institutions in the UK, with attendant increased potential for contested governance, may increase the pressure for more explicit SPP-type arrangements to replace the often *ad hoc* and opaque formula bypass of the past. In some ways, of course, SPP-type funding measures have been an integral part of central government financing in the UK for many years, in terms of ring-fenced grants and similar funding arrangements, in EU Objective One funding for example. In that sense, therefore, use of such measures in a future replacement for Barnett would already have a precedent. Given the tendency of the federal tier of government to try to control important areas of expenditure, some element of SPP may be likely for areas such as education and health in particular in any changed arrangements, if the Australian experience is a guide. At a minimum, this could replace formula-bypass for specific elements of health and education, while the possibility exists for greater use of SPP arrangements to ensure (for the UK government level) a minimum per capita spend in these areas and/or incorporation of some measure of need and cost. The type of SPP (in particular how specific the coverage, regulation of roles and responsibilities) is of particular importance, however, to avoid the contested governance issues that currently exist in the Australian system.

This would be of particular importance with relation to any Council of Australian Governments (COAG)-type arrangement, where federal and state premiers meet to discuss these issues, which currently brings its own problems in Australia (for example, see Pickernell and McGovern, 2002; Kelly, 2006). More transparency and agreement in COAG-type arrangements involving more co-operative solutions, including agreed outcomes would, however, likely require giving up some sovereignty for genuine partnership agreements and better outcomes. The question would then be whether this is too politically difficult for programmes where political elements pervade.

This would, however, obviate the need for 'Barnett bypass', by making the governance arrangements more transparent in areas likely to become increasingly contested. While it would also give some degree of leeway for the devolved institutions to pursue different

policies, this would still allow the UK level of government some 'steer' over important areas of government expenditure, a solution perhaps more in keeping with the political realities of the UK's experience of devolution. Clearly there is no ideal technocratic solution to the problem of allocating public expenditure, and whichever system is adopted, the power of politics will continue to prevail. ■

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