Devolution: Economy and Finance

Does Devolution Bring an Economic Dividend?

Optimism about the positive economic effects of devolution were a strong factor in the devolution debates in Wales and the English regions, less so in Scotland and Northern Ireland. That optimism drew heavily on academic research on a 'new' economic regionalism which was perhaps too quick to draw generalisations from a combination of ambitious theory and a narrow range of case studies. More recently researchers have been more sanguine, balancing their initial optimism with a fuller consideration of the constraints on improved economic performance and on the negative economic impacts that devolution could bring. Table 1 sets out the potential 'pros and cons' as applied to the Scottish case.

Table 1: The Economic Benefits and Costs of Scottish Devolution

Potential Benefits	Potential Costs
Devolved policies better reflect Scottish preferences	The additional administrative costs of an additional layer of government
Democratic accountability via the Scottish Parliament improves efficiency of policy formulation and implementation, fosters innovation	Weaker disciplines of monitoring and evaluation (is HM Treasury a tougher driver of efficiency than the Scottish Parliament
Better information on the Scottish economic environment	The loss of economies of scale in the conduct of policy Increased 'rent-seeking' by interest groups better able to influence the Scottish than the UK Parliament
Barnett funding formula gives hard budget constraint and tax-varying power allows marginal changes to taxation and spending	Relative contraction of size of budget as convergence effects of Barnett bite Weak incentives due to lack of mechanism linking public spending with tax revenues raised in Scotland
Lower coordination and compliance costs vis-à-vis rest of UK	Reduced coordination with rest of UK with possible negative spillover effects both on and from Scotland

Source: Is Devolution Good for the Scottish Economy? Devolution Briefings No. 25 at www.devolution.ac.uk/Briefing_papers.htm

Whether or not Scotland (or any other part of the UK) is reaping the benefits or feeling the economic costs of devolution is not clear. We are still in the early days, and disentangling devolution effects from all the other variables that affect economic performance is difficult not least because the institutional arrangements for devolution were not simply, or primarily, responses to economic concerns. As one of our projects put it: 'the impact of devolution on the Scottish economy is likely to be complex, subtle and difficult to measure'.

What is clear is that economies across the UK have generally grown in the last few years, and that much of that growth has been driven by growth in public expenditures, notably on health. One effect in Scotland and Wales has been growth in public sector employment since devolution. This does not mean that the Scottish Parliament or the National Assembly for Wales are necessarily more 'statist' and less market-oriented than the UK government, though this is something they are periodically accused of. It means that they have spent the increases in their own budgets – which are automatic consequences of growth of public spending in England – on broadly the same things, in particular more infrastructure, more employment and higher wages in the NHS and in education.

Equally clear is that private sector-led employment growth and, as a consequence, overall economic growth has been weaker in Scotland and Wales than (parts of) England since devolution. The extent to which that weaker growth is due to devolution is unclear. Much is the result of long-term structural factors that six years of devolution cannot overturn. Some may have to do with the relative effectiveness of policy-making structures for regional economic development.

Our research on economic governance structures suggests that the Scottish Executive has developed more effective performance assessment and delivery mechanisms for its economic strategy *Smart, Successful Scotland* than the equivalent strategies in Wales. There, protracted institutional restructuring, culminating in the absorption of the Welsh Development Agency and other economy-related quangos into the Assembly, has so far hampered an integrated approach to regional economic development.

Devolution and Regional Economic Disparities

Though the effects of such Scottish-Welsh differences are not easily measured, they do point to a further possible outcome of devolution: that its effect may, in principle, be to widen economic disparities between regions. Most divergence will again be structural: long-term evolutions of economic structure mean that some places are better placed to open up into new growth sectors, while others face the effects of long-term structural economic decline; there is relatively that policy in the short term since devolution in 1999 can be expected to do. But still, some places may prove more able and effective than others – e.g. through more effective delivery mechanisms – in managing their regional economies.

Table 2 The UK's Regional Economic Disparities 1995-2003 (GVA/head, UK average = 100)

	1995	1997	1999	2001	2003
North East	84	81	79	79	79
North West	91	90	89	89	88
Yorkshire and Humber	90	90	88	88	88
East Midlands	94	94	92	91	91
West Midlands	93	93	92	92	91
East of England	97	96	95	96	96
London	146	148	152	150	151
South East	103	105	108	110	109
South West	92	93	93	93	93
Scotland	101	99	96	95	96
Wales	84	81	79	79	79
Northern Ireland	81	81	80	80	80

Source: National Statistics

Regional economic disparities have been central to the debate about the 'north-south divide', above all in England. Even a cursory glance at the crude GVA per head figures in Table 2 shows the persistent economic imbalance between the South East of England, including London, and the rest of the UK. Labour policies on strengthening regional administration in England, in particular the introduction of Regional Development Agencies, but also the abortive policy on Elected Regional Assemblies, was understood as a way of addressing that regional economic 'deficit' or of opening up the 'winners' circle in the south-east to the rest of England.

It was equally clear from the first set of regional economic strategies produced by the RDAs that they would not, of themselves, achieve this, as each highlighted more or less the same sets of objectives. The same objectives overlain on substantial economic differences appeared unlikely to bridge those differences and more likely, if anything, to entrench them further. The rethink that followed – a Public Service Agreement target on regional economic disparities in 2003 (Box 1) – was at best a partial response.

Box 1 2002 PSA target on regional economic disparities
"make sustainable improvements in the economic performance of the English regions and over the long term reduce the persistent gap in growth rates between the regions, defining measures to improve performance and reporting progress against these measures by 2006."

There are three issues left outstanding by that PSA target:

1. There is widespread scepticism – as expressed in Select Committee reports on the PSA target itself and later on the Draft Regional Assemblies Bill – that Whitehall departments are committed to devolving the powers and resources to the regional level in England that might give real grip on regional economies
2. Research conducted in 2002-3 for Whitehall departments by Iain Maclean confirmed that Whitehall departments generally had no means of disaggregating what they spend on a region-by-region basis. This supports our findings of insufficient administrative adaptation in Whitehall to regional policy agendas, and though changes have been introduced, casts doubt on how effectively Whitehall spending levers can be used for regional economic ends
3. The PSA target applies to England only, even though Wales and Northern Ireland appear at the lower end of the regional economic league table. The explanation is not obviously one of principle: if economic disparities are bad, why, in a shared state, should their badness end at the English border? The explanation lies much more in the fact that the levers foreseen for addressing disparities in England are now in the hands of devolved government outside England.

Coordination, What Coordination?

The restriction of the PSA target to England points to a wider feature of the UK's arrangements for devolution: there are few mechanisms beyond macroeconomic levers of fiscal and monetary policy that enable policy interventions for UK-wide economic balance or coordination. As in other fields there are largely informal and unsystematic interactions between civil servants and much less frequently ministers. It is not clear that these relationships generally consider or (where they do) have obvious policy instruments to mitigate 'spillover' effects of decisions on one jurisdiction on another that are inevitable in a single domestic economy.

Our econometric modelling of the UK as a 'multi-levelled' economy suggest significant spillovers are possible:

- *Vertically*, for example through a rigorous adherence to the Barnett formula, which would, through the formula's convergence effects, ultimately lead to significant contraction of the devolved economies
- *Horizontally*, for example through a negative effect, say, on the economy of North East England, of a major success of the Scottish Executive in attracting inward investment. In this case the net effect on the UK economy as a whole might well be a

positive one – but on the basis of Scotland's gains outweighing the North East's losses.

Territorial Financial Arrangements

The UK's arrangements for funding devolution are well-established. Baseline funding levels for Scotland, Wales and Northern Ireland – the 'blocks' – were set in the period 1979-82 at levels higher than per capita spending in England and have been adjusted incrementally since by the 'Barnett formula' and its variations. This mechanism allocates funding to Scotland, Wales and Northern Ireland at the *same* per capita levels as funding decisions for policy programmes in England. The allocation of increments on a simple per capita formula has the effect, in principle and over time, of eroding the initial per capita spending bonus set in 1979-82 and bringing down per capita spending levels in Scotland, Wales and Northern Ireland towards the English level – the so-called 'convergence effect' of the Barnett formula.

This system, which set blocks administered by the Scottish, Welsh and Northern Ireland Offices before devolution, was simply continued after devolution. The Barnett formula has the merit of familiarity, and its use has helped avoid serious dispute over territorial finance since devolution. But there are a number of problems which suggest the retention of these funding arrangements in the long-term will fall under challenge:

- They have no regard to 'need', that is to those differences in economic structure, topography, or patterns of social disadvantage which make particular types of policy more expensive to deliver in some places than others. If and when Barnett's convergence effect begins to bite – which is likely to happen first in Wales, which carries forward a lesser per capita bonus from 1979-82 than Scotland and Northern Ireland – we are likely to see calls for 'need' to be taken into account.
- With exceptions only at the margin, devolved funding is awarded as an unconditional block from the UK taxpayer. The Scottish Parliament has not yet used its power to vary the UK standard rate of income tax by ±3% (the 'tartan tax'). As a result there is no clear relationship between the taxes paid in the devolved jurisdictions, and the services citizens receive. This creates an accountability deficit at the heart of devolved government and arguable gives Scottish policy-makers little incentive to improve the tax take.