

## 4. An analysis of national and devolved economic policies the economics of devolution/decentralisation in the UK: some questions and answers\*

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\* The authors gratefully acknowledge the support of the ESRC (grant L219252102) under the Devolution and Constitutional Change Research Programme. We are grateful to the co-authors of the research papers that underlie some of the analysis of this paper, including the other members of the FAI's current (Linda Ferguson, David Learmonth, and Karen Turner) and past (Gary Gillespie, Donald MacLellan, Ya Ping Yin) regional economic modelling team and Nick Hanley. While this is the first version of a paper with this title, the authors have benefited from comments on presentations with similar titles to the ESRC's Seminar on Devolution and Policy Making, University of Ulster, February, 2002 and the CSPP conference, Glasgow, March, 2001.

### Introduction and background

In this paper we provide a non-technical account of recent research into the economics of devolution, with particular emphasis on work relevant to developments in the UK. We proceed by exploring a series of questions and answers intended to highlight the implications of this recent research for the conduct of regional and national policy. We organise the questions and answers into four main sections dealing with: the nature of decentralisation in the UK; government expenditure: taxation and economic development issues. While our focus is on the UK, the Scottish case figures rather prominently, since it effectively serves as a natural "laboratory" for the study of devolution in the UK, given the asymmetrical distribution of powers in favour of the Scottish Parliament as compared to the other devolved authorities, and the continuing lively debate on greater fiscal autonomy and independence there. However, we refer to other European and North American experience where this seems relevant to the UK case.

This summary differs from the full paper in two important respects. First, we have omitted all references and footnotes (to cut the length and simplify our account), but this is not of course intended to deny the importance of others' contributions. Secondly, and most importantly, while we identify the main questions that we pose in each area, we provide comparatively brief answers in this summary. We do not attempt therefore to provide a

full rationale for our responses and, in particular, provide no empirical evidence in support of them.

### The nature of decentralisation in the UK

*Does the type of decentralisation matter for the conduct and evaluation of regional policies in the UK?*

In principle there exists a continuum of degrees of decentralisation from simple regional transfer of administrative responsibility within a central government at one extreme, through delegation of some powers to lower authorities, to devolution with "full" fiscal autonomy at the other. While the full spectrum is not represented within the UK, a wide variety of forms of decentralisation exists with different forms applying to different regions. While the resultant marked asymmetry is a distinctive feature that is often noted, the complexity that it creates for the appropriate formulation and evaluation of policy is not yet well-understood. Fiscal federalism typically envisages systems of symmetrical decentralisation, and focuses primarily on vertical linkages. In the UK we have considerable asymmetry and also need to give explicit consideration to relationships *among* decentralised authorities.

*What issues does **delegation** raise for UK regional policy?*

Delegation to the RDAs, for example, can be motivated through asymmetric information, with regional agencies having better information than central governments about their own localities. In this context principal-agent problems arise where the government (the principal) can only imperfectly monitor regional agencies' (agents') efforts and moral hazard problems arise.

*What issues does **devolution** raise for UK regional policy?*

In general this depends on the precise form of devolution, but the issue does not correspond directly to a principal-agent problem (though this may be relevant for some reserved issues, where delegation is effectively involved), because there is a far greater degree of autonomy in this case (over

devolved issues). Preferences of the devolved authority in this case are of paramount importance. However, what this does imply is that there is some variation in preferences – and indeed this is a major part of the motivation for devolution in the first place. In principle this is very important for policy evaluation, because the weights that devolved agencies attach to different goals may – and indeed are likely to – differ.

### **Public expenditure**

*Would an increase in government expenditure in Scotland (financed through an increase in the assigned budget of the Scottish Parliament) be likely to stimulate the Scottish economy?*

Of course, such a policy could only be implemented by a decision of the Westminster Parliament, since the Scottish Parliament has no control over the scale of its assigned budget. However, it is the simplest type of expenditure change to analyse and therefore a useful starting point. Our response is that this will typically result in a permanent stimulus to economic activity in Scotland (there is not 100% “crowding out” within the recipient region – see below).

*Are there any circumstances in which employment within any region is invariant with respect to demand for that region’s output?*

There are limiting cases (involving either inelastic labour supplies or very elastic commodity demands), but they are unlikely to be applicable to UK regions.

*By how much is activity likely to be stimulated by an increase in government expenditure (financed through an increase in the assigned budget)?*

The effects may be non-trivial, especially in the long-run when capital stocks and population are fully adjusted.

*How long does it take for these effects to arise?*

Full adjustment can take many years.

*What about the effects on the rest-of-the UK?*

The increase in the Scottish Parliament’s assigned budget has to be financed somehow. If it is financed by a contraction in government expenditure in RUK, there are clearly negative effects arising from this. Until recently the Treasury view appeared to be 100% “crowding out” from the perspective of the UK as a whole: that is any stimulus to activity in Scotland must be offset by an exactly offsetting contraction elsewhere in the UK. We explain why we reject this view in Section 5 below.

*What if government expenditure changes also have direct supply-side impacts?*

Public expenditures may generate amenities that are valued by the public, as emphasised in the literature on fiscal federalism, but often ignored in other contexts. Furthermore, there may be direct supply side effects from e.g. training expenditures. If expenditures do have supply-side effects there is

even less rationale for assuming the effects of regional distribution of expenditures must automatically be neutral.

*Is the Barnett formula good news or bad for the peripheral regional economies of the UK?*

Some commentators appear to believe that the Barnett formula gives Scotland (and Wales and Northern Ireland) an unfair share of public expenditure, while others warn of the impact of an implied “squeeze” on expenditure in Scotland. Which of these views is correct? The answer depends in part on whether we focus on the *level* of the assigned budget or its UK share, and on whether the focus is on current cross-section comparisons, or future projections. The Barnett formula implies that Scotland’s initial beneficial position, in that its expenditure share exceeds its population share in the base year, is preserved in the form of a fixed amount of *nominal* expenditure. However, the real value of this fixed nominal expenditure and its importance relative to nominal government expenditure in England declines as the latter grows. Barnett therefore implies that Scotland’s expenditure share will fall through time, towards its population share. Ultimately expenditure per capita tends towards equality with that in England. This is the basis of the assertion that there exists a Barnett “squeeze”.

*But is the Barnett formula fair?*

In the UK context “fairness” in the regional distribution of expenditures is typically thought of in terms of whether regions “needs” are properly accommodated. The Barnett formula only takes account of population levels, and while we would expect needs to increase with increases in population, it is clear that there are many other determinants of needs.

*What would be the consequences for the peripheral economies of the UK of rigorous adherence to the Barnett formula?*

This would generate contractionary forces in the periphery, a tendency reinforced by the shift to a system of up-dating the population weights used in the formula (the Darling amendment).

*Do we need to be concerned about the contractionary impact of Barnett in the immediate future?*

Because the formula only applies to the increment to expenditures, it is likely to take a long time to achieve the long-run effects noted in the preceding paragraph.

*Does Barnett really matter in practice?*

Some argue that there is a more fundamental reason than the very extended adjustment process why we should not be unduly concerned, since their view is that Barnett does not in fact govern changes in the assigned budget. However, the evidence

since devolution is as yet too limited to permit a firm conclusion.

*Is the Barnett formula likely to survive?*

Not in the longer-run, although the highly asymmetric nature of devolution in the UK may inhibit radical change other than to an alternative *ad hoc* arrangement.

### **Taxation (and deficits)**

#### ***Do regional public sector (and current account) deficits/surpluses really matter?***

Most commentators, and official data published in GERS, imply that Scotland has a structural public sector deficit, essentially due to the higher per capita government expenditure that it enjoys, although there is no unanimity on this issue. The example of Northern Ireland, which has sustained large public sector deficits over a long period of time, suggests that it may not be the problem for regional economies that it is presumed to be for national economies, given central government commitment to the union.

#### ***What are the likely consequences of the Scottish Parliament exercising its current degree of fiscal autonomy and raising revenues through the “tartan tax”?***

*Were the Conservatives correct to warn of the likely adverse consequences of raising the tax to finance a balanced budget fiscal expansion?*

In practice what matters is the balance of the beneficial demand side and adverse supply side effects: so a negative outcome is possible, contrary to what simple Keynesian models tell us. However, such an outcome is by no means inevitable.

*Under what circumstances would there be no wage stimulus following a hike in the income tax rate?*

One would be where the Scottish economy is characterised by national bargaining, so that the nominal wage is unaffected by the expansion (and indeed the real wage moves “perversely”, to reinforce the demand effects). Even if wage bargaining is regional in nature, the tendency for local wages to rise can be moderated if the increment to public expenditure is genuinely valued by migrants and workers, and this is reflected in a willingness not to press for higher nominal wages.

*Can the Scottish Parliament influence the likely direction of the effects of the “tartan tax”?*

Possibly, if notions of a “social wage” and perhaps partial hypothecation is successful in moderating any union pressure in the wage bargaining process.

#### ***What are the likely consequences of a move to greater fiscal autonomy in Scotland?***

*What are the lessons from the literature on fiscal federalism in assessing the probable impact of greater fiscal autonomy in Scotland?*

There is now an extensive and impressive academic literature on the economics of “fiscal federalism”, which does provide strong intellectual arguments in favour of greater fiscal autonomy. Of particular importance is the improved efficiency that would be expected to result from bringing tax and expenditure decisions closer to those who benefit/pay as compared to a system of grant allocation (such as Barnett) that obscures incentives. There is also likely to be a greater stimulus to innovation as the local government would reap the benefits directly, and there may be a benefit in terms of increased participation in the democratic process. However, there are countervailing views and the evidence on even the efficiency effects of greater fiscal autonomy is mixed.

*Would “hard” regional budget constraints be “bad news” for Scotland?*

A movement to full fiscal autonomy in the UK would imply that surplus regions could stimulate their activity through tax cuts or expenditure rises, whereas deficit regions would experience contraction. If, as is believed to be the case in the UK, the South East is a surplus region and the peripheral regions are in deficit, full fiscal autonomy could have major adverse effects on regional equity in the UK.

#### ***What about other sources of revenue?***

*Current options?*

These are limited but have not yet been fully explored.

*Potential future options?*

Under full fiscal autonomy the full range of tax powers would become available to the devolved authorities (subject to EU restrictions), but little work has as yet been done the likely consequences for regional and national economies.

#### **Regional economic development**

This is perhaps the single most important aspect of devolution, in that most of the devolved economic powers relate to supply-side oriented development policy. This is apparent from the emphasis in, for example, Smart Successful Scotland and the Framework for Economic Development in Scotland.

#### ***If policy stimulates activity in a peripheral region such as Scotland, is this necessarily at the expense of activity in the rest of the UK?***

*Is there any rationale for the “100% crowding out” view that the Treasury appeared to adhere to until recently?*

Until very recently the Treasury tended to adopt the view that regional policy was simply about distribution: it could have no macroeconomic effects. A key problem with this view is that much recent regional policy has been supply-oriented, and there is no economic theory that implies general 100% crowding out of supply disturbances. At best, the

view would be applicable, then, to simple re-allocations of demand across regions of the U.K. However, the conditions required for 100% crowding out in the UK as a whole seem restrictive.

*What is implied by the view underlying the “new regional policy”?*

The 100% crowding out view appears to have been superseded by a focus that is very much on each region “realising its potential” and seeking to grow through supply-side-reform-induced productivity growth. Indeed, here not only is there apparently no adherence to the old notion of a 100% crowding out, but the impact of any individual region’s actions on any other region is ignored entirely.

*If not “100% crowding out” nor “autarky” what is it?*

We can be fairly confident that the truth is captured by neither of these two views of regional interaction (or lack of it), but not surprisingly identifying the correct view of interregional interaction is not straightforward. There is little alternative to detailed consideration of the demand and supply conditions of individual regions, for interregional interactions depend on the precise configuration of demand and supply sides of all the regions in the system.

*What are the consequences for devolved and delegated regional policies of the presence of “spillover” effects to other regions?*

Spillover effects arise wherever the policy pursued by one regional authority impacts on economic activity in another. These are typically regarded as externalities since under delegation or devolution there may be no reason why such effects would be taken into account by the authorities responsible for regional policies: their concern is with their own local economy.

*Are regional economies interdependent?*

Most economic theories would lead us to assert that they are through interregional trade and labour market linkages, for example. A wide range of alternative visions of the interregional economy imply the presence of some form of spillover (although traditional Keynesian models imply the spillovers from demand disturbances are most likely positive, whereas national supply constraints suggest that they are likely to be negative).

*Are UK regional economies interdependent? (Or, do spillover effects matter in the UK regional context?)*

Research is surprisingly limited, but what evidence there is suggests considerable interdependence. The fact that the migration process is extended means that typically it is the positive spillovers that may predominate in the shorter-run, but negative spillovers are more likely in the longer run.

*What are the implications for the conduct of regional policy under devolution/delegation?*

Suppose initially that the spillovers associated with a particular policy are negative but that devolved authorities are ignorant of, or simply choose to ignore, their existence. Then intuitively the devolved authorities would “overuse” this policy relative to the use that would maximise the welfare of the UK as a whole. Region 1 would implement this policy, but this would have an adverse impact on region 2, which might respond by further increasing its expenditure on this policy. In turn this would have a negative spillover to region 1 and so on. The presence of interdependence therefore may give rise to potential gains from the co-ordination of regional policies.

*What if spillovers are positive?*

Suppose spillovers had been positive, as suggested by literature that abstracts from the supply side, or is short-run in nature. Here the policy would be under-used relative to the socially optimal level, since the external benefits would not be taken into account by devolved or delegated authorities.

*Would gains from co-ordination be significant?*

There is as yet no empirical evidence on this at the UK regional level (although an extensive literature exists on macroeconomic policy co-ordination).

*Do Scottish Enterprise’s activities benefit Scotland/ RUK or neither?*

Some research suggests that SE’s policies always have a beneficial impact on the economies of Scotland and the UK, but not necessarily on that of the RUK economy, especially in the longer-run in the presence of strong migration responses.

*Does inward investment have beneficial impacts on the Scottish economy?*

There may be both costs and benefits associated with inward investment, but the latter probably predominate for greenfield investments.

If space permits, we shall also investigate questions relating to: *innovation; clusters.*

*How can devolved authorities assess whether their policies are compatible with their commitments to sustainable development?*

If space permits we shall consider the relevant issues.

## **Conclusions**

Our conclusions will seek to draw a number of general lessons from recent research into the economics of devolution, and identify lacunae for future research. The latter will include the need for further theoretical development relevant to policy formulation under the marked asymmetrical devolution of the UK, improvements in regional data (with respect to interregional trade and financial

flows in particular), and in empirical evidence (notably in relation to the nature and scale of spillovers and regional impacts of national policies).