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Devolution in a Downturn

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An extracted chapter from **Devolution and Practice 2010**, edited by Guy Lodge and Katie Schmuecker, forthcoming May 2010

April 2010

Institute for Public Policy Research
Challenging ideas – Changing policy

5. Devolution in a downturn: who'd have thought it would come to this?

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The UK economy enjoyed one of its longest periods of continuous economic growth between 1998 and 2008, a period that broadly coincided with the UK's first decade of devolved government. But in 2008 this growth came to an abrupt halt. Output dropped sharply. By late 2008 it was clear that the British economy was experiencing its deepest recession since the 1920s.

For almost a decade the devolved institutions in the UK reaped the benefits of this economic growth. Increased tax revenues allowed public spending to grow rapidly. Like other parts of the public sector, the devolved institutions enjoyed significant real increases in spending power. They applied this to the areas they had control over, such as health, education and transport.

Thus, during their first decade, the devolved bodies did not have to take unpopular spending decisions seriously. None embarked on significant reductions in the size of the public sector. They may have looked for efficiency savings, or reallocated resources at the margin between spending programmes. But they did not have to deal with the politics of withdrawing support from major public programmes. The next decade will be much more challenging for devolved government due to the public expenditure consequences of the recession.

This chapter looks at how the devolved administrations in the UK have dealt with the recession thus far. It considers the extent to which their existing powers enable them to institute policies to counteract its effects. It also details the types of measures that they have put in place and reflects on what the recession has revealed about the nature of the relationship between the UK government and the devolved institutions.

The recession

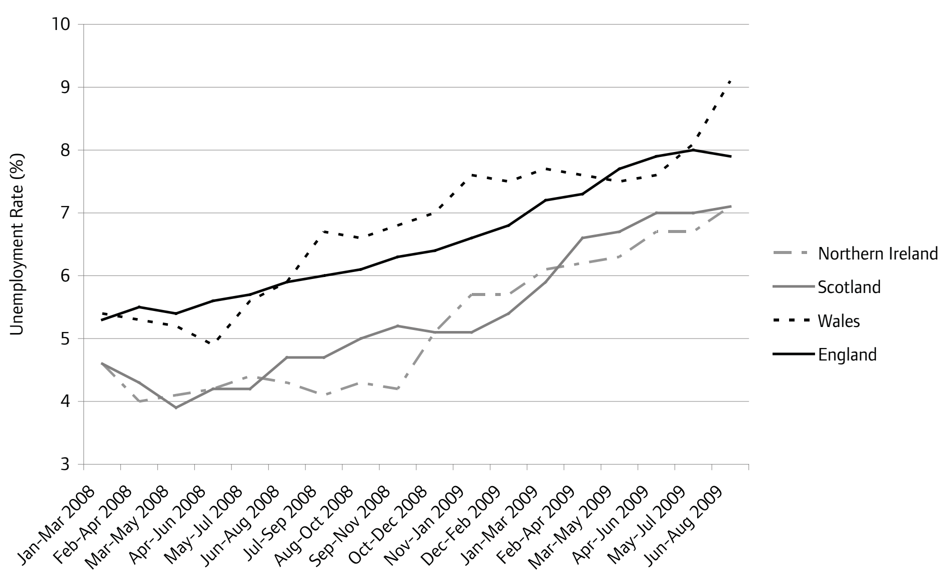
The genesis of the recession lay in the financial markets. Reckless expansion of credit in asset markets, particularly in housing and commercial property, led to a worldwide loss of confidence in financial institutions. This was particularly marked in the UK, Ireland and the United States. Central banks and national government had little option but to intervene to shore up these institutions, at great cost to the taxpayer. Forced by the authorities to reduce their exposure to risk, financial institutions cut back their lending drastically both to consumers and businesses. Businesses and households found it difficult to access loans: credit conditions moved from feast to famine almost overnight.

The result was not only a substantial cut in local demand for goods and services, but also a cut in the demand for exports, which had further adverse effects on output and employment. UK output fell by 5.4 per cent between the first quarter of 2008 and the second quarter of 2009, a decline unprecedented since the Great Depression. Between the second quarter of 2008 and the third quarter of 2009, UK unemployment rose by 841,000.

The recession has been especially harmful to the public finances. Borrowing increased at an alarming rate. The Chancellor of the Exchequer, in his 2009 Pre-Budget Report, forecast that the public sector deficit would be £178bn in 2009–10. This is in excess of 12 per cent of GDP, a peacetime record. The effects on the devolved institutions will come in the future: following the next election, whichever party is in power, the UK Government will have to put in place a credible plan to reduce the deficit, which will involve sharp cutbacks in Departmental Expenditure Limits (DEL). The Barnett Formula will ensure that the devolved administrations take their population share of these cuts.

The effects of the recession have thus far been broadly similar across the nations that comprise the UK. Figure 5.1 shows the path of unemployment in each of the home nations from January 2008: a broadly parallel increase in unemployment rates over

Figure 5.1: Unemployment rates, January 2008–August 2009



Source: Office of National Statistics (2009), Labour Market Statistics First Release, October the period to August 2009. While there are some minor differences in starting points and timing, the increases are broadly the same across the home nations.

Figure 5.2 takes a longer-term perspective on the unemployment data. It shows how the claimant count unemployment rate has varied in the home nations since devolution began in 1999. The increase in the unemployment rate during 2008 was very marked and followed a long period of declining rates in all of the home nations. The recession has reversed these advances but in international terms, the UK labour market has been more resilient than countries such as Ireland, Spain and the US, whose recessions also originate with the difficulties of the financial sector.

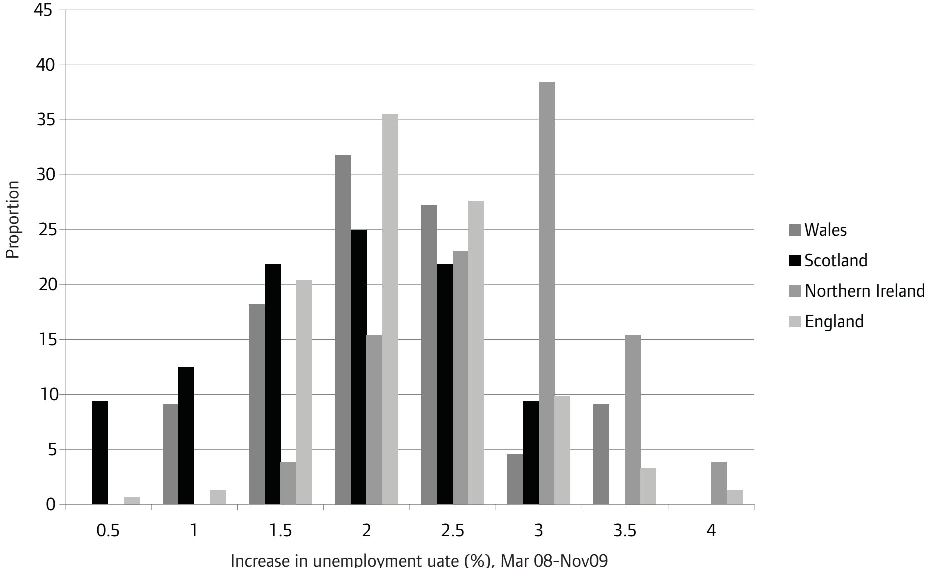
Figure 5.2: Unemployment rates since 2009

Source: NOMIS

Figure 5.3 illustrates the changes in unemployment within the home nations. It shows how the increase in the claimant count unemployment rate between March 2008 and November 2009 was distributed across the local authorities within each of the nations. It is evident that Northern Ireland has a larger share than the other nations of local authorities experiencing unemployment rate increases of 3 per cent or more.

Table 5.1 shows how broader labour market measures have performed across all parts of the UK during the recession. It gives the change in the numbers of economically active, employed, unemployed and inactive by region for the 12 months to August–October 2009. Since these data are based on the Labour Force Survey (LFS), they give a more complete picture of the labour market than the claimant count

Figure 5.3: Distribution of unemployment rate changes by local authority, March 2008–November 2009



Source: NOMIS

unemployment rate, which counts only those eligible for Job Seeker's Allowance. The rows are ordered by the increase in the broader LFS-based unemployment rate.

It is clear from the table that the West Midlands and South West have experienced larger increases in their unemployment rate than either Northern Ireland or Wales. However, the picture changes slightly when inactivity rates[1] are taken into account. In the UK as a whole, there has been very little increase in inactivity during the current recession. In previous recessions, the 'discouraged worker' effect led to large increases in the number of individuals, particularly older men, who dropped out of the labour market entirely. This effect was particularly strong in Wales and Northern Ireland during the 1980s. These areas still have high inactivity rates, but only in Northern Ireland has there been an increase during this recession (of 1.2 per cent). Thus, while the LFS-based unemployment measure implies that the Northern Ireland labour market is not performing as badly as the claimant count data show, the data on inactivity show that the overall effect of the recession on the Northern Ireland labour market has perhaps been worse than it has been elsewhere in the UK.

The downward path in economic activity is confirmed by data on output that are available only for Scotland, which show the decline in production there broadly matched that in the UK as a whole (Scottish Government 2009).

1. The economically-inactive are those out of the whole population, including those not eligible to work, who are not in the labour force.

Table 5.1: Labour market changes, 12 months to August–October 2009

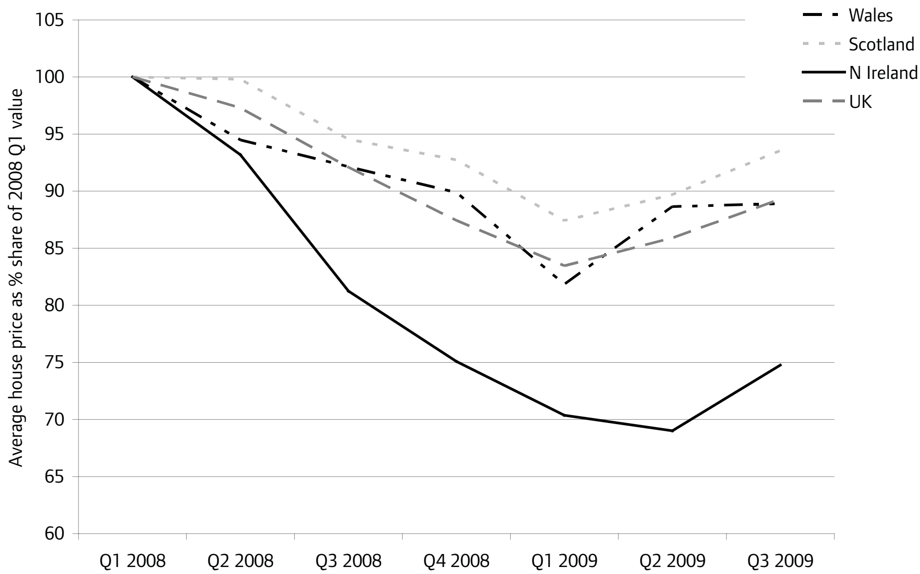
	Economically active		Employed		Unemployed		Economically inactive	
Age	16+ (000s)	16-59/ 64 (%)	16+ (000s)	16–59/ 64 (%)	16+ (000s)	16–59/ 64 (%)	16+ (000s)	16–59/ 64 (%)
North West	45	0.9	1	-0.1	44	1.2	-39	-0.9
London	64	-0.5	-5	-1.7	69	1.6	45	0.5
North East	14	-1.2	-33	-2.5	20	1.7	21	1.2
South East	1	-0.7	-77	-2.3	76	1.7	41	0.7
East Midlands	30	0.2	-15	-1.4	45	1.8	-3	-0.2
East	23	0.9	-35	-0.7	57	1.9	-27	-0.9
England	186	-0.1	-323	-1.6	510	1.9	60	0.1
Scotland	15	-0.3	-38	-1.9	52	1.9	12	0.3
Yorks & H'ber	5	-0.2	-47	-1.8	52	2	9	0.2
Wales	9	-0.1	-39	-1.8	30	2.1	2	0.1
N. Ireland	7	-1.2	-25	-2.7	18	2.2	14	1.2
South West	26	-1.7	-86	-3.5	59	2.3	53	1.7
West Midlands	61	1.3	-26	-1.3	87	3.1	-42	-1.3
UK	175	-0.2	-432	-1.7	608	1.9	96	0.2

Source: Office of National Statistics (2009), Labour Market Statistics First Release, November

There have been some small differences between the nations in the performance of the housing market (see Figure 5.4). The decline in house price values from the beginning of 2008 has been much more marked in Northern Ireland than in the rest of the UK. This may partly reflect its proximity to the extremely depressed housing market in the Republic of Ireland. But housing finance is not an area where the devolved institutions have a strong policy presence, reflecting the fact that the UK housing market has been lightly regulated in recent years.

The economic problems that the recession has caused seem to be broadly common across all of the home nations. Previous recessions were more focused on particular industries. Because these were not evenly distributed across the UK, past recessions were characterised by higher rates of unemployment in Wales, Scotland, Northern Ireland and the North of England. But it seems that this recession, perhaps because its origins are more financial than sectoral, is presenting the devolved authorities and the UK Government with broadly the same set of economic problems. For individuals, these include unemployment and associated issues of debt and poverty. Businesses

Figure 5.4: House prices, 2008 Q1 to 2009 Q3



Source: Nationwide Building Society House Price Index (www.nationwide.co.uk/hpi/)

are suffering not only from a drop in orders, but also from a sharp contraction in credit availability, which threatens their viability.

Employers' organisations and trade unions raise such difficulties with the devolved administrations, but their ability to respond is limited. They can offer advice and information, and have a limited ability to influence demand through government purchases of, say, affordable housing. But the policy instruments available to the devolved administrations are much less extensive than those held by Westminster, as will be shown.

Economic powers of the devolved institutions

The devolved administrations lack the economic powers needed to fight a recession on their own. Fiscal policy is reserved and monetary policy rests with the Bank of England. Furthermore, all policy matters relating to financial services and financial markets are reserved.

Most national or federal governments guard their right to control both fiscal and monetary policy, though different mechanisms exist to inform and/or consult sub-national governments about changes to these policies. The duty to consult might be seen as an impediment to decisive policy action by central government but international evidence suggests otherwise. In Germany, for example, the Financial Planning Council proposes fiscal policy actions at the Federal and Länder (state) level, and comprises Federal Ministers of Finance and of Economics, the Länder Ministers responsible for finance and four representatives of municipalities. The model has produced much greater fiscal discipline than in the UK. In the UK, there is ex-post explanation of the contents of the UK Budget by the Treasury in the devolved territories, but the devolved administrations have no defined ex-ante role in determining its contents. Determining how effective consultation is in changing outcomes is notoriously difficult to measure, but the fact remains that there are models outside the UK that seem to be more consensual in arriving at budget priorities whose fiscal outcomes are certainly no worse than those in the UK.

Most countries allow sub-national government to borrow as well as to raise some taxes. Part 3 of the Scotland Act restricts the Scottish Government's ability to borrow from the Treasury in Westminster to a maximum of £500 million. Such borrowing can be used only for temporary working capital. It cannot be used to fund public sector investment. The Wales and Northern Ireland Acts contain provisions for 'advances' by the Secretary of State to the respective Assemblies. In the case of Wales, the advance is not to exceed £500m and for Northern Ireland the limit is £250m. As in Scotland, these monies are to be used to meet temporary imbalances, rather than to fund capital spending. But in Northern Ireland a separate borrowing mechanism for capital expenditure does exist. This was agreed by the Prime Minister, Chancellor of the Exchequer and the First and Deputy Ministers in May 2002 and was introduced in the 2003 Budget. Known as the Reinvestment and Reform Initiative (RRI), it was designed to address infrastructure deficits and to modernise services following 30 years where security was the main focus of spending. The borrowing facility operates under the standard terms for borrowing from the National Loans Fund and is funded through revenue from rates. Recent borrowing from this fund has been around £200m per annum.

The Scottish Parliament, unlike its Welsh and Northern Irish equivalents, was granted the power to vary the basic rate of income tax by no more than 3p in the pound. In addition, it was granted powers over local authority taxation. These provide a modest control over aggregate taxation revenues raised in Scotland and so over the level of demand in the Scottish economy. However, the Scottish Government has never used this tax power, perhaps because it fears that it might lead the Treasury to reduce the level of Scotland's block grant.

The ability of the devolved administration to influence economic forces is therefore largely confined to the 'supply side' of the economy. For example, the Scottish Government can pursue economic development policies, such as improving transport or information infrastructure, and it can choose to spend resources on improving the quality of training and education. But it cannot make a significant impact on the demand side of the economy.

The workings of the Barnett Formula

On the spending side the devolved nations are funded by an annual grant from the Treasury. They have no control over the size of the grant but they do decide how it should be spent. Its value is determined by the Barnett Formula, which relates changes in the grant provided to the devolved administrations to changes in spending on 'comparable' programmes in England. Within the UK public expenditure framework, this type of spending is part of Departmental Expenditure Limit (DEL). Its value is set during the Comprehensive Spending Review (CSR), which reflects public spending priorities for the UK over the short to medium term.

The grant to each administration comprises the 'baseline' plus 'increment'. The baseline is made up of the baseline in the previous year plus that year's increment. The increment is determined by applying the 'comparabilities' in the Statement of Funding Policy to changes in DEL. The recent report by the Lords Select Committee on the Barnett Formula points out that this means that previous increments become embedded in future allocations, irrespective of their relevance to current need:

> *Thus everything in the past is taken as given. The original baseline when the Formula was first applied now represents barely one tenth of the total expenditure but there are a culminating series of new baselines, which become increasingly out of date, leading to further anomalies. Together, these account for the vast bulk of the block grant.* (House of Lords Select Committee on the Barnett Formula 2009)

The Barnett Formula is a convention that has been accepted by successive Labour and Conservative governments. It has no legal status and could be replaced by some other funding mechanism without legislative difficulty. None of the devolved administrations can be assured of its longevity and, as we shall see subsequently, this uncertainty has perhaps been part of the motivation for the recent reviews of funding in the devolved territories carried out in Wales (the Independent Commission for Finance and Funding in Wales – chaired by Gerald Holtham), Scotland (the Commission on Scottish Devolution – chaired by Sir Kenneth Calman) and by the House of Lords Select Committee on the Barnett Formula.

As well as DEL, total public expenditure (also known as 'Total Managed Expenditure' – TME) in the UK includes 'Annually Managed Expenditure' (AME), which comprises those elements of spending that cannot be so readily controlled over a time horizon longer than a year. Recessions tend to result in upward pressure on AME, mainly because it includes both social security payments and interest on the national debt, and these tend to increase during recessions. When overall public expenditure is constrained by the state of the economy, upward pressure on AME implies downward pressure on DEL.

Thus, if economic circumstances warrant cuts in overall spending, the devolved administrations have to adjust not only to an overall reduction in resources, but also to a further squeeze arising from the diminishing share of DEL in total public expenditure. This is illustrated in Table 5.2, which shows how DEL and AME resource and capital spending together contribute to TME from 2008–9 to 2010–11. With an overall budget fixed by the need to reduce the rate of growth of the public debt and AME spending increasing because of increased social security spending and debt interest, the squeeze on DEL is particularly apparent between 2009–10 and 2010–11.

Table 5.2: Departmental Expenditure Limits (DEL) and Annually Managed Expenditure (AME), 2008–9 to 2010–11

	2008–9		2009–10		2010–11	
	Amount (£bn)	Share (%)	Amount (£bn)	Share (%)	Amount (£bn)	Share (%)
DEL resource	321.2	51.2	342.2	50.6	353.4	50.0
AME resource	242.7	38.7	264.8	39.2	293.6	41.6
Total resource	**563.9**	**89.8**	**607**	**89.8**	**647**	**91.6**
DEL capital	48.1	7.7	56.6	8.4	52.7	7.5
AME capital	15.9	2.5	12.1	1.8	6.8	1.0
Depreciation	-18.7	-3.0	-19.2	-2.8	-20.1	-2.8
Net capital	**45.3**	**7.2**	**49.5**	**7.3**	**39.4**	**5.6**
Total Managed Expenditure	**627.9**		**675.7**		**706.5**	

Source: HM Treasury (2009)

The squeeze will fall most severely on capital spending, perhaps because it is anticipated that this will be less unpopular than cuts to resource (current) spending. Cuts in resource spending often lead to cuts in frontline services and/or public sector jobs, both of which carry significant political dangers. Between 2009–10 and 2010–11, DEL capital spending will fall from 7.3 to 5.6 per cent of Total Managed Expenditure. In practice, this means that the share of capital purchases in UK public spending will fall by 23 per cent over this period – quite a dramatic downturn.

Comprehensive Spending Reviews have taken place at irregular intervals since 1998, but are normally expected to occur every two years and to look three years ahead. Given the framing of the Scotland, Wales and Northern Ireland Acts, it is not surprising that there has been no significant overspend on the devolved authorities' CSR allocations, although as we shall see, the Northern Ireland Executive is struggling to keep its spending within current DEL limits.

There has been some history of underspend. This mainly occurs when capital projects are delayed or postponed, resulting in actual spending falling short of budgeted amounts. Underspends are given the rather curious title of 'end year flexibility' (EYF). These are held by the Treasury, but remain part of the budgets allocated to the devolved authorities. The rules governing EYF are set out in the Statement of Funding Policy. The most recent version of this was published in 2007 and states that the devolved administrations 'have a full discretion over the use of these resources' (HM Treasury 2007). In practice, this does not seem to be entirely the case. For example, the devolved administrations cannot shift EYF funding between capital and resource budgets. Furthermore, as the Statement says, 'expenditure cannot be anticipated': EYF is solely for underspends. It cannot be used to bring expenditure forward. The rate at which it can be drawn down into devolved administration budgets has to be agreed with the Treasury.

Because it has had a history of underspend, the Scottish Government now typically over-allocates its budget by a small amount. This reduces the likelihood that EYF will be accumulated with the Treasury, but also runs the relatively small risk of overspend if all budgets are fully spent during the fiscal year.

The inability to bring expenditure forward is important because a Keynesian response to recession would be to increase the level of government spending and fund this through borrowing. The Statement of Funding Policy precludes the devolved authorities from using EYF as part of a Keynesian strategy to boost demand, unless they have built up a reserve of EYF at the Treasury either by accident or design. There is clearly a political case for the devolved authorities to have more extensive powers to influence demand. Interestingly, however, the recession does not seem to have significantly heightened demands for fiscal autonomy. One exception has been the specific demands by the Scottish Government for powers to bring forward capital expenditure.

There have been clear differences in the use of EYF in recent years across the devolved administrations. Some have been more willing than others to draw down from their accumulated 'savings'. The Scottish Government has run down its EYF reserves most rapidly. This is shown in Table 5.3, which gives the value of EYF at the end of each fiscal year and expresses this as a share of the relevant 2007–8 DEL. It

Table 5.3: End Year Flexibility (EYF) (£m) and as share of 2007–8 Departmental Expenditure Limit (DEL)

	Scottish Government		Welsh Assembly Government		Northern Ireland Executive	
	Value (£m)	Share of DEL (%)	Value (£m)	Share of DEL (%)	Value (£m)	Share of DEL (%)
2006–7	1,528.6	5.6	607.0	4.4	912.5	9.1
2007–8	952.3	3.5	899.9	6.5	915.6	9.1
2008–9	669.8	2.4	970.4	7.0	675.1	6.7

Source: HM Treasury Public Expenditure Outturn 2006–07 to 2008–09 thus gives an estimate of the value of accumulated savings to each administration. Between 2006–7 and 2008–9, the Scottish Government reduced its share from 5.6 to 2.4 per cent; the Welsh Assembly increased the relative value of its EYF by more than 50 per cent, while in Northern Ireland, its value fell from 9.1 to 6.7 per cent of DEL.

The motivation behind the reduction in EYF in Scotland had little to do with the recession. The SNP Government realised that there were opportunities to increase the level of public spending in Scotland beyond that available in current DEL by accessing previously accumulated EYF. It agreed a rundown of these funds with the Treasury shortly after the publication of CSR 2007, and well before the beginning of the recession. As a result, public spending in Scotland in 2008–9 was around 3.2 per cent (5.6 per cent, less 2.4 per cent) higher than it would have been, had the decision to reduce the EYF funding not been taken. But, looking forward, the unspent EYF available to Scotland is less than that in Wales or Northern Ireland. Thus, if the recession is prolonged, Wales and Northern Ireland will have more of a safety net which they may be able to draw on to maintain levels of public spending.[2]

In the next section, we discuss the specific responses that have taken place within the devolved administrations to the recession. These measures have to be seen in the context of the framework for public expenditure in the UK that has been discussed in this section.

Responses to the recession

By the end of 2008 it was clear that the UK economy was rapidly deteriorating. In the November 2008 Pre-Budget Report, the Treasury introduced a number of measures to maintain a balance between supporting aggregate demand on the one hand, and thus preventing the recession from getting worse, and protecting the UK's reputation as a reliable borrower on the other. These included:

a) Temporarily reducing the rate of Value Added Tax to 15 per cent

b) Bringing forward £3bn worth of capital spending from 2010–11

c) Introducing a new higher rate of income tax of 45 per cent for those with incomes above £150,000 from April 2011

d) Setting an additional £5bn worth of efficiency savings for 2010–11

Measures (b) and (d) had implications for the devolved administrations. Firstly, as a result of the Barnett formula, the bringing forward of capital spending had 'Barnett consequentials'[3] for the devolved administrations. Because of the regulations laid out in the Statement of Funding Policy, the consequentials had to be restricted to capital spending. Thus, the 2008 Pre-Budget Report changed the plans set out in the CSR

2. There are no detailed plans regarding how such monies might be used, perhaps because of uncertainty associated with the process of agreeing with the Treasury how EYF will be drawn down.

3. If baseline DEL is changed, allocations to the devolved bodies are changed by their population share of such changes – these changes are known as 'Barnett consequentials'.

2007 and triggered an increase in government-funded capital spending throughout the UK. In Scotland it facilitated the bringing forward of £346m of capital spending from 2010–11 to 2008–9 and 2009–10. The downside was the offsetting adjustment that had to be made in the 2010–11 budget. Similar adjustments applied to the Welsh and Northern Irish accelerated capital expenditure programmes.

This illustrates one of the most important properties of the Barnett Formula. Increases in spending at the UK level are reflected immediately in the devolved administration budgets. There is no need to negotiate the strength of the case for increases in Scotland, Wales or Northern Ireland relative to England. But, as we shall see, there is also no need for the Treasury to negotiate with the devolved administrations when spending is being cut.

Secondly, the efficiency savings, insofar as they affected 'comparable programmes', would have negative effects on the budgets of the devolved administrations in 2010–11. In Scotland, the costs directly attributable to the efficiency savings were £392m. But a downward adjustment of £1.3bn in the Department of Health's capital budget resulted in a further £129m cut in the Scottish budget. These cuts became a potent political issue, with the SNP government claiming that the Chancellor had imposed £500m worth of cuts in the Scottish budget. None of these were cuts specifically imposed on Scotland. Rather, they were the Barnett consequences of decisions made about levels of funding in England. Similar but smaller effects impacted on Wales and Northern Ireland.

Compared with 2008, the effects of the 2009 Pre-Budget Report on the devolved administrations were negligible. Much to the regret of the SNP administration in Edinburgh, there was no extension of the capital acceleration programme. Due to economic uncertainty, but probably also partly for electoral reasons, there were no specifics on DEL beyond 2010–11. This leaves the devolved administrations in limbo: they know that, whichever party is in power, there will be significant cuts in their block grants from 2011–12 onwards, but they do not know how large these will be.

We now look in more detail at the specific policy measures that the devolved administrations have introduced in response to the recession. It is too early, however, to determine definitively how economically effective these may have been.

Responses – Scotland

The policy response of the Scottish Government to the recession is described in the Scottish Economic Recovery Plan (Scottish Government 2009) and the 2008 and draft 2009 Scottish Budgets. The Economic Recovery Plan is interesting in the sense that it provides a list of actions that the Scottish Government intends to take, but makes no attempt to set the difficulties that the Scottish economy faces in the context of a worldwide recession; neither does it look at the factors that might influence the depth of the recession or assist any future recovery. The plan focuses on three areas – jobs and communities, education and skills, and investment and innovation, which we discuss below.

In the category of supporting **jobs and communities**, the highlights include:

- An additional £120m investment in affordable housing in 2008–9 and 2009–10. This was partly funded by shifting capital spending from other parts of the capital budget.
- £50m to invest in council house building – a radical step given the lack of support for council house building since the time of Mrs Thatcher.
- Reduced rates for small businesses and an extension to the agreement with local authorities to freeze council tax.
- £35m to support home owners in financial difficulty and £60m for a shared-equity scheme for first-time house buyers.
- £60m for town centre regeneration and £30m to improve household energy efficiency.

Not all of these schemes are new: the freeze on council tax had already been in place for two years. The town centre regeneration fund was a concession to the Conservatives, necessary to ensure their support for the 2009–10 Scottish Budget. The major innovation was the acceleration of capital expenditure. But, as mentioned above, the overall amount to be spent on capital between 2008–9 and 2010–11 remained fixed. If some spending was brought forward to 2008–9 and 2009–10, less could be spent in 2010–11. It was not clear what the net effects of this rescheduling might be on tackling the recession. In response to the Scottish Parliament Finance Committee, the Cabinet Secretary argued that:

> *The Government hopes and believes that by accelerating affordable housing investment, for example, we can try to stem some of the losses in the construction sector. By 2010–11, there may be some recovery in private sector activity that allows construction activity to fill some of those gaps in the programme.* (Scottish Parliament Finance Committee 2008: para 54)

The Cabinet Secretary's judgement was that capital acceleration would tide the economy over until it emerged from recession. The difficulty was that such a favourable outcome was conditional on the recession being shortlived, which turned out not to be the case. The basis on which this forecast was made is not explained in the Economic Recovery Plan.

The second component of the Economic Recovery Plan focuses on **strengthening education and skills**, including wage subsidies in some circumstances, help for people facing redundancy, an additional £16m to support 7,800 apprenticeships, improving services for the unemployed and spending £16m on helping young people seeking to work in the community or third sector.

The scheme for those facing redundancy, known as PACE (Partnership Action for Continuing Employment), was partly funded by the European Social Fund. PACE had already been in existence for nine years. The recession involved closer partnership working, but the basic mission to provide advice and assistance to those facing redundancy did not change. Thus, not all of the policy measures that are listed in the Economic Recovery Plan were initially designed as responses to the current recession.

The final part of the Economic Recovery Plan focuses on **investment and innovation**. It includes increased incentives for businesses to use and pursue innovation, to establish a Scottish Investment Bank with initial funds of £150m provided by Scottish Enterprise, and to work with the private sector to increase competitiveness. The Scottish Investment Bank would be the first of its kind in the UK. It was intended that it would receive some funding from the European Investment Bank but is being told by the Treasury that the funds should be administered privately, rather than in a public sector organisation.

The Economic Recovery Plan in Scotland contains some elements that were already planned, and some that were the result of deals made previously to enable the last Scottish Budget to receive parliamentary approval (the SNP formed a minority government in 2007). Many of the measures are rather small in the context of a Scottish government budget that totals around £34.8bn in 2009–10. Most also focus on the supply side of the economy, for which it is too early to judge their effects.

The Scottish Government is not the only agency with responsibility for economic issues in Scotland. Another key body is the UK Government's Scotland Office which has taken an active interest in the impact of the recession in Scotland almost entirely distinctly from the Scottish Government. Since the beginning of the recession, the Scotland Office has been involved in consultation with key groups in the Scottish economy, such as the Confederation of British Industry (CBI) and the trade unions, and has championed measures taken by the UK Government that have affected economic conditions in Scotland. An example is the Future Jobs Fund. Announced in the 2008 Budget, this is a UK-wide fund of around £1bn aimed at supporting the creation of jobs for long-term unemployed young people and others. In July 2009, the Secretary of State for Scotland was able to announce that 2,800 jobs would be supported in Scotland as a consequence of this measure.

The interesting political aspect of this development is that the Scotland Office provides a mechanism for the Labour Party to claim credit for the effects in Scotland of UK macroeconomic policies intended to stimulate demand. This is no doubt intended to convey a message to the Scottish electorate that the UK Government is responsible for many of the policy measures focused on alleviating unemployment and economic recovery. The Secretary of State, Jim Murphy, is the focus for the local delivery of this message.

Responses – Wales

One of the key measures taken by the Welsh Assembly Government was to set up a series of Welsh Economic Summits. The intention was to use these meetings to facilitate information flows and to develop policies to respond to the recession. Eight summits had taken place by November 2009. They have usually involved the Deputy

First Minister, senior officials, businesses, social partners, community representatives and others. This is a more corporatist response to the recession than in Scotland, perhaps reflecting a more cohesive political approach in Wales to the difficulties that the recession presents.

The summits have focused on issues including:

- Skills, interventions by the Department for Work and Pensions, Jobs Programme and initiatives from Jobcentre Plus
- The role of the Strategic Capital Investment Fund and brought-forward expenditure
- Release of Assembly land for affordable housing purposes
- Sustainable development
- Green jobs strategy
- Social implications of the recession
- The contribution of further and higher education
- Procurement and prompt payment of invoices
- Availability of bank finance.

A second response is via the ProAct policy, which arose from ideas generated at an economic summit (see Keep *et al*, Chapter 6). It aims to help businesses cope with the downturn, and develop staff skills ready for the upturn, by providing training for employees who are on short-term contracts, and to keep skilled staff who may otherwise be made redundant by offering wage support. It is initially available until March 2010 and offers to meet training costs of up to £2,000 per individual and a wage subsidy up to £2,000 (£50 a day) per individual during training.

This measure bears similarities to policies introduced at the national level in other European countries. For example, both Germany and Italy have introduced subsidies to support short-term working: it has been argued that the relatively modest increase in unemployment in these countries is attributable to these policies. Nevertheless, because of their high cost, their longevity is in doubt. At a UK level, it is probable that such schemes have been rejected not only because of cost but also due to a belief that they may be ineffective. This is likely to be based on evidence from the past, such as the 1980s recession, when such schemes did form part of UK Government policy.

This touches on an important general principle. The devolved administrations are not necessarily familiar with the historical evidence of what does or does not work in terms of, say, labour market interventions. The same may even be true within Whitehall Departments (see for example Lodge and Rogers 2006). Even if the devolved administrations are familiar with the history, the use of evidence that is based largely on English experience may be politically problematic for them. The costs of gathering evidence on the effectiveness of policy in the devolved nations are also relatively higher than they are in England. Of course, the extent to which any policies reflect evidence is always in question at any level of government. But in the absence of effective mechanisms for sharing information, the devolved authorities are at a disadvantage in using such evidence to design policies compared with the UK Government.

A further initiative has taken the form of joint working between the Department for Children, Education, Lifelong Learning and Skills (DCELLS) and the Department for Work and Pensions. This initiative arose from a perceived need to harmonise the work these agencies perform in relation to supporting labour markets. This is also interesting in that it demonstrates a fairly high level of cooperation between a UK Government ministry and a devolved administration. In Scotland and Northern Ireland, cooperation with UK Government agencies is weaker than it is in Wales, perhaps reflecting the political difficulties which it might raise.

The Welsh response to the recession has emphasised partnership to a greater extent than the other devolved administrations. The ProAct initiative emerged from this. It provides the clearest example across all of the devolved administrations of direct intervention in the labour market to reduce the adverse effects of unemployment. While increases in unemployment in Wales have been relatively high, this does not mean that ProAct is not working, since unemployment might have risen further had it not existed. It cost £48m in 2009–10, a small fraction of the Welsh Assembly's budget.

As in Scotland, changes in the profile of capital spending announced in the UK Budget provided opportunities for additional capital spending in Wales. These were relatively modest: an additional £23m was announced in December 2008 and a further £41m in July 2009, with the spending being distributed across a large number of projects.

Another focus of the economic summits has been availability of finance for businesses. They have facilitated discussions between employer organisations and banks on the availability of credit. The Welsh Assembly has no direct powers in respect of bank lending, but has clearly been trying to persuade banks to increase lending. The devolved authorities may have limited policymaking powers, but this does not preclude them from trying to encourage stakeholders to take actions that would support recovery. They may have difficulty with the banks, however, since their immediate focus is on increasing their capital base rather than increasing lending.

Responses – Northern Ireland

The Northern Ireland Assembly published a three-year budget shortly after the publication of the Comprehensive Spending Review 2007 (Northern Ireland Executive 2007), meaning that this document did not anticipate the recession. After the stop-start history of devolution in Northern Ireland, this approach to budgeting marked a significant change. It anticipated the Northern Ireland Assembly would make its own decisions about priorities and resource allocation over a significant period of time.

However, progress on an economic agenda is difficult for the Assembly, while there are major unresolved political issues, such as responsibility for policing. As a result, specific actions to combat the recession have been more limited in Northern Ireland than in the other devolved nations. This is particularly problematic since, as we have seen, the province suffers from very high rates of economic inactivity as well as having experienced a rapid rise in unemployment during this recession. The Northern Irish economy has also been affected by its southern neighbour. Following the most rapid rise in house prices in any part of the UK in 2007, which to some extent mirrored the house price bubble in the Irish Republic, Northern Ireland has experienced a precipitous fall in house prices, creating difficulties for the construction sector and for those locked into negative equity.

The Budget has been dealt with somewhat differently in Northern Ireland than in the other devolved administrations. Thus, in March 2008, the Northern Ireland Executive decided to undertake a Strategic Stocktake of its budget position for 2009–10 and 2010–11. This was seen as an acceptable alternative to producing an annual budget for 2008–9 but the downside was that it meant that no immediate measures could be put in place to combat recessionary pressures. To counter this, the Minister for Finance and Personnel, Nigel Dodds, announced a number of measures in December 2008, which included:

- An acceleration of £9.4m of capital spending into 2008–9
- A review of the Northern Ireland planning system
- As in Wales, face-to-face meetings with local banks to encourage them to increase the flow of credit
- 20 per cent reduction in rates for those aged over 70
- Freezing of non-domestic rates
- £20m for the farm nutrient management scheme
- £15m for fuel poverty, which amounts to a £150 payment to 100,000 households in receipt of income support or pension credits
- £150 for pensioners on top of their winter fuel allowance of up to £250 for those aged 60 to 79 and £400 to those aged over 80.

The statement also notes that:

> *As a consequence of sustained dialogue with the Chief Secretary to the Treasury and the Prime Minister, an assistance package has been secured that is worth more than £900 million over this year and next. That includes access to funding to assist with our response to the current economic position, and the removal of significant cost pressures that we would otherwise have faced.* (Northern Ireland Assembly 2008)

This substantial payment, which is outside the Barnett Formula, is closely linked to the abortive attempt to privatise water services in Northern Ireland. The Northern Ireland Water Company was established in April 2007 on the basis of an agreement with the

Treasury that water charges would be introduced and the company would become self-financing. But the Northern Ireland Executive subsequently decided not to go ahead with this plan. In the absence of charge income, the Water Company's deficits have to be met from general public expenditure, costing the Northern Ireland Assembly more than £500m in 2009–10 and 2010–11 (Hewitt 2009). This expenditure reduces the latitude of the Assembly to introduce new policies in response to the recession, given that its total budget for 2010–11 will be around £9bn. Furthermore, the capital charges for water now have to be met from the Northern Ireland block grant. This will cost around £800m in 2009–10 and 2010–11 – thus using up a large share of the additional money provided by the Treasury in November 2008.

Additional budgetary difficulties were highlighted by the Committee for Finance and Personnel (2008) which, in its submission to the Strategic Stocktake, argued that some departmental plans were insufficiently detailed to be used as a basis for taking forward expenditure plans. Further, in his review of the public expenditure outturn in 2008–9, Sammy Wilson, Minister for Finance and Personnel, had to admit that several departments had exceeded their budgets (Wilson 2009). And, as Hewitt points out, further serious problems have arisen on the capital budget, with prospective shortfalls in the value of asset sales of £176m in 2009–10 and £435m in 2010–11, largely because of the collapse in property values mentioned above. In addition, there is around £100m in back-pay claims from civil servants that have not been budgeted for within or beyond the current CSR period. Further, transfer of policing and justice from the Northern Ireland Office to the Northern Ireland Executive is likely to have serious budgetary consequences. These functions are much more expensive in Northern Ireland than in the rest of the UK, but would fall within the remit of the Barnett Formula as a result of this transfer. This would result in significant downward pressure on other parts of the Northern Ireland Executive budget.

Thus the response to the recession in Northern Ireland is constrained by the difficulties that the Executive is having in managing its own budget. As Hewitt puts it:

> *[T]he financial situation facing the Executive is very tight and, consequently, there is very little capacity to launch new and expensive initiatives to address the recession unless existing programmes are cut back.* (Hewitt op.cit., p12)

Unlike in Scotland and Wales where social security benefits are administered centrally by the Department for Work and Pensions, Northern Ireland administers its own social security system. Though the rates and eligibility are largely the same as in Great Britain, Northern Ireland has recently broken rank with other parts of the UK by offering a significant top-up to Winter Fuel Allowance – boosting household incomes in the face of the recession.

To conclude, the Northern Ireland Executive is maintaining the level of demand in the local economy, but this is largely by accident rather than design. Spending not budgeted for in CSR 2007, changes in the planned privatisation of the water industry, and falls in the values of assets, mean that it has virtually no latitude to introduce specific measures to combat the recession. As mentioned previously, Northern Ireland's EYF is around 6.7 per cent of the value of DEL. It may have to further run down this source of funding to meet its commitments – and in an environment where the outlook for public spending in the UK is grim, there may be little option for the Executive but to cut back on its commitments to support public services, including those that may be aimed at alleviating recessionary pressures.

Northern Ireland may, however, benefit from events in the Irish Republic. In contrast to the lack of substantive recession-related policy action in the North, the Irish Government has been forced into making drastic cuts in the public sector and increasing taxes sharply to reduce its fiscal deficit. The Northern Irish economy is therefore benefiting from the acquiescence of the UK Government to the effective devaluation of sterling in relation to the Euro, which has given it a considerable competitive advantage over the Republic. This in turn has stimulated demand in the North, particularly in sectors such as retailing.

Conclusions

The recession has exposed the lack of powers within the devolved administrations to influence demand in their local economies and so stave off the adverse effects of falling incomes and increases in unemployment. But this is not unique to the UK version of sub-national governance. For example, although the German Länder appear to have more extensive taxation powers than the devolved authorities in the UK, their ability to differentiate fiscal policy is limited. They do control car tax and inheritance tax. But in relation to the major taxes, such as VAT, corporation tax and personal income tax, they receive fixed shares of total revenues collected. They cannot unilaterally increase or decrease the share that they receive when their particular economic circumstances change. Their ability to respond differentially to a recession is heavily constrained.

American states are able to exercise their tax powers more independently. But most are constrained from implementing expansionary policies because of their existing levels of debt. Indeed, part of the 2009 Federal Recovery Act is aimed at reducing levels of state debt by around $140bn, between 30 and 40 per cent of their aggregate indebtedness. Even with this subsidy, many states are already cutting back on spending due to worries over debt levels. Thus, 43 states have reduced spending on a range of services, including schools, colleges, universities and health-related programmes. Rather than maintaining demand, these states are taking active steps to reduce it. This illustrates that having greater political freedom to influence fiscal policy is no guarantee that there will be sufficient economic freedom to exercise such fiscal powers.

In most countries, federal or national authorities control macroeconomic policy. This is not necessarily harmful if national policy is sufficiently flexible to respond to differences in the impacts of the recession in different regions (known by economists as asymmetric shocks). One obvious danger with allowing devolved authorities the right to control demand at a local level is that of moral hazard: if devolved bodies overspend and debt accumulates, the federal authorities cannot guarantee such debt either implicitly or explicitly. Otherwise, there would be no incentive for the devolved bodies to control spending. Thus, for example, the granting of increased borrowing powers to the Scottish Government would have to be accompanied by cast-iron repayment guarantees based on tax-raising powers.

This discussion relates to the debate about extending fiscal powers, particularly in Scotland. This debate began prior to the onset of recession, but the recession has cast it in a new light. One major issue is that neither national nor sub-national governments can escape the constraints of the market in framing fiscal policy. If sub-national governments borrow from central government to fund expansion, then their policies will be constrained by the national policy stance, which inevitably will be influenced by the conditions under which central government can borrow. If sub-national governments borrow directly on the market, then these market constraints are more direct, as many American states have recently discovered.

The argument about whether additional fiscal powers would permit the devolved bodies to better deal with recession cannot be simply about their willingness to spend more than central government. All levels of government have to observe fiscal discipline either directly or indirectly. The argument for greater fiscal powers has to be more sophisticated: it might hinge on arguments that sub-national governments are better informed about local economic conditions than central government is and so may be able to adjust tax and spending plans to better align with the wishes of the local electorate and conditions in the local economy. This recession has perhaps shown that the freedom to make such adjustments is perhaps more heavily constrained by the market than had been imagined in the first decade of devolution.

The Calman Commission has made the case for extending the Scottish Parliament's fiscal powers. In particular, it argues in favour of giving Parliament a significant share of the income tax revenues it raises. This will lead to a reduction in the grant coming to Scotland via the Barnett Formula. The Commission acknowledges that ultimately the Barnett Formula may be replaced by a needs assessment. The case for a needs assessment has also been made strongly by the Holtham Commission, given that it is widely acknowledged that Wales is disadvantaged by the current funding arrangements.

It is also generally believed that carrying out a needs assessment for the nations of the UK would be an extremely complex process. However, a recent working paper by the Holtham Commission suggests that this may not be the case (Independent Commission on Funding and Finance in Wales 2009). It argues that a needs assessment could be carried out using only seven indicators of need and shows that these indicators could closely mimic the outcomes of the very complex needs assessments that are used to allocate funding to local government in England.

Using this small number of indicators and applying them to the devolved nations, the paper further shows that this surrogate needs assessment would result in a small improvement in funding for Wales relative to the current Barnett allocation. For Scotland, however, the effect would be dramatic: rather than receiving a Barnett-determined allocation of around 20 per cent per head more than in England, the gap would be squeezed to 5 per cent. Bell has pointed out that this would mean a reduction of around £4.5bn in the Scottish block grant, which would have very severe consequences for the provision of public services in Scotland and in turn significant political consequences (Bell 2009a). This effect would be independent of any reductions in Scotland's block grant that might result from recessionary pressures.

The devolved nations have been affected by the recession in broadly the same way as England has. This is perhaps the result of the origin of the crisis being in the financial sector: the consequent sharp reduction in lending has affected all parts of the private sector in the UK. The case for radically different policies in different parts of the Union to address the problems caused by the recession is not particularly strong. An argument might be made that policy experimentation should not be discouraged, since there are always opportunities for joint learning. But formal mechanisms to facilitate such learning within a UK context, such as the Joint Ministerial Committee, are not being used to their full potential.

In addition, the devolved nations find it relatively more expensive to properly evaluate policy interventions. There are also political barriers, in some cases, to the use of lessons from policy experience gained in England. An alternative approach is to utilise experience and advice from the social partners to develop policy. Wales has perhaps developed this mechanism to a greater extent than Scotland or Northern Ireland.

There is now little doubt that significant cuts to public spending will occur from 2011–12 onwards. The devolved administrations will feel their consequences through the Barnett Formula. Although there will be intense pressure to cut DEL, the effect on the devolved administrations' allocation will depend on how these cuts are distributed across UK Government departments. If, in the run-up to an election, political parties are unwilling to cut spending on health or education, the devolved administrations' budgets will also be to some extent protected, since these services account for more than half of devolved spending. The devolved administrations will not play any direct role in negotiating spending cuts, but may be prepared to forego that pleasure if, as a consequence of the Barnett Formula, they escape relatively lightly. In addition, as Bell argues, the 'Barnett Squeeze' goes into reverse when spending cuts are being made, so that the proportionate fall in spending in the devolved administrations is lower than that in England when DEL budgets are being cut (Bell 2009b).

Of course, there may be political consequences if Scotland, in particular, is perceived to be suffering less pain as a result of the idiosyncrasies of the Barnett Formula. This could hasten the formula's demise and bring forward an alternative funding mechanism, almost certainly needs-based.

Another political aspect of the recession is how UK policies are being presented within the devolved nations by their respective Secretaries of State. Whereas the Welsh and Northern Irish secretaries have played a low-key role, Jim Murphy, the Scottish Secretary of State, has been active in promoting any beneficial impact that UK Government policies have had on Scotland. This no doubt stems from a desire to counter SNP arguments about which institutions are having the greatest impact in alleviating the effects of the recession. However, there has also been some cooperation between the Scotland Office and the Scottish Government, with Jim Murphy attending a Scottish Government cabinet meeting for the first time.

But there is no doubt that UK central government has the strongest policy hand in dealing with recession. The weakness of the devolved bodies in responding to a demand shock is that they cannot significantly expand or reduce spending. Neither can they significantly change the tax burden. Instead the devolved authorities have limited powers to shift the time profile of spending, a policy likely to be of second-order importance in influencing aggregate demand. They may reallocate spending towards programmes that promote economic growth.

But again the effects are likely to be small given that all of the devolved bodies have claimed that they have used the promotion of economic growth as a guide to allocating spending even before the recession occurred. It is difficult to establish whether their influence on economic growth has been positive or negative, given that it is impossible to calibrate the counterfactual – that is, what economic growth would have been in the home nations had devolution not occurred. But at least the devolved authorities in the UK can console themselves with the fact that their relatively weak position in respect of the recession is not much different from that of many other sub-national governments around the world. National governments are rarely prepared to devolve macroeconomic policy.

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