EFFECTIVE DEVOLUTION

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Executive Summary

Brexit creates deep challenges for the UK's structure of governance; not least concerning the degree and manner in which powers are devolved within one of the most centralised countries in the world. Departing from the EU is likely to exacerbate regional inequalities and possibly social divide, while at the same time leading to further centralisation of powers, at least in the short term. Most Brexit analysis looks at the reorientation of the UK's external relationships, but the most significant impact may be on its internal constitutional affairs.

While it is generally agreed that the UK needs more devolution, there is little discussion about how and why it sometimes succeeds, but also sometimes falls short of expectations. Ever since Adam Smith it has been known that economic prosperity, justice, and social cooperation are mutually reinforcing. Therefore, policy must be built around community and a sense of belonging, rather than a collection of anonymous individuals. The Core Design Principles set out by Elinor Ostrom provide a framework to transform governance structure at every level from the smallest communities all the way to parliament.

Necessary institutional changes include giving local authorities much greater control over revenue-raising powers and therefore the services they wish to support. National legislatures must have the power to borrow for investment without limit, but with sole responsibility for repayment, to enhance local political accountability. A statutory body should be established, including representatives of the devolved assemblies and English regions, to address regional disparities, and there should be a much stronger regional presence in decision-making by HM Treasury and the Bank of England.

Introduction

Governance within the UK has changed profoundly over the past twenty-two years. Citizens of Northern Ireland, Scotland, and Wales have voted by referendum for their own national legislatures. More powers have been gradually devolved, culminating in the Scottish Parliament and Welsh Assembly, obtaining permanency within the UK's constitutional structures (unless citizens vote for dissolution). Some constitutional experts suggest that the permanency implies that the UK has become either a quasi-federal state, or at least a unitary state with federal characteristics.[1] Regional Development Authorities in England were abolished in 2010, and replaced with Local Enterprise Partnership and City-Regional devolution deals.

Brexit creates some deep challenges for the UK's structure of governance. First, some of the poorer areas that voted Leave will probably be most adversely affected. This may lead to further disillusionment and divide. Second, the UK Parliament has reclaimed some powers from the national legislatures through the EU Withdrawal Bill leading, at least temporarily, to more centralisation

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of decision making. The Supreme Court ruled that constitutional conventions were not justiciable, which raises questions about the status of conventions integral to the UK's constitutional arrangements. Third, the UK will be repatriating areas of policy from the EU including commercial, competition, and single market policy. This raises the question of how these powers will be devolved while respecting the need for a domestic single market?

Most economic analysis of Brexit concerns the reorientation of the UK's external relationships. Yet the most significant impact of Brexit may be on its own internal constitutional affairs. The aim of this paper is to contribute some policy ideas to this rare opportunity of constitutional change. While there is near-consensus that more devolution is necessary and a good thing, there is little discussion about how and why it sometimes succeeds, but also sometimes falls short of expectations. There is a gap between the abstract case for devolution and institutional design that makes the difference between success and failure. The ideas presented here are an attempt to bring the ideas of identity and local control, so clearly expressed in the Brexit discussions, into the heart of the debate.

Devolution

The classic justification for devolving economic decisions was given by Oates, writing in 1972. Local decision making is optimal where local preferences are sufficiently different, where there are no cost savings from centralisation, and where spillovers can be reasonably minimised. Subsidiarity implies that public services should be provided by the lowest level of government if these conditions are met. In this standard account, no distinction is made between whether the funds are raised at local or central government level: the emphasis is on preference revelation, information advantages, and competition.

Beyond this traditional 'policy assignment' question, regional policy has been based on the application of some very basic economic ideas. The argument posits that inventive people in poorer areas tend to move to richer areas for better job matches, thereby raising both their real wage and national prosperity. This migration of talent in turn reaps economies of scale and information advantages, in the process creating prosperous city agglomerations. Over the long term, prices adjust until businesses are eventually attracted back to the provinces. When Tim Leunig was pilloried for a famous speech in Liverpool's Anglican Cathedral for saying as much, he was sincere that this was the implicit assumption behind decades of regional economic policy.[2]

It is important to be explicit about what is left unsaid by abstracting from spillovers:

- **First**, there is no notion that the loss of talent and wealth in one region might lead to a deterioration in the expectations, conditions, or social behaviour of those left behind.
- **Second**, it is far from clear whether successful agglomerations can be easily replicated simply by central government spending.
- **Third**, if local public service provision is funded by central government, incentives are not always aligned, possibly leading to excessive spending, improper budgetary control, and a lack of local accountability.
- **Fourth**, if local governments instead fund their spending by borrowing, there is a risk of moral hazard to the extent that they expect to be bailed out by central government.

The question of how decision-making is devolved thus raises important questions that greatly influence the effectiveness of the policy. As so often with public policy, the details really matter. Given the challenges that this raises, the default position has too often been 'you can't buck the market'. This may be why the UK remains one of the most centralised countries in the world. But the price of centralisation is likely to be egregious differences in regional productivity, prosperity, and social cohesion.

Identity and location

Getting the prescription right for a post-Brexit world requires first an accurate diagnosis of the problem. The underlying causes have some commonalities with other countries but, borrowing from Tolstoy, every unhappy country is unhappy in its own way. The American Dream is a distant past for much of the rust-belt and fly-over states; in France the *gilet jaunes* began as a rural protest in response to fuel duties; and Hong Kong has been seeing the biggest per capita demonstrations in defence of the region's special autonomy. Elections in Austria, the Netherlands, Italy, Germany, and Eastern Europe show extreme voices based on regional grievances gaining a foothold. Each case shows widening disparities between communities, leading to division and political fragmentation.

Regional disparities in the UK are well documented in the excellent work by the UK2070 Commission. It claims that the UK is the most centralised major

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economy in the world, and that this is patently not working for many citizens. There is a plethora of evidence. Economic measures show that the amount that households have to spend or save in the ten richest local authorities is three times higher than in the ten poorest authorities. Social indicators show the divergence in healthy life expectancy is nearly twenty years between local authorities – and in some, absolute life expectancy is actually falling.

Ahead of the Scottish and EU referendums I was awarded Economic and Social Research Council (ESRC) Fellowships to engage with members of the public about the economic issues. I take three lessons from this experience:

- **First**, economic aggregates matter only so far. When there is so much variation between peoples' standards of living, talking about averages or national income means very little.[3] This is now immortalised by the woman in Newcastle who said, "that's your bloody GDP not mine".

- **Second**, Brexit is not a *ceteris paribus* question: all else will not be held equal. Trade reorientation due to Brexit might well cost 5 per cent of GDP, but this is not the full story, as many other changes need to be considered. On matters of constitutional change, 'all else equal' answers are incomplete.

- **Third**, identity and local connection are extremely powerful forces. In each discussion there would be different and strongly-held views, but a common sense of loyalty and commitment to the community.

Colleagues from the independent ESRC think tank *UK in a changing Europe* had more thorough and representative discussions in citizen assemblies and focus groups.[4] They found that people identified with their communities, and the most pressing issues were local, concerning crime, policing, community resources such as libraries and facilities, and pressure from immigration on shortages of school places and housing. Whatever the economic position of the area, people had a strong sense of what needed to be done in their communities. Yet there was also a sense of frustration at not having the tools or wherewithal to make the necessary changes. There is too much distance from policy makers, and from those in London and Westminster in particular.

Groups over individuals

All this raises the question whether the powerful sense of identity and community can be brought into a framework for effective devolution? This is part of a research agenda being led by the Social Macroeconomics hub of the ESRC's *Rebuilding Macroeconomics* network.[5] A new approach would start by focussing on 'groups' rather than individuals. This is quite natural. We humans are naturally prosocial animals, with feelings and affiliations for others; we can reciprocate; and even be altruistic and see matters from others' perspectives. Rather than assume that our preferences are given and stable, it is appropriate to recognise that our values are shaped by our social context, and that we share with others in order to help us navigate our uncertain world.[6]

Adam Smith's famous opening words in *The Theory of Moral Sentiments* remind:

> "How selfish so ever man may be supposed, there are evidently some principles in his nature which interest him in the fortunes of others, and renders their happiness necessary to him, though he derives nothing from it except the pleasure of seeing it."

This is a long way from being motivated purely by self-interest. Smith understood that we have emotional needs that can be satisfied only when we engage with others. Psychologists and neurologists identify emotions that are susceptible to uncertainty, and can be satisfied only by or with others. Being a member of a group involves accepting some values and patterns of behaviour of the group. These behaviours become a 'social identity', which evolves according to its members and circumstances. Groups can also erode or dissipate if behaviours and values are no longer being upheld.

Groups also have a spatial texture. Like his great friend David Hume, Smith believed that sympathy is strongest for those who are closest, and becomes fainter for those farther away.[7] Here there is a sense of a local community of people. Depending on the values and strength of identity within a group, it can command tremendous loyalty far beyond self-interest – and even the ultimate sacrifice. The psychological costs of violating group norms can be high, for example in terms of divided loyalties.

Economic efficiency

Groups also serve a vital economic role. Such are the uncertainties in the real world that, in most transactions, all possible eventualities can be known rarely, if ever, let alone agreed upon and priced in advance. In other words, we all live in a world of incomplete contracts. In some simple transactions, such as buying a cup of coffee, the uncertainty is resolved quickly. But many

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other transactions do not take place because the two parties cannot resolve to manage the risks. Groups, however, offer a durable solution to many of these problems, by creating informal and formal institutions (Arrow, 1992) – codes and customs that become stable behaviours that promote reciprocity and trust, allowing transactions to take place. Large groups can formulate formal institutions such as laws and public goods to overcome these risks.

Recent writings by Alex Lindbeck and Dennis Snower (2019) suggest that economic cooperation rests on social cooperation, and vice versa. Typically, the most successful economic groups tend to dominate the less successful groups. However, if the group fragments and cooperation is undermined, they become economically less successful. Evolutionary biologist David Sloan Wilson (2019) describes how this is exactly Darwin's great insight of natural selection.[8] Selection happens at the level of groups: those that sustain the most effective cooperation tend to be the most successful, and thereby perpetuate.

Our world is of course more complicated. Groups are necessarily nested within bigger groups in order that we live together in harmonious societies. If they are not nested, then we fragment along group lines. For example, social groups exist within a community, which exists within a region, which exists within a collection of regions or a nation. The past century even had groups of countries cooperating. Relations between the tiers of nested groups are paramount to social cooperation and prosperity. This resembles Gandhi's famous 'oceanic circles'. Edward Wilson and David Sloan Wilson (2007) refer to this as Multi-Level Selection.

Tragedy of the Commons

The basic arguments for devolution tend to abstract from the all-important practical issues of institutional design, and this can make all the difference between success and failure. Public sector action involves a collective effort to deliver goods and services, or to influence private actions to achieve outcomes that would not otherwise arise out of individual decision-making. Each of these public actions inevitably carries its own side-effects, which may variously be insignificant or important.

If local goods are funded from centrally collected money, the local authority may be less inclined to spend wisely. If local goods are funded through borrowing, the fact of support of others can lead to over-borrowing. These are versions of the 'Tragedy of the Commons Problem', whereby individual incentives can undermine the best social outcome. The standard economics answer is to privatise or regulate. Yet experiments demonstrate that imposing fines may 'crowd out' the very ethical behaviour that it is desired to promote (Gneezy and Rustichini, 2000).

An alternative approach to solving 'Commons Problems' is given by Elinor Ostrom, for which she (the only woman) was awarded the Nobel Prize in Economics. Rather than start from modelling individual optimising agents in a world without real uncertainty, she observed how groups around the world have actually found solutions. The observations are perforce grounded in real-world uncertainty, and they show people acting together as a group to achieve a better outcome for all members. From these observations Ostrom extracted eight Core Design Principles (CDPs), which determined the difference between success and failure in the groups she observed (Wilson *et al*., 2013). They are:

1. Strong group identity and understanding of boundaries and purpose.
2. Proportional equivalence between benefits and costs to members.
3. Fair and inclusive decision making by members.
4. System for community members to monitor members' behaviour.
5. Graduated sanctions for transgressions from group rules.
6. Fast, fair and low-cost means for dispute resolution.
7. Rule-making rights of community to be respected by outsiders.
8. Polycentric governance where nested groups must follow the same principles.

CDPs 1 to 6 apply *within* groups, and 7 to 8 apply *between* groups. They encourage members' actions to be consistent with the whole group. Principle 8 recognises that groups are nested within bigger groups; and yet the same principles apply at each tier. In other words, the principles are independent of scale. These principles give rise to the all-important question: how can they be used in the context of devolving power to achieve better outcomes in terms of citizens' engagement, greater inclusion, and more prosperity?

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Policy implications

This chapter began with the claim that the most significant impact of Brexit may be on the UK's internal constitutional arrangements. Narratives of being left behind, of elites and metropolitans, and taking back control reflect inequality, differences in identity, and a sense of disempowerment. More devolution may be necessary, but it is not sufficient unless it reverses these deep-rooted divisions.

The key question is how, or to what extent, devolution can harness natural, inherent, prosocial instincts to have more responsive and effective local policy that supports productivity and prosperity. Ostrom's CDPs show how groups within groups can lead members to work for the social good in real-world situations. Devolution is about more than delivering public services. The Lyons Inquiry into Local Government in 2007 introduced the idea of 'place-shaping' which includes building and shaping local identity, maintaining cohesion as well as understanding local needs and preferences.

The immediate governance challenge from Brexit is specific to Northern Ireland. A broader problem relates to Scotland, where 62 per cent voted to Remain. The Scottish Government has taken the opportunity to introduce a bill for a second Independence Referendum only five years after the last 'once in a generation' independence vote. This is only three years after more powers were devolved under the Scotland Act (2016), making the Scottish Parliament one of the most autonomous sub-central assemblies in Europe. While it is too early to reach firm conclusions, it is worth considering whether devolution has been consistent with the CDPs.

In keeping with CDP8, consider first local government. Scotland has 32 local authorities, designated as councils, that cover very different areas (e.g. Glasgow with 600,000 citizens, Orkney with just 20,000). Councils have a strong sense of identity and purpose, with councillors subject to a code of conduct with clear complaints, enforcement, and discipline procedures. However, they have little control over revenues. Local fees and customer receipts account for around 15 per cent of revenue; business rates and council taxes are controlled or capped by central government. This violates CDPs 3 and 7, and possibly 1. Local authorities have little power over revenue raising, and therefore the services they can support.

The Scotland Act (2016) devolved further spending, and especially revenue-raising powers, to the Scottish Parliament. More than 40 per cent of spending and revenue decisions are under the responsibility of the Scottish Government, and the Scottish Fiscal Commission and Audit Scotland provide important oversight. There are tight controls over the Scottish Parliament's borrowing powers. It can borrow to cover fiscal forecast errors and reconciliations from the National Loan Fund (NLF), an HM Treasury-subsidised account. However, capital borrowing has a statutory aggregate limit of £3bn (less than 2 per cent of GDP including oil). The funds may be borrowed from the NLF; commercial loans; or through the issue of bonds. Not surprisingly, the Scottish Government has opted to borrow from the NLF.

The capital borrowing limits clearly violate CDPs 3 and 7. They limit the freedom of the Scottish Government to make its own decisions, and diminish political accountability. Because it can borrow from the UK Government, the capital borrowing limits also violate CDP2, because borrowing from the NLFs is cheaper than market rates. Some have argued that devolving borrowing powers may lead to higher overall debt and an inflation bias (fiscal dominance). The risk of excessive borrowing is minimised where the authority has significant revenue raising powers (as in Scotland), with clear legal delineation of responsibility and with a clear dispute resolution system. Inflation bias is unlikely to hold where there is an asymmetry of size in the monetary union (Armstrong and Ebell, 2014).

Devolution must support a common UK identity and purpose for constituent nations consistent with the CDP1. At present, devolved governments and the UK government meet on an *ad hoc* basis through the Joint Ministerial Committee. This is a consultative committee that does not have statutory basis, does not make binding rulings, or even have a regular meeting schedule. The obvious weakness is the absence, or rather dual role, of England through UK representation. The question of English regional representation, which gave rise to Brexit, has to be grasped.

Finally, important economic institutions, such as the Treasury and the Bank of England, must also have a stronger and more substantive regional presence, and perhaps even some form of regional representation in decision making. The point may well have been reached where citizens of all constituent nations require significant institutional change if they are to believe that their economic interests are being represented fairly.

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Policy proposals

- *Local authorities should have much greater control over local tax-raising powers, including setting local business rates and council tax (or alternatives), to allow them to best represent local preferences.*
- *National legislatures should be able to borrow for investment without limit, but only from the private sector, and with sole responsibility for repayment to promote greater local control and political accountability.*
- *The Joint Ministerial Committee must be overhauled or replaced with a statutory body in which English regions are represented, to address regional disparities which in part gave rise to the Brexit vote.*
- *The Treasury and Bank of England must have a much stronger regional presence, and perhaps some form of regional representation in decision-making if all UK citizens are to be convinced that all have the same interests.*

NOTES

1 A shorthand distinction is temporary sovereignty is devolved while permanent sovereignty is federal.
2 This approach has been championed in the think-tank Policy Exchange's reports.
3 The closeness of the Scottish Referendum was the biggest surprise. By every economic, social and cultural measure Scotland is far more integrated with the rest of the UK than the UK is with the EU. There is an undisputed net fiscal transfer to Scotland. Yet Scotland came within 5 percentage points of becoming independent from the rest of the UK.
4 For example, see Menon and Bevington (2019).
5 See www.rebuildingmacroeconomics.ac.uk.
6 This distinction between trivial tastes and values goes back to the 1980s debates between Milton Friedman and Gary Becker on one side and Albert Hirschman and Amartya Sen on the other.
7 Forman-Barzilai (2010) suggests an enticing insight that Smith's meaning of 'sympathy' was a principle of judgement and influenced by cultural, affective as well as physical proximity. This means that we may have sympathy for others far away who perhaps share our values and culture.
8 Sloan Wilson (2019) cites the following passage from Darwin's Descent of Man: "It must not be forgotten that although a high standard of morality gives but a slight or no advantage to each individual man and his children over other men of the same tribe, yet that an increase in the number of well-endowed men and advancement in the standard of morality will certainly give an immense advantage to one tribe over another. There can be no doubt that a tribe including many members who, from possessing in a high degree the spirit of patriotism, fidelity, obedience, courage, and sympathy, were always ready to aid one another, and to sacrifice themselves for the common good, would be victorious over most other tribes; and this would be natural selection."

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