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Fiscal and Economic Decentralisation: Britain and Germany Compared

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Fiscal and Economic Decentralisation: Towards an Agenda for Policy Learning Between Britain and Germany

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**Anglo-German Foundation
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FISCAL AND ECONOMIC DECENTRALISATION

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Preface

This report is one of six commissioned by the Anglo-German Foundation in an effort to give added focus to its work in supporting comparative research and discussion of key issues facing policy-makers in both the public and the private sector in Britain and Germany.

Topics were selected for their relevance in both countries, and for their potential to yield policy-learning dividends. Authors were selected for their expertise in the 'state of the art' in Britain and Germany. They were asked to review current knowledge, and to identify gaps in that knowledge, which might form an agenda for future bilateral research and discussion.

The Foundation's Board of Trustees will use the reports, and the reaction and comments they generate, to assess the potential of each topic as an area of focus for future investment by the Foundation.

Key points

- In both the UK and Germany debates about the economic and fiscal implications of decentralisation are intense. There is a clear need for policy-relevant research to inform those debates. Research needs to reach across conventional disciplinary boundaries. Research needs to be aware of possibility of policy learning between jurisdictions within and across state boundaries.
- Questions about fiscal and economic decentralisation in the UK and Germany (and elsewhere) tend to revolve around a single conundrum: What is the right balance to strike between territorial social diversity (which imply divergences in standards of policy provision) and nationwide standards of social equity (which imply uniform, or 'equalised' standards of policy provision)?
- There is a global trend for the 'rescaling' of economic policy-making below the level of national governments, frequently dubbed the 'new regionalism'. This global trend intersects with the devolution process in the UK and debates about the reform of the German federal system.
- Research on the new regionalism has been fragmentary and spread across different academic disciplines. However, there appears to be a linking thread: the importance of bringing together regional actors in public and private sectors and civil society in support of a common project focused on economic innovation and competitiveness.
- Research has focused disproportionately on a small number of "cases – usually notably successful or notably problematic ones. Too little emphasis has been placed on the transferability of policy lessons from one case to other cases, especially the applicability of features of policy success to cases where the regional economy is structurally weak. The EU's attempts at stimulating policy learning have been under-researched, and the role of regions in EU structural policy over-researched.
- Regions may be seen as 'laboratories of democracy' engaged in a competition of ideas which fosters innovation, addresses regional preferences, diffuses good practice and in these ways strengthens regional and national economic welfare.
- Asymmetrical devolution in the UK, designed in part to express regional social diversity better, might be seen as a 'laboratory' process for addressing regional preferences and 'joining up' government. Initial post-devolution evidence – which needs to be developed further – is that innovations in one region are diffusing to others and increasing standards of policy provision. Research again needs to focus on how the diffusion (or learning) process happens.
- Aspirations for a more 'competitive' federalism in Germany might be fruitfully understood in terms of a similar 'laboratory' process of policy innovation, learning and, conceivably, reconvergence around new (not necessarily lower) norms of policy provision.
- Research needs to consider the constraints on policy innovation and differentiation as 'deployed' by national governments responsible for nationwide interests and standards and by popular expectations about social equity. Are national governments changing (or having to change) their conceptions of the national interest under the conditions of the 'new regionalism'? How can a better

understanding of the balance of national/uniform and regional/differentiated popular preferences be won?

- More work needs to be done on how the regional parts add up to a national whole. Such work could fruitfully draw on theories of fiscal federalism which set out trade-offs between the economies of scale of uniform policy provision and the territorial heterogeneity of social preferences. Applied fiscal federalism analysis could establish benchmarks: first, for how a German federal system under pressure to reform might be recalibrated and, second, for assessing the sustainability of asymmetrical devolution in the UK.
- Research needs to build a clearer idea of how national and regional economic policy decisions interact with, constrain and 'spill over' onto one another, both in the 'vertical', national-regional relationship and in the 'horizontal' inter-regional relationship. Fuller insights into these interactions could be won by developing territorially disaggregated models of the national economy or by using analogues such as the coordination of national economies in international organisations.
- The fiscal equalisation processes in the UK and Germany are the least well understood and most contested issues in operating decentralised government. The Barnett formula in the UK and the *Finanzausgleich* in Germany are both under long-term pressure for substantial reform, yet reform thinking in both countries is blocked by the balance of interests of the actors involved and by the parochial 'path dependencies' of policy traditions.
- There is a need to establish a wider 'map' of approaches to fiscal equalisation, building on experience elsewhere, in order to open up new alternatives for policy which would ensure positive incentives for all actors and provide adequate – and legitimate – assessments of fiscal needs. Additional work also needs to be done on the level and impact of fiscal autonomy (on the lines of the Scottish 'tartan tax', which has attracted interest in some German *Länder*).

1 Introduction

This report takes stock of the research on fiscal and economic decentralisation in Germany and the UK. It provides a map of the key conceptual and empirical issues and problems surrounding fiscal and economic decentralisation and builds a vision of where future steps in research might be taken. It is committed to setting out a research agenda which is *politiknah* – near to and relevant to the policy concerns with which policy communities in the UK and Germany are engaged.

This introduction sets out the context for taking stock of research under the heading of fiscal and economic decentralisation in Germany and the UK. It then sets out the approach the rest of the report will take in delineating the ‘state of the art’ and in setting out an agenda for policy-relevant research.

1.1 UK and German contexts

In both the UK and Germany debate about the territorial decentralisation¹ of government is intense. In the UK the Labour governments since 1997 have devolved important powers to new decentralised institutions in Scotland, Wales, Northern Ireland, London and the English regions. Powers have been devolved in a unique, asymmetrical pattern which has allocated extensive autonomous powers of legislation to the Scottish Parliament at one end of the spectrum, and limited powers of regional economic policy coordination to Regional Development Agencies in the English regions at the other. The full implications of these reforms are not yet clear, though their scale and ambition are – devolution, according to Tony Blair, is part of “the biggest programme of democratic reform ever proposed” (Hazell and Cornes 1999, 1).

An initial read-across to Germany reveals a very different situation. Since unification a persistent clamour for the reform of the federal system has run up against the buffers of *Reformstau*, a reform gridlock which has left Germany “timorously holding fast to the constitutional status quo” (Glaessner and Reutter 2001, 21). However, under the surface of this constitutional stagnation there has unfolded a vibrant debate about the renewal of German federalism. The broad thrust of this debate concerns the decentralisation of German federalism. There is a growing perception that the German federal system as currently organised leaves too little scope for territorial autonomy, that the system favours coordinated, nationwide policy solutions at the expense of policies tailored to the individual circumstances of the German *Länder*.

In both the UK and German decentralisation debates economic issues loom large (though are often overshadowed in research terms by work on constitutional reform,

¹ ‘Decentralisation’ is the term used here as a neutral common ground between the different constitutional assumptions underlying the concepts of ‘devolution’ in the UK and ‘federalism’ in Germany.

intergovernmental relations, and electoral processes). While UK devolution's primary rationale has been the concern to give fuller political expression to the social diversity of a multinational state – most notably in Scotland and, for different reasons, Northern Ireland – economic policy considerations have also played an important role.

Reflecting wider concerns about the growing ineffectiveness of central state intervention in regional economic management (see Section 2 of this report), devolution has also been about releasing 'endogenous' potentials within the regions, building economic development strategies 'from the bottom up', mobilising public and private sector actors at the regional level in pursuit of shared economic objectives. And in the English regions, where the identity rationale of devolution is at its weakest, this economic rationale has been the predominant argument for decentralisation (and is likely to be reflected as such in the White Paper on further reforms in the English regions which is expected in spring 2002).

The same sets of issues resonate in different ways in Germany. One of the main drivers of debates on decentralising German federalism has been the dissatisfaction of some of the economically more successful *Länder*, who argue that they have too little opportunity and incentive to innovate by investing their own resources into regional economic strengths and regionally defined economic priorities. However, strong counter-arguments, rooted in the ethos of cooperation evolved in the German federal system after the Second World War, stress the 'duty' of the 'richer' *Länder* to show solidarity with their 'poorer' counterparts by supporting them.

The debate is in essence about what balance should be struck between what the German Basic Law calls a 'uniformity of living conditions'² and allowing policy outcomes to be differentiated according to distinctive regional priorities, resources and capabilities. Logically enough, that debate has become much more acute since unification, which has introduced stark and territorially concentrated socio-economic disparities. In these circumstances pre-unity assumptions about both the desirability and feasibility of 'uniform living conditions' have increasingly been challenged.

It is in these circumstances that demands for a more decentralised and more territorially differentiated federalism have gathered strength. These demands produce, on the one hand – as in the UK – policy visions about maximising 'endogenous' potentials and, on the other, conflict over the allocation of resources. In all decentralised systems there are mechanisms of fiscal equalisation which attempt to allocate tax revenues vertically between the central and regional governments and horizontally among the regional governments in broad relation to the responsibilities that centre and regions are supposed respectively to exercise. In all decentralised systems periodic conflict over how best to divide up a finite fiscal 'cake' is routine. In post-unification Germany that conflict has become endemic as arguments about solidarity and arguments about providing incentives for economic success have been launched from either side of a now gaping divide between the richer western *Länder* and their poorer eastern counterparts.

Disputes about the territorial allocation of resources are also becoming prominent in the UK. The UK's system of territorial resource allocation – the 'Barnett formula' – was

² *Einheitlichkeit der Lebensverhältnisse.*

inherited from the pre-devolution era. Its operating assumption is that historically higher per capita public expenditure in Scotland, Wales and Northern Ireland should converge on a lower English baseline. The legitimacy of this assumption is, understandably enough, increasingly under challenge in Scotland, Wales and Northern Ireland. But 'Barnett' is also attacked from the other direction by English regions which feel they have a socio-economic need for per capita expenditures as high as or higher than the Celtic nations. The net result is a growing pressure for a review and reform of the UK's approach to fiscal equalisation.

1.2 Aims and structure of this report

These initial comments set the scene for this report on the current state of research on fiscal and economic decentralisation in Germany and the UK. They point to a set of issues surrounding the practice of economic and fiscal decentralisation which resonate strongly – albeit with different emphases – in the UK and Germany. These issues can be reduced to one central question, which is inherent in the operation of all decentralised systems of government: *What is the right balance to strike between territorial social diversity (which imply divergences in standards of policy provision) and nationwide standards of social equity (which imply uniform, or 'equalised' standards of policy provision)?*

This balance between uniformity and diversity is the leitmotif of this report. The assumption underlying the report is that while both the UK and Germany have to meet the challenge of defining what that balance should be, precisely how they do so reflects their national differences in political structure (asymmetrical devolution v federalism); political tradition (post-Thatcher neo-liberalism v German consensualism/corporatism); and economic performance (German growth rates are currently lagging behind those of the UK).

It is from these contrasting approaches to meeting a common challenge that important analytical and policy lessons can be drawn. It is the aim of this report to point to research challenges which have clear implications for opinion-formers and policy-makers in the UK and Germany. Developing and understanding contrasts through focused comparative analysis may identify where good – or better – policy practice lies. It may open up opportunities for policy learning and transfer.

No assumption is made about the location of good practice or the direction of learning. Each country may well have lessons for the other, and those lessons may be both positive and negative: they may be about what the other *might* do or what the other should *not* do. Where appropriate the report also draws on work on other places. Ideas developed about other places may well open up new ways of thinking about Germany and the UK. Both may have lessons to learn from elsewhere; neither have a monopoly on relevant knowledge.

Nor do particular academic disciplines have a monopoly on relevant knowledge. In different ways, using different analytical frameworks and methodologies, economists, human geographers, political scientists, public lawyers and accountants all work on aspects of fiscal and economic decentralisation. Where possible, perspectives from all these disciplines and their sub-fields will be drawn into this report. Logically enough, the

research agenda which the report sets out will also stress the need to work across conventional disciplinary boundaries.

Each of the four research themes of the report is thus cross-disciplinary, has a clear relevance to concrete policy challenges, and relates to the central question of balancing uniformity and diversity in decentralised states. Each theme is accorded a section of the report.

The first section, *Managing the Regional Economy*, explores the trend towards the decentralisation of regional economic policy-making in western democracies. It sets out ideas from partly disconnected debates in different disciplines on what regional governments can do to best maximise regional economic potentials, and explores how far these ideas have been applied in Germany and the UK.

The second section, *Regions as Laboratories of Democracy*, explores US ideas on the value of territorial policy differentiation in order to cast light on related debates in the UK and Germany: the notion that UK devolution is about providing a framework in which devolved administrations can develop distinctive policies to reflect territorial social diversity; and in Germany the reform model of a 'competitive federalism' which would (in some views) better match policy with distinctive territorial preferences and needs.

These first two sections look at regions³ as locations for autonomous and differentiated policy-making. The final two themes introduce a nationwide and multi-level dimension, reflecting the assumption that what the regions do needs in some way to be coordinated with what the country as a whole does. Section three is entitled *Managing the Multi-Level Economy*. It explores how the whole is coordinated with the parts by reviewing ideas on: a) what level of government should have what policy powers; b) how the coordination of powers and their outcomes at different levels should be organised; and c) how policy decisions made in one jurisdiction impact on the scope for policy decisions in another.

The final section, *Fiscal Equalisation*, reviews ideas on how to raise, allocate and redistribute national resources across levels and among territorial units. It explores the principles and mechanisms of the UK and German systems of equalisation, the causes and dynamics of the political conflicts which emerge around them, and the options for reform which might be developed, including the scope for fiscal autonomy at the regional level.

³ Despite inevitable semantic objections from the UK's constituent 'nations' and German Länder keen to emphasise their 'statehood', this report uses the standard comparative terminology of 'region' to describe the territorial units of both the UK and Germany.

2 Managing the regional economy

2.1 The new regionalism

Over the last 15 years or so there has been a growing interest in regions as locations for economic activity and management. This interest reflects some of the impact globalisation processes have had on the organisation of economic activity within states. As production and markets operate increasingly with a global reach, limits have been placed on what the traditional levers of economic management – those deployed at the centre of the state by national governments and parliaments – can do to manage national economies. These traditional levers of economic policy interventionism have in other words become increasingly redundant.

As a result, the central state has become progressively ‘hollowed out’. In the EU and in other regional trading blocs some powers of economic intervention have been pooled at an intergovernmental level. At the same time new processes and structures of regional economic government have often emerged to fill the gap within states. Decentralisation is a common, worldwide trend. Of 75 developing and transitional states studied by Garman et al (2001, 205, cited in Hooghe and Marks, 2001, 18), all but 12 were in the process of devolving some authority to the local or regional level. And in the EU no member state “became more centralised since 1980, while half have decentralised authority to a regional tier of government” (Hooghe/Marks, 2001, 18).

One of the main rationales for this resurgence of regional government is economic, to compensate for the withdrawal of central economic intervention by finding the right niche for the regional economy amid global economic flows. As Rosabeth Kanter (1995, cited in Goddard 1997, 3) puts it, economic policy decentralisation is about how to “thrive locally in the global economy”, how to build at the regional level “world class places” for economic location and development.

This rescaling of economic policy-making has broadly come to be known as the ‘new regionalism’ (cf Jeffery and O’Sullivan, 1994; Keating, 1998), a set of strategies for economic development which operate from the bottom up. This kind of strategy has increasingly replaced the old form of regional economic policy, where the central state designated development areas from the top down and then handed out cash to business as an incentive for development. Instead, the new regionalism is about nurturing and maximizing the ‘endogenous’ potential that regions possess in resources and know-how, and about offering different kinds of locally grown incentive – cultural, environmental, educational – to help tie down footloose global capital in the form of inward investment. Put another way, the new regionalism is about a shift from demand-side to supply-side economic intervention.

The Structural Funding policies of the EU add a nuance to the debate about the rescaling of economic policy-making. Member states have pooled significant powers of policy support for regions undergoing structural economic decline or other forms of economic disadvantage, not least in order to ensure common rules for policy intervention across the

union. The European Commission has introduced a series of reforms since the later 1980s designed to involve region-level actors in the formulation and, in particular, the implementation of these structural policies. Here, economic policy powers transferred from the central state upwards to the EU 'meet' with powers transferred downwards to the regions in a new pattern of 'multi-level governance'.

2.2 The policy debate in the UK and Germany

As was noted above, economic policy concerns have been part of the currency of the devolution debate in the UK. The neo-liberal reforms of the 1980s had the twin effect of exposing the UK economy to global market forces while at the same time for the most part renouncing traditional 'Keynesian' economic interventionism. However, the UK government at the same time resisted meaningful decentralisation of economic decision-making powers.

Only in the 1990s did economic development agencies in Scotland and Wales begin to build a profile as catalysts for mobilising endogenous resources and, in particular, attracting inward investment (though they remained subject to the UK-level Scottish and Welsh Offices). The establishment of Government Offices in the English regions in 1994 represented a more limited attempt to deliver central government policy initiatives more in line with specific regional circumstances and needs.

These developments remained, though, a half-hearted attempt to come to terms with new economic conditions and were limited by a suspicion, on the part of central government, of decentralised power. The election of the Labour government in 1997 transformed the political context for decentralised economic policy. The new devolved authorities in Northern Ireland (1998), Scotland and Wales (1999) and London (2000) were each accorded core responsibilities for regional economic development. These responsibilities also covered EU Structural Funding which is economically significant in the three Celtic nations.

In the English regions only limited powers of regional economic coordination were devolved to new, appointed, and business-led Regional Development Agencies (RDAs). The RDAs were given a strategy-setting role designed to 'join up' economic governance in the regions. The situation in England remains fluid, with strong pressure from parts of central government and parts of regional civil societies to move beyond this limited form of economic decentralisation towards elected regional government. A White Paper setting out a route to, and the functions of, English regional government is anticipated in spring 2002. Any move to regional government is likely to happen on a region-by-region basis and only following a yes-vote in a regional referendum. At this stage it is likely that only the North East region would be in the position to win such a referendum, though the other northern regions – the North West, Yorkshire and the Humber – are set to follow.

A reading of debates in central government in the run-up to the White Paper suggests that 'new regionalist' arguments are central to further English devolution. Much has been made of the need in the northern regions to open up a 'winners circle' (Tomaney, 2002, 4)

of economic success, which is currently limited to southern and eastern England. According to Ed Balls, adviser to Chancellor Gordon Brown:

Our new regional policy is based on two principles. It aims to strengthen the essential building blocks of growth... by exploiting the indigenous strengths of each region and city. And it is bottom-up not top-down, with national government enabling powerful local and regional initiatives to work by providing the necessary flexibility and resources (cited in Tomaney, 2002, 4).

If the UK is only now aligning itself and its economic policy infrastructure with wider 'new regionalist' trends, Germany has long been at the forefront of regional economic policy innovation. Regional economic policy is a core task of the *Länder*, and a number of *Länder* have been seen as 'market leaders' in developing new and successful approaches to policy. Some of the key examples include the 'regionalised' industrial policy which has revived areas affected by the structural decline of heavy industry in North Rhine-Westphalia (Jochimsen, 1992), and the economic dynamism of the two southern *Länder*, Baden-Württemberg (Götz, 1994) and Bavaria.

At the same time, many of the groundrules and major policy initiatives for combating regional economic decline have been set out since the 1970s through 'Joint Task' arrangements which link the federal level and the *Länder* in coordinated and consensual policy-making structures (and, where relevant, in the formulation and delivery of EU Structural Funding policies). A growing tension has emerged since German unification over the right balance of autonomous and coordinated policy-making. This tension reflects the widening of economic disparities since unification which have left one group of *Länder*, mainly in the east, dependent on cooperative arrangements for combating economic backwardness (including the EU Structural Funds) and another group, mainly in the west, which feels that cooperative policy structures inherited from pre-unity Germany are no longer appropriate and hinder their capacity to innovate and maintain their global competitiveness.

The demands for a greater regional economic policy autonomy and for the reduction or abolition of regional policy coordination have been one of the mainstays of the debate about introducing a more 'competitive federalism' (this is discussed more fully in section 3 below). As the Bavarian Minister-President Edmund Stoiber put it in 1996: "Through a competition of the *Länder* federalism can mobilise a significant potential for innovation for the economic development of our country" (cited in Fischer and Grosse Hüttman, 2001, 131).

These post-unification tensions, and concerns about the sustainability of cooperative policy-making in economic development, have shifted attention in Germany to the conditions for best mobilising 'endogenous' resources to maintain innovative capacity and competitiveness. In that sense there is a convergence with the UK: in both states there is a growing demand, fed by debates on decentralisation, for knowledge on how best regional institutions of government can build 'world class places' for economic location and development.

The knowledge supply – and its lacunae – can be assessed under conceptual and empirical headings.

2.3 Concepts and disciplines

On the conceptual side – how to understand the operation and management of the regional economy – it is striking how fragmented academic thinking has been. A number of perspectives on the regional economy have emerged from different disciplines. These in part cover the same ground, and in part stress different components of a successful, ‘ideal-type’ regional economic policy. Among these are:

- **Innovation capacity** (in the field of business economics): focuses on the capacity to generate new technological knowledge and transfer it to commercial applications. Places great importance on research and technology policy (including university and private sector research). There is a clear contrast between a German ‘model’ with a supportive, state-led (often regional state-led) environment within which companies can innovate and an Anglo-Saxon model with a competitive approach to public research funding and a venture capital market providing strong incentives for entrepreneurs to stimulate competitive advantage through radical innovation (eg Harding and Soskice, 2000).
- **Regional growth poles** (in the field of applied economics): focuses on how economic growth in a region can be initiated by ‘cluster’ patterns around a ‘propulsive’ set of industries which induce further development of economic activity throughout their zone of influence (eg Hochberg 2000).
- **Social capital** (in the field of political science): focuses on traditions of civic community, based on the existence of interpersonal trust; these are exhibited in particular in a strong ‘associational culture’, and are demonstrative of a capability of society to cooperate for common economic benefit. This model is associated with a tradition or work launched by Putnam (1993) and discussed by Grix (2001). It links into ideas about the ‘social embeddedness’ of the economy, which suggest that economic activity is not only determined by market forces but also by social norms and conventions.
- **Institutional thickness** (in the field of economic geography): focuses on the capacity of public and private sector actors to interact in policy networks supportive of regional economic goals (eg Amin and Thrift, 1995).
- **The learning economy** (in the field of economic geography): focuses on the dynamic process of innovation of production in a given space. This perspective is about how public and private sector actors combine their resources to install and preserve a dynamic that secures the competitive advantages of a region vis-à-vis competitors (eg Storper, 1997).
- **Multi-level governance** (in the field of political science/EU studies): focuses on how actors in the region maximise (or fail to maximise) the opportunity structures opened up by European Structural Funding and other EU policies with an economic impact in the regions (eg Hooghe, 1996).

2.4 Empirical challenges

It is clear that these conceptual approaches have much in common. They share an emphasis on the importance of bringing together regional actors in support of a common

project focused on economic innovation and competitiveness. There would be value in linking research across disciplinary boundaries. Such a synthesis raises a set of empirical questions for future research, including:

- What are the circumstances in which public sector actors (at regional, national and EU levels), firms and regional societies (in the form of shared norms) cohere around a common project?
- What can regional governments do to support processes of innovation and economic learning and create the conditions for firms to expand (or locate) in their regions? What are the components of an effective regional research and technology policy?
- How can regional governments create conditions for regional firms or industries to have a 'propulsive' effect on economic development throughout the region?

Naturally enough, research has sought to address these questions in the contexts of the UK and Germany. However, the empirical focus has tended to be partial, with a disproportionate emphasis on a limited number of cases. In addition, the changes in the policy agenda sketched out above mean that new questions need to be posed (or existing ones reformulated) to capture changes in policy context and maintain the policy relevance of research.

Empirical research has tended to focus on examples of regional economic success on the one hand, and examples of regional problem economies on the other. We therefore know a lot about Baden-Württemberg, Bavaria and North Rhine-Westphalia in Germany and equivalent examples of regional economic success in the UK, notably the successes in attracting (but not necessarily maintaining) inward investment in growth poles in South Wales and Scotland's 'silicon glen'.

Much of this work successfully mobilises the various conceptual ideas noted above: the creation by the North Rhine-Westphalian government of effective ('institutionally thick') public-private regional policy networks (Benz et al 2000); the successes of Baden-Württemberg in matching research and technology infrastructure with regional economic needs (Cost and Körber-Weik, 2002); and the attempts in Wales and Scotland to 'socially embed' new economic activities by playing on regional identity (Cooke et al 1995; Mitchell, 1997).

Much of that work is also open to the accusation that a generalised prescription of the conditions for regional economic success is simply being extrapolated from these essentially isolated examples of regional economic success. Too little emphasis has been placed on the transferability of policy ideas from one place to another. The assumption that, say, Baden-Württemberg has 'good practice' only holds if that practice can inform policy improvements elsewhere in Germany (or in the UK or other states). More emphasis needs to be placed on what facilitates and constrains policy learning.⁴ There needs to be a more rigorous examination of contrasts between examples of success and examples of weakness, and how lessons from the former may be applied in the latter. This theme is developed further in section 3 below.

⁴ The scope and processes of policy learning or transfer has itself become a major field for research and policy analysis. Cf Dolowitz/Marsh (1996) and the ESRC Research Programme on the Future of Governance at <http://www.hull.ac.uk/futgov/>

Work on economically weaker regions has focused disproportionately – but for obvious enough reasons – on the EU Structural Funds and the patterns of multi-level governance which has grown around them. We know a lot in this respect about the eastern *Länder* and those parts of the UK, in particular northern England and parts of Scotland and Wales, which have received Objective 1 or 2 Structural Funding.

Though the flow of new research on this theme shows no sign of abating, it is doubtful that it adds much value any more. The Structural Funding process is one of the most heavily ploughed research furrows in EU and regional studies. This weight of work has probably had a skewing effect which has arguably limited rather than advanced knowledge of how policy works across regional, national and European tiers of government (cf Jeffery 2000). Future work on the regional economy in an EU context could profitably develop different emphases, not least since the scale of traditional funding policies is likely to reduce after the current funding round, which ends in 2006.

More important now, arguably, and certainly more important in the future, are the attempts by the European Commission to use relatively small financial incentives to catalyse cooperation between regions in sharing information and ideas about common problems. Identifying examples of good practice, and diffusing it through structured dialogue and exchange was one of the key themes of the Commission's White Paper on European Governance published in 2001. It will remain an EU priority, not least as a means of speeding the integration of new member states. Testing the impact of this form of policy learning mechanism – whether UK or German regions 'import' or 'export' ideas – seems a research priority with a clear future orientation and policy relevance.

3 Laboratories of democracy

3.1 Regions as policy laboratories

A common denominator of the empirical challenges set out above is that of identifying, or benchmarking examples of good practice and opportunities for policy learning between regions. The ideas of benchmarking and learning are developed further in this section, which draws on the concept, familiar in research on US federalism, of regions as 'laboratories of democracy'. There is a notion in the USA that the existence of the states as 50 separate locations for policy-making promotes a 'competition of ideas' which fosters innovation, diffuses good practice and in these ways strengthens both regional and national economies.

The term 'laboratories of democracy' was a metaphor used initially by the US Supreme Court Justice Louis D. Brandeis in 1932:

It is one of the happy accidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory, and try novel social and economic experiments without risk to the rest of the country.⁵

Interest in this idea in the US has revived in recent years (cf Peterson, 1995), in particular since the vogue of decentralising policy responsibilities in US federalism in the Reagan era. Michael Greve (2001, 1) sums up the laboratory idea as follows:

Much can be said for the piecemeal diffusion of new policies: when we do not know what we are doing, it is best not to do it everywhere at once. A state-based process facilitates gradualism and, therefore, feedback and institutional learning. Successful state and local experiments... built confidence in innovative policies, and provided testing grounds for social scientists' models and policy recommendations that might have gone unheeded in a centralised policy environment. State-based policy innovation also facilitates adaptation to local needs, circumstances and preferences.

This ostensibly powerful theoretical case for decentralised policy innovation and differentiation has not been widely applied in European contexts, in part because of the notion that laboratory federalism in practice equates to a 'race to the bottom' as states reduce social and welfare expenditures either to reduce business taxation/regulation and retain competitive advantages or to deter citizens from other states from in-migration to enjoy supposed welfare largesse (Heaney and Lock, 1999). More generally, there is a stronger notion of social equity in European states – in Germany rather more than the UK – which has supported arguments for uniform policy provision.

⁵ Supreme Court judgement 285 US 262, 311.

3.2 UK and German policy laboratories?

However there are clear points of intersection between developments in regional government in Germany and the UK and the idea of laboratories of democracy. In the UK devolution is in part about giving fuller expression to territorial social diversity. The demand for devolution in Scotland and Wales (and in peripheral English regions) has much to do with a sense that the centre in 'London' was incapable of making sufficient allowance for clearly different territorial policy preferences. In particular there has been an assumption based in part on the strength of a traditional version of Labour Party politics that political cultures in Scotland and Wales are more 'egalitarian' than in England and have been ill-served by UK-wide policies which reflect a more individualistic English tradition.

Devolution in Northern Ireland is also about reflecting social diversity, but naturally in rather a different way: that of finding ways of accommodating and ameliorating the tensions of a society divided between two community traditions demarcated by Irishness/Catholicism and Britishness/Protestantism.

In these contexts, devolution might be expected to provide testing grounds for innovative policies better matched than policy designed in London to local needs, circumstances and preferences. This innovation potential need not be limited to economic policy, narrowly defined. It may more easily be possible to 'join up' government on a regional scale so that, say, measures on education, health or social inclusion can be combined with more traditional economic development policies as complementary components of an overarching strategy for growth. And, in theory at least, the generation of policy alternatives in different parts of the UK may throw up some worthy of emulation and may expose others as failures. Either way it would improve the general knowledge base for policy-making, conceivably leading to a re-convergence of policy across the devolved territories around new, commonly accepted norms of good practice (cf Keating, 2001).

There are of course limits to the scope for territorial policy differentiation in the UK. Some will reflect the need to maintain certain minimum standards of nationwide commonality and, therefore, state cohesion (see further in section 4). Others may reflect popular expectations of equitable treatment (for example in the National Health Service).

In Germany these constraints are clearly posted at a higher level than in the UK. As a multinational state the UK has always had a certain level of territorial differentiation. Germany, despite being a federal state, has sought rather more uniformity of policy provision, as reflected in the complex coordination structures of 'cooperative federalism' designed to mesh the federal level and the *Länder* together in meeting the constitutional task of 'maintaining uniform living conditions'. Popular expectations of equitable treatment are, as a result, higher.

However, some of the consensus on institutional cooperation in the pursuit of uniform living conditions has eroded since unification. Wider economic disparities between east and west and the consequently very different nature of social and economic policy challenges in east and west has made the pursuit of common goals increasingly difficult. It is in this situation that the idea of a more 'competitive federalism' has gained currency

and, in some views, now sets the agenda in debate about how the German federal system could be better organised (cf Fischer and Grosse Hüttmann, 2001; Jeffery, 2002a).

Put briefly, the vision of a 'competitive' federalism is one where the federal level would withdraw from areas of joint policy-making with the *Länder* (eg in regional economic development), where a wider range of legislative powers would be returned from the federal level to the *Länder*, and where the obligations of financial solidarity and equalisation among the *Länder* would be cut back in the cause of greater financial self-reliance. The outcome would be growing policy differentiation or an incipient German version of the US laboratories of democracy.

The driving forces in propagating a more competitive federalism have been the economically stronger *Länder* – Bavaria, Baden-Württemberg and Hessen in the south, North Rhine-Westphalia and Hamburg in the north. As such competitive federalism can be – and often is – seen as a self-interested agenda for the advancement of the 'rich' at the expense of the 'poor'. The result, in pessimistic evaluations of this policy, would be growing economic disparities and, for the economically weaker *Länder*, a German-style 'race to the bottom'.

3.3 Issues for research

Despite understandable opposition from the weaker *Länder*, it is clear that the German federal system is moving – in its practice rather more than its formal structures (cf Jeffery, 2002a) – away from older cooperative traditions and is adopting parts of the competitive agenda. In these circumstances there is a clear need for research to focus more clearly on the level of policy differentiation which results; on the evidence of policy learning and diffusion from 'pioneer' to 'emulator' *Länder*; and on what kinds of constraint exist on the scale of policy differentiation.

Much the same questions can be asked of the UK, where evidence of policy innovation is now beginning to accumulate: in Scotland on student tuition fees, teachers' pay, long-term care for the elderly; in Wales on prescription charges, child care policy and the handling of the foot and mouth crisis; in Northern Ireland on equal opportunities policy. In a number of these cases there is evidence that new policies in one place are beginning to diffuse into, or at least set the terms of policy debate in other places.

Tracking processes of policy innovation and the routes of transmission of policy diffusion are clearly – in the UK and in Germany – of vital importance in understanding the changing dynamics of decentralised governance. It may be the case that the UK's experience can act as an antidote to the notion, in Germany and elsewhere, that a regional competition of ideas has the negative outcomes of some form of 'race to the bottom': the evidence so far on issues such as student fees, prescription charges and equal opportunities suggests that the UK's regional 'laboratories of democracy' are ratcheting *upwards* the level of policy provision.

Finally, research needs to produce a better understanding of constraints on policy differentiation. At one level this is an issue for central government, whose stewardship of an overarching national interest – and whose competences for the national internal

market, citizenship and security policy – sets certain minimum nationwide standards. As devolution and moves towards a more competitive federalism shift the terms of policy debate, national governments need to rethink their national stewardship roles. Arguably they are only slowly coming to terms with a changing form of decentralised politics. Research needs to show where they have got to, and what more they need to do.

A final constraint on policy differentiation concerns popular expectations on social equity. How much differentiation do people want, how much will they take, and how do we know? In both the UK and German there is conflicting evidence on public attitudes to uniformity of policy provision. When asked in opinion polls whether they want policy conditions to vary, Britons and Germans typically say no (cf Grube, 2001). Yet when voting in regional elections (or asked about voting intention for regional elections) they tend increasingly to act differently from national elections (cf Jeffery and Hough 2001; Paterson et al 2001). The latter ostensibly signals a demand for regional differentiation, the former its opposite. Research needs to find ways of plotting a more reliable course between these two conflicting indicators and identifying credibly just where popular constraints on policy differentiation lie.

4 Managing the multi-level economy

4.1 Regions – and the States they are in

The second and third chapters of this report have focused on regions and their economic impact individually, largely in isolation from the wider state structures of which they form part. The emphasis has been on the factors that may improve any one region's economic performance, or the policy lessons and demonstration effects any one region may have for any other, whether in the same or a different states.

The emphasis shifts in the final two sections to regions as components of larger nation-state and national economic structures. The underlying assumption is that if regions have substantial autonomous policy-making powers with an impact on economic activity and performance, then what regions 'do' to their economies poses a challenge to national economic policy. Developing the theme raised at the end of the last section, the remainder of this report is about how the regional can be coordinated with – or constrained by – the national.

This section explores ideas about how regional and national economic policies interact. It sets out a number of approaches, largely drawn from economics, which cast light on this regional-national relationship, yet which have not been the focus of sustained research in the UK or Germany. The first sub-section sets out ideas on competence allocation across tiers of government drawn from the largely American research tradition of fiscal federalism. The following sub-section explores understandings of regional-national policy coordination.

4.2 Fiscal federalism and competence allocation

Fiscal federalism is not just about the allocation of tax and other government revenues across tiers of government. More fundamentally it is a branch of economics which theorises the optimal allocation of policy competencies across tiers.⁶ It sets out a trade-off between the economies of scale of centralised policy provision and the territorial heterogeneity of social preferences (eg between Scotland and Northern Ireland or Bavaria and Mecklenburg-Vorpommern).

At the most general level the traditional theory of fiscal federalism suggests that central government should have the basic responsibility for macroeconomic stabilisation, social security and national defence. Decentralised levels of government, by contrast:

⁶ The following relies closely on Oates (1999, 1121–24).

...have their *raison d'être* in the provision of goods and services whose consumption is limited to their own jurisdiction. By tailoring outputs of such goods and services to the particular preferences and circumstances of their constituencies, decentralised provision increases economic welfare above that which results from the more uniform levels of such services that are likely under national provision (Oates, 1999, 1121–22).

Within the parameters of these principles, there is, naturally, tremendous room for qualification and interpretation. In certain policy fields – or in some political cultures, arguably that of West Germany before 1989 – social preferences may be uniform at the national level and lack regional differentiation. More generally, the distribution of social preferences may not match regional boundaries. And the dividing line between economic activities or policies with a limited regional impact and those with significance for macroeconomic stability may be blurred and shifting. Finally social preferences for uniform, nationwide and differential decentralised provision may shift over time.

Nonetheless, the central principles of fiscal federal theory can provide a set of abstract reference points against which to measure policy practice. The transformation of German society as a result of unification has certainly had an impact – as has been suggested throughout this report – on the balance of homogeneity and heterogeneity of social preferences in Germany. There is now significant evidence of growing demand for regionally heterogeneous policy solutions ranged against a set of policy structures designed to deliver 'uniformity of living conditions'.

Out of this mismatch reform pressure (for a more diverse or competitive federalism) has built. An application of ideas of fiscal federalism might open up 'objective' benchmarks for policy-makers to refer to in the event of a recalibration of policy responsibilities in the German federal system (cf Stahl, 2000). It may also provide a means of thinking about what public policies still need to be delivered uniformly and which can – or should – be allowed to vary with the aim of increasing overall economic welfare.

An equivalent application of the principles of fiscal federalism may also serve to illuminate the dynamics of asymmetric devolution in the UK. Asymmetrical devolution may be seen as an answer to the problem of an asymmetrical distribution of social preferences with, for example, a stronger demand for distinctive policies in Scotland than in England. It has led to an odd situation in which the UK central government makes some policies with UK-wide application, some which apply to Great Britain (ie without Northern Ireland), some to England and Wales, and some to England alone.

This situation – which has come about as the net result of a series of essentially unconnected devolution reforms – has been characterised as inequitable, unstable and unsustainable (cf Hazell and O'Leary, 1999). That may or may not be the case. Asymmetry may (coincidentally) have created a map of policy responsibilities which 'fits' the distribution of social preferences. Research using ideas of fiscal federalism may offer a means of gauging the closeness of 'fit' and of justifying and shaping reforms.

4.3 Coordinating regional and national economic policy

What fiscal federalism does not do is offer much insight into regional-national policy coordination. It is about the delineation of powers rather than their interaction. Yet in reality policy decisions at one level shape policy conditions at another. Relatively little is known about the transmission processes through which policy decisions taken at one level mix 'vertically' with decisions at others.

Central governments (and/or the EU) retain key monetary and fiscal policy decision-making and basic framework-setting powers (eg on competition policy/subsidy controls) which set a context of constraints in which regional governments make policy decisions for their regions. The debate about the 'one-size-fits-all' interest rate policy of the Bank of England – widely seen as inappropriate for large parts of the UK – is a key example. We also know little about how centrally decided changes in fiscal policy (including fiscal equalization), or changes in regulatory frameworks for competition impact territorially.

Equally we know too little about the 'spillover' impact of decisions made in and for one region on other regions (eg greater incentives for inward investment in one place may deprive another of investment opportunities). Some regions may even have sufficient economic weight for their economic policy decisions to have national repercussions (as might be the case, for example, in North Rhine-Westphalia in the German context, or as would be the case in the UK if the Greater London Authority were allocated greater economic development powers).

There is clearly a need to know more about these 'vertical' and 'horizontal' economic policy 'spillovers'. They can be addressed in two ways:

- by developing territorially disaggregated models of the national economy and exploring the impact on the model of changes in key variables
- by thinking about how economic decision-making powers are best allocated across levels, and how they may be best coordinated with one another

In neither field are there fully developed research literatures upon which we can draw, although there are some examples of territorial economic modeling in both countries (eg McGregor et al 1997) as well as useful analogues (including studies of national economic policy coordination in international organizations – cf Hughes Hallett 2000) which can help begin to map the research agenda.

This is a field in which central and territorial UK government actors have expressed especially strong interest in relevant research. Similar interest can be expected in Germany as ideas on 'competitive federalism' and policy differentiation gain in currency. A better understanding of spillover effects will have a clear relevance for improving macro-economic management and for fine-tuning the coordination arrangements which exist for balancing regional and national economic programmes ('concordats' in the UK, intergovernmental coordination machinery in Germany).

5 Fiscal equalisation

5.1 The equalisation problem in Germany and the UK

The other element of the literature on fiscal federalism concerns fiscal equalisation, the sets of rules for allocating financial resources in decentralised states. These rules are both crucially important for the operation of government and deeply controversial. They are important because they provide the financial wherewithal for carrying out policy responsibilities and, therefore, shaping the balance of statewide/uniform and regional/differentiated policy provision. They are also important because the ability to tax and spend has a significant direct economic impact.

They are controversial for the same reasons. Governments compete for finite resources to carry out their tasks and to manage their economies, and they frequently disagree about who should get what, not least because visions of policy priority differ at different levels and among regions. Finance is an easily politicised issue which has a potent capacity to divide, to set the centre against the regions and regions against each other. Decentralised states have therefore often had to devise highly complex mechanisms for allocating resources and managing the potential for conflict over them.

This mixture of complexity and controversy applies equally to Germany and the UK. Without doubt the Barnett formula for territorial allocation of public finance in the UK and the fiscal equalization process in Germany are the most contested and least well understood issues in operating decentralized government. Put simply the financial aspirations of the players in the resource allocation game always exceed available resources; this encourages zero-sum calculations among those actors. For this reason the German *Finanzausgleich*, which is an issue regularly before the Constitutional Court (cf Kirchhof 2001), while 'Barnett' is under attack from all quarters that do not manifestly benefit from it (cf Bell 2001).

The problems of fiscal equalisation in Germany concern incentives and needs. Significantly, these problems are different for the economically stronger and the economically weaker *Länder*. This creates a line of conflict which makes an enduring reform of the system an unlikely prospect. The incentives issue concerns the level of equalisation. The German system is based on the equalisation of tax income per capita, or 'financial capacity' among the *Länder*. It sets out a complex process of raising, allocating and redistributing tax incomes between the federal level and the *Länder* on the one hand and among the *Länder* on the other. Its final aim is that none of the *Länder* should have less than 99.5 per cent of the average financial capacity of all the *Länder* taken together.

Economically stronger *Länder*, which start out the process with a higher financial capacity and see their tax incomes eroded by equalisation dislike the high equalisation aim. They argue that it penalises them for their economic success and that it gives little incentive for economically weaker *Länder* to improve their financial capacities of their own accord; they know they will always end up with 99.5 per cent of the average (cf Homburg 1994). Economically weaker *Länder* dislike the emphasis on equalising incomes. Because of

economic weakness they (can) have disproportionately high expenditure needs, which the equalisation process does not address systematically (although it does have some, rather haphazard expenditure components and weightings). Income equalisation for them is only half the story.

The net result is a generalised dissatisfaction with the system, and an inability to achieve agreement on any substantial reform. The system is kept from grinding to a halt only by periodic side-payments by the federal level to one, or other, or both groupings of dissatisfied *Länder* (cf Jeffery 2002b).

The problems of the Barnett formula in the UK lie on the needs side of the equation. The Barnett formula does nothing more than allocate marginal changes in public expenditure territorially to the units of England, Scotland, Wales and Northern Ireland. It uses expenditure programmes in England as the benchmark and population size relative to England as the allocation key.

Scotland, Wales and Northern Ireland currently have higher per capita expenditures than England, reflecting a historical pattern resting on calculations of differential need made in the 1970s. The problem for Scotland, Wales and Northern Ireland is that the formula tends, if rigorously applied, to produce a convergence in public expenditures per capita on the English benchmark, irrespective of whether Scotland, Wales and Northern Ireland still have higher needs than England. For a number of reasons the rate of convergence has increased since 1997 (the so-called 'Barnett squeeze').

Convergence is, in other words, a growing problem for the devolved administrations in Scotland, Wales and Northern Ireland, which feel their needs to be increasingly underweighted. However, at the same time voices in the English regions (which do not as yet receive an assigned budget), especially those with weaker economies and higher expenditure needs, make the case that Scotland, Wales and Northern Ireland are unfairly advantaged by the system.

5.2 Issues for research

For these reasons there is in the UK, as in Germany, growing pressure for reform of the equalisation system. But, as in Germany, because different reform lobbies balance each other, the prospects for substantial and enduring reform remain remote. Against this background there is an obvious marketplace for ideas on how best to raise, allocate and redistribute resources across levels and among territorial units.

However, in both Germany and the UK the supply of ideas has been deeply parochial, bound up in the 'path dependencies' of particular institutional and procedural traditions. There is a need to establish a wider range of approaches to fiscal equalization, placing UK and German ideas in a wider comparative context and in that way generating new questions on the principles and practice of equalization. Key issues would include:

Equalisation of needs: in both Germany and the UK there are demands for a fuller consideration of expenditure needs. Any objective assessment of needs is difficult. Needs assessment tends easily to fall foul of 'pork-barrel' politics, with all participants entering

into special pleading for particular and often spurious regional needs. This was evident in the assessment of needs in the UK before the 1970s and is illustrated by the odd and at times contradictory needs elements in Germany's equalisation calculations. There is therefore an obvious demand for models which lift the needs assessment process out of the 'barrel'. Other states – for example Australia, with its Commonwealth Grants Commission – might provide such models (cf Nicholas 2002).

Building in incentives: there are two elements to the incentives issue. The first concerns the high level of income equalisation in Germany. There is a need for building incentives for raising additional tax income which does not currently exist at any significant level (despite some tinkering at the margins in the latest reforms to the system in 2001). The second concerns what has been called in the UK debate 'fiscal autonomy'. The Scottish Parliament has the power to vary UK income tax rates by ± 3 per cent. There is an academic and policy consensus that this kind of fiscal autonomy at the margin – i.e. after an equalisation process has created a more or less level playing field among all regional units – enhances both the incentive for enhancing economic performance and the accountability of government (Ahmad 2002). It also brings into relief a relationship between distinctive territorial policy preferences and the funds needed to pay for them. The incentive is to maximise funds to best satisfy preferences.

The Scottish Parliament's tax-varying power is the object of envy in other parts of the UK and has attracted the attention of some of the German *Länder* attracted to greater policy autonomy. Although it has not yet been used, there is also a debate in Scotland about extending Scottish fiscal autonomy (Heald and McLeod 2002). In these circumstances fiscal policy options in the UK and in Germany would benefit from illumination by comparative experience of the impact of limited autonomous fiscal powers and the modeling of the effects of their usage.

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