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BREXIT AND THE NATIONS

Evidence to the Finance and Constitution Committee of the Scottish Parliament on the Funding of EU Competences post-Brexit

Prof JD Gallagher CB FRSE

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A Gwilym Gibbon
Centre for Public Policy
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Prof JD Gallagher CB FRSE
Gwilym Gibbon Policy Unit
Nuffield College, Oxford
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This note considers the options for replacing the two main streams of European Union funding currently in the Scottish budget, agricultural support and structural funds. Different considerations apply to each, but it seems unlikely that the Barnett formula will provide a satisfactory mechanism for allocating resources in future in either case.

Background

At present European Union (EU) receipts are in addition to the Scottish budget (as determined by Barnett and the mechanisms for Annually Managed Expenditure) but they are matched and offset by the associated spending. Agricultural support is determined by the Common Agricultural Policy (CAP) rules and is directly managed by the Scottish government. The EU allocates structural funds according to measures of need in different areas, the simplest example being Objective One, historically allocated to areas with less than 75% of the EU average GDP per head. Entitlement is determined by the rules of the various funds and the success of bids against them. Spending is managed by the Scottish government, local authorities and others. Neither programme has ever been part of the Barnett allocation process.

Scotland is a major beneficiary of the CAP, proportionately more so than England because of the significance of agriculture in the economy. Scottish spending per head on agriculture is about 3 times higher than in England. It is roughly the same in Wales, and Northern Ireland's spending is nearly 6 times higher[1]. The CAP determines virtually all agricultural spending and (assuming the process of leaving the EU is completed) is likely to be completely replaced by domestic programmes. These will be constrained by whatever international trade obligations the UK enters into with the EU and others. The UK government has also indicated that it wishes to preserve an internal UK single market in food and agriculture (as in other areas). This will make obvious sense for Scottish agricultural exporters, and indeed consumers[2].

Historically Scotland has also done well out of the structural funds, eg in the Highlands and former industrial areas, but this is less true now, with Scotland as a whole one of the richer regions of the UK. It is important to realise that under the Scotland Act, economic development is not solely a devolved matter. It is one of the few Ministerial functions that

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[1] Data from PESA 2017 table 9.16 at www.gov.uk/government/uploads/system/uploads/attachment_data/file/630570/60243_PESA_Accessible.pdfData

[2] I make no assumption here about where responsibility for legislating on the necessary rules will lie.

are exercisable by both the Scottish and UK governments[3]. Additionally, structural funds are by no means the only regional economic development tool available. More is spent by the Scottish government themselves on economic development than via the structural funds. Those are simply a source of additional money, spent in different ways. All economic development activity, however, is constrained by EU State Aids framework. European rules rightly give priority to areas which have fallen behind economically.

Replacing EU frameworks

If the UK is outside the EU, a replacement set of rules for agricultural support will be needed. In the short run, and certainly during the transition period, this will be very similar if not identical to the CAP rules. It is common ground between the Scottish and UK governments that the new rules will be a UK framework: the present dispute between the governments is essentially about how much influence the Scottish Parliament will have over setting them[4]. For purposes of this evidence I assume that there will be an agreed UK agricultural support framework.

By contrast, the European structural funds are by no means the only economic development instrument available to government, and are markedly smaller than other economic development budgets, such as the spending through Scottish Enterprise. Although the UK may choose to replicate or replace the structural funds post-Brexit, it is under no obligation to do so. It could simply rely on other existing economic development programmes, perhaps with somewhat larger budgets. Most likely the UK government will wish to set up a UK-wide programme, as it is legally entitled to do under the Scotland Act. In any event, the UK will require a set of State Aids rules. These too will be uniform across the UK, in all likelihood stemming from international obligations, whether WTO rules or whatever trade relationships the UK agrees with Europe.

Funding Agriculture

The resources the EU applies to agricultural support come of course from the member states, via their contributions to the EU budget, mostly from a share of VAT. The UK will no longer make those contributions, and in particular is unlikely to agree to share VAT. Additional tax revenue (other things being equal) will therefore accrue to the UK government, and could be used to fund agriculture. No additional tax income will accrue to the Scottish government as a result of this, hence funding will have to come from London to Edinburgh.

If there is a single UK framework for agricultural support, analogous to the Common Agricultural Policy, then there is a strong argument that resources should be directed to fund the common framework. To the extent that it subsidises production, land management, marginal farming etc, then the resources should be directed towards production, land etc. Even the CAP, however, has a degree of flexibility in it, and it might well be that the UK framework will allow the devolved administrations perhaps quite substantial flexibility in how

[3] Scotland Act 1998, section 56.

[4] If, as the UK government say, agriculture will in due course become a wholly devolved matter, then in effect the Scottish Parliament will in effect have a veto over the UK framework's application in Scotland.

they allocate the resources. In those circumstances a simple formula (so much per hectare, head of cattle or the like) may not work.

An obvious solution would be to adopt for agriculture the same principle as is adopted for Northern Ireland social security expenditure, often referred to as the "parity principle". That is to say that the UK government will fund from UK taxable resources the same level of provision by the devolved administrations as it funds in England, although there is no obligation (within the boundaries of whatever common framework is agreed) on them to spend it in exactly the same way. The devolved administrations could supplement spending (or otherwise) from their other programmes, again so long as this was consistent with the agreed common framework.

The obvious deficiency of the Barnett formula here is that it gives the same per capita change in expenditure, which would be proportionately much smaller than Scottish spending. It has been suggested that agricultural spending will reduce once the UK is out of the EU. (The UK may simply have less money to spend overall, and it may be less inclined than the EU to invest in the agriculture for reasons of food security. Put more bluntly, the sector has less political clout in the UK than in the EU.) So it might be argued Barnett would be tactically advantageous to Scotland as decreases too would be proportionately smaller. This however is designing the funding system to meet tactical need which may or may not emerge. In the very short run, UK ministers seem to indicate that no immediate cash reductions in expenditure are planned. In any event, there is in fact no ‘baseline’ within the Scottish or UK government agriculture budgets to which these increments could be applied.

Funding regional economic development

Structural funds were intended to produce greater equality in economic development across the EU. Abolishing them will provide the UK with an opportunity to revise its own regional policies, which over recent decades have struggled to offset increasing disparities, as London and the south-east move further ahead of other parts of the country. Over the five and a half decades from 1963 until around 2008, Scotland stood out against this trend, as GDP per head grew steadily by very slightly more than the UK average. This took Scotland from one of the poorer to one of the richer regions of the UK over this period. Since 2008, Scotland's growth per head been lagging the UK, but Scotland nevertheless remains one of the country's richer regions. The contrast with the challenges facing the other devolved administrations in Cardiff and Belfast is very marked.

The UK might simply conclude that existing domestic regional economic development mechanisms and funding (which in financial terms is within the baselines of the relevant Whitehall departments) are adequate. If that is the case, any additional resources allocated to them in the normal day-to-day processes will be subject to the Barnett formula in the usual way.

Alternatively, the UK might introduce a programme to replicate the objectives of the structural funds in directing development resources to poorer parts of the country. Wales, Northern Ireland and much of Northern England might benefit most from this. While Scotland has poorer areas, overall its needs will be less than those of Wales and Northern Ireland in particular. Allocating such a programme on a per capita basis, in line with the Barnett approach, is unlikely to be seen as fair in either Belfast and Cardiff. Nor would it be consistent with the philosophy of replacing the structural funds. It seems likely that the present UK government might adopt a “challenge fund” approach, which is a mixture of targeting need and development opportunities.

Here the role of a UK regulatory framework is likely to be less significant. State Aids rules or their successors (to some degree mandated by the EU, and most likely set in London) will set constraints on how money is spent, rather than how much is spent. The Scottish government will be free to allocate resources to economic development from whatever source. They already spend around 50% per head more on economic development than in England.

Tactical Considerations

Naturally, the Scottish government will want to maximise the resources available in Scotland to replace these EU funds. For agriculture, their key leverage lies in agreeing the new UK framework, and ensuring it makes explicit reference to those issues that matter most in Scotland. Here it should be possible to make common cause with Wales (and, were there an administration, perhaps Northern Ireland too).

On structural funds, the Scottish government might argue for no direct replacement but rather extra resources for existing economic development programmes, and hope to gain Barnett consequentials. This is unlikely to be attractive in either Cardiff or Belfast, and makes little sense from a strategic UK perspective. Instead they might argue for the replacement programme to be targeted on smaller geographical areas than the structural funds, so the poorer parts of Scotland have a better chance of participating. The Scottish government should also already be well prepared to gain the maximum benefit from any challenge fund approach, given the scale of match funding available in the Scottish budget already.

Conclusion

For different reasons, it seems unlikely that the Barnett formula is the answer to funding agriculture or whatever replaces the structural funds after EU membership. The UK agricultural support framework to be agreed will give the Scottish government scope to influence spending, and it might sensibly be combined with a “parity principle” to set budgets. If, as seems likely, a new UK-wide programme replaces the structural funds, then the Scottish government should argue for narrow geographical targetting so Scotland’s most needy areas can benefit from it, and ensure that any bids to such a scheme are high quality and well resourced.