BREXIT:
CHALLENGES
AND
OPPORTUNITIES

ECONOMY, PUBLIC FINANCE AND ECONOMIC STRATEGY

Summary

• Brexit has led the UK economy into an unprecedented period of uncertainty. The Royal Society of Edinburgh (RSE) is concerned that the Brexit process should minimise adverse effects on business and the economy and maximise economic opportunities that may flow from this process. The RSE Economy, Public Finance and Economic Strategy Subgroup intends to contribute to this debate both in general, and by focussing on areas that have received little attention thus far. This paper outlines some of the areas that have received scant attention in the debate which, nevertheless, are important for the business sector and for the economy in both Scotland and the UK as a whole.

• One issue that has largely been absent from discussions of Brexit is the extent to which powers repatriated from Brussels will implicitly define how the ‘UK Single Market’ will replace the EU Single Market. The main elements of the EU Single Market are the ‘four freedoms’ – free movement of labour, capital, goods and services. A disorderly repatriation of powers from the EU to the UK to different levels of government could potentially weaken the UK Single Market. This could arise, for example, if businesses are subject to unfair competition from other parts of the UK. The European Court of Justice (ECJ) currently adjudicates on such issues within the EU, while the Competition and Markets Authority has the responsibility to ensure that markets work well for consumers within the UK. However, its terms of reference do not extend to any consideration of the effect on markets of policy differences between different parts of the UK.

• Using this concept of the UK Single Market as a central theme, this paper highlights some issues that have received little attention in the Brexit debate thus far, but which have the potential to distort this market unless their assignment to different levels of government within the UK is handled carefully. These include public procurement, state aid, regional funds, debt accounting and tax powers. We do not claim that this list is exhaustive, but rather mark a start point from which to take our further research.

• The Brexit process is multi-faceted: there are significant overlaps between the four RSE sub-groups which are assessing this process. Competition policy, as discussed above, has extensive overlaps with the Law and Governance Sub-Group.
There are further synergies: non-tariff barriers are particularly salient for trade in services, which are extremely important for the service-dominated Scottish and UK economies. Such barriers also involve many legal issues that again relate to the activities of the Law and Governance Sub-Group. There are also close linkages with the Economy Sub-Group and the Migration and Rights Sub-Group, given the importance of migrant labour to many parts of the UK economy. We intend to examine issues relating to non-tariff barriers and migration in subsequent work.

Introduction

1 It is not yet clear how economic powers currently held by the EU will be distributed to the various levels of government in the UK following Brexit. Attention has focused on the many difficulties associated with the repatriation of agriculture and fishing policies. Other powers, including state aid, public procurement, debt accounting, regional aid and some aspects of fiscal policy, have received little attention. Significant change in these policies following their return to the UK would lead to policy divergence between the UK and the EU. Thus, for example, the UK government might adopt a more interventionist industrial policy, an option not readily available under EU state aid rules. Similarly, repatriation of public procurement rules might prevent UK companies from tendering for contracts in the EU and vice versa. Within the UK, some firms would likely gain and some would lose from this change. But, for consumers, the likely effects are negative since balkanisation of public procurement will weaken competition.

2 The extent to which these powers are returned to the UK will depend on the nature of the Brexit settlement. Any outcome that involves the UK remaining part of, or close to, the EU Single Market is likely to mean that the UK will be forced to accept much of the EU regulatory framework including the rules that govern state aid, public procurement and debt accounting etc. Whether, in those circumstances, the UK will accept the jurisdiction of the ECJ as the dispute resolution mechanism remains to be seen, though this is perhaps unlikely.

3 For the purposes of this paper, we assume that such an outcome will not occur, given recent pronouncements by the UK Government. In these circumstances, there will be a repatriation of powers to the UK and in the rest of the paper we discuss how the allocation of these powers to different levels of government within the UK will affect the UK Single Market.

The UK Single Market

4 The UK is currently a member of the EU Single Market whose purpose is to eliminate barriers to trade in goods, services, capital and labour throughout the EU. It is intended to increase competition and opportunities for economies of scale which ultimately benefit EU citizens by making goods and services cheaper and more accessible.

5 If the UK does leave the Single Market after Brexit, there will inevitably be a transfer of economic and regulatory powers to the UK. Decisions will have to be made about the level of government to which these powers are assigned. These decisions will be both politically and economically significant. If the UK Government insists on retaining all powers repatriated to the UK, it will face considerable opposition from the devolved administrations (DAs) which generally argue that they can design policies more appropriate to their respective territories. Many EU policies are already largely administered by the DAs. For example, the implementation of Structural Fund policy (regional aid) is largely based on agreements between the DAs and the EU Commission. Such policy assignment accords with the principle of ‘subsidiarity’, whereby powers should be exercised ‘as close to the citizen as possible’.

6 While there may be considerable support for further devolution of economic powers, not only in the DAs, but also within England, there is no equivalent structure to the EU Single Market within the UK that sets out the principles that underpin trade between the UK’s constituent parts. This is perhaps because it has largely been taken as given that markets within the UK are open to competition and that any impediments to the flows of goods, services, capital and labour that do exist are insignificant. Thus, for example, the existence of separate legal systems in Scotland and England may increase costs, but not excessively so. However, the prospect of a range of powers being repatriated to the UK from the EU should perhaps open up a wider discussion of this issue. The devolution of
fiscal powers within the UK, separate from the Brexit process, adds to the potential for destabilising the UK Single Market. For example, the devolution of corporation tax to Northern Ireland may result in market distortions if they result in company relocation on the grounds of tax minimisation rather than economic efficiency.

7 It would be politically unrealistic and potentially inefficient to retain all powers migrating from the EU at Westminster. However, if devolution of powers results in policies that cause negative externalities in other parts of the UK, then it seems reasonable that the DAs should be prepared to meet the costs of these effects. This argument is a variant of the ‘no detriment’ provision that was included in the “fiscal framework” agreed between the Scottish and UK Governments in relation to the devolution of fiscal powers last year. This clause committed the Scottish Government to compensate the UK Government for any negative effects on UK tax revenues or welfare payments arising from decisions on taxes or welfare by the Scottish Government.

8 The devolution of a range of policies that currently reside with the EU to the DAs substantially widens the scope for potential detriment. Piecemeal responses to the different policies may be inconsistent and confusing. Thus, separate policies to penalise the Scottish Government if its welfare policies reduce UK tax revenues and another for fining the Welsh Government if it unfairly assists local firms through its procurement policy would be administratively expensive and could not be seen as principled. A more general approach might be to define a set of principles that underpin the operation of the UK Single Market. This would provide for free and fair competition in relation to issues such as market dominance, anti-trust, state aid and public procurement. The DAs could set their own policies within this framework but:

- they would have to bear the revenue implications of these policies; and
- they would be responsible for any detriment affecting other authorities.

These detriments are notoriously difficult to measure, but the establishment of the principles would also be a deterrent to the introduction of policies by a DA that clearly disadvantaged other parts of the UK.

9 The UK intends to establish a range of free-trade agreements once it has left the EU. Some of the policies that the DAs may expect to be devolved may have a role in these trade negotiations. An obvious example of such a policy is agriculture. A free-trade agreement that resulted in reduced external tariffs on foodstuffs would have different levels of detriment across the DAs, each of which has a larger agricultural sector than England relative to the size of its economy. There is a need for consultation between the UK government and the DAs concerning sectors which may play a role in trade agreements but also are governed and administered by the DAs. Within the context of the UK Single Market, these sectors should be treated consistently with equitable funding to offset any detriment so that trade within the UK is both fair and transparent.

10 In the remainder of the paper, we consider some of the issues that may be devolved from the EU and which might be candidates for inclusion in the statement of principles that might be used to define the UK Single Market. Further work on these issues will be taken forward by the sub-group as necessary.

State Aid

11 In the event of a hard Brexit, the UK will not be subject to EU state aid rules. Outside the EU, it would automatically be subject to WTO anti-subsidy regulations. These mostly cover goods and exclude services. Measures that do not involve a cost to government are also outside the scope of WTO rules. Further, WTO enforcement of state aid rules is weak, since its dispute resolution mechanism is cumbersome. The WTO has no scope for enforcement by private operators and there is no right of redress in national courts.

12 State aid regulations are closely tied to the Single Market; they are intended to ensure fair competition – businesses should not have an unfair market advantage through government support. If there was no trade agreement with the EU, the UK will have to develop its own state aid framework. This already exists, at least implicitly: there are a plethora of schemes to support business investment across the UK. The Scottish and Welsh Governments use Regional Selective Assistance to support firms in Scotland and Wales respectively. Their
schemes have been approved by the EU. Similarly, the Regional Growth Fund existed until 2015 to support business expansion in England. If responsibility for the regulation of state aid is transferred from the EU to the UK, then there will be an opportunity to set out principles for the design and limits of business support so that the various policies implemented across the UK do not significantly distort competition.

Public Procurement

Currently, the EU Procurement Directive defines the processes, procedures and standards associated with public procurement. It is intended to ensure that there is a ‘level playing field’ for public contracts in all EU countries. The EU procurement legislation has evolved over time. The most recent directives were developed and adopted by the European Council in 2014. The UK has played a pivotal role in developing this policy. EU procurement regulations are currently covered across the UK by the UK Public Contracts Regulations (2015) and the Procurement Reform (Scotland) Act (2014) with Scottish regulations being refreshed in 2016.

If the UK pursues a soft Brexit by joining the EEA or EFTA then it must comply with EU procurement rules covering openness, fairness, transparency and non-discrimination. Other trade agreements such as the Comprehensive Economic and Trade Agreement (CETA) between the EU and Canada do not require Canada to comply with EU procurement regulations.

In the absence of a UK–EU trade deal, the UK would automatically join the WTO’s Government Procurement Agreement (GPA). It is much weaker than current EU procurement rules. An agreement with the EU based on WTO–GPA could increase opportunities for government intervention in areas such as utilities, defence and transport.

Currently both the UK and Scottish Governments have implemented procurement conditions that go beyond those required by EU law. For example, the Scottish Government has committed to considering favourably firms that pay the ‘living wage’ in procurement exercises. There is already variation in the way that public procurement policies operate across the UK. Again, to avoid trade distortions, there is a case for codifying the principles that underpin procurement rules in different parts of the UK. Again, this is an issue that warrants further investigation.

Regional Aid

Post-Brexit, the UK will no longer have access to the EU structural funds. These are part of the EU ‘cohesion’ framework that is intended to reduce regional disparities across the EU. Among all EU countries, the UK currently has the largest difference between the average income of its poorest and most prosperous regions.

The Conservative manifesto proposed to replace the EU structural funds with a “Shared Prosperity Fund”, which is intended to reduce inequalities within and between the four nations of the UK. This proposal was not included in the Queen’s speech. It may re-emerge over the course of the Brexit negotiations.

Although the DAs have an important role in the administration of the structural funds, their allocation is largely determined by the application of EU-wide eligibility criteria. For example, in the present budget round, regions whose per capita income is less than 75% of the EU average are classed as ‘less-developed’ regions and are eligible for the highest level of structural fund support.

Since 2013, the UK Government has agreed ‘City Deals’ with cities and regions across the UK. These are intended to devolve powers, stimulate growth and transfer financial responsibilities to a range of cities across the UK. The DAs have participated in, and helped finance, those deals that fall within their jurisdiction.

---

If the ‘Shared Prosperity Fund’ goes ahead, there is a case for assessing the alignment of the objectives and funding of this initiative alongside those of the ‘City Deals’ and alongside other components of UK policy that have a spatial dimension. This assessment might consider how the combined effect of these policies supports equity and promote economic growth within the context of the single UK market.

**Debt Accounting**

At present, the EU implement strict rules on debt and deficit accounting. The current Eurostat manual on debt and deficit accounting stretches to 431 pages. Its interest in these issues partly stem from the EU’s failure to establish accurate measures of member state’s debt and deficit when the euro was established and during the financial crisis. The UK will inherit the ability to set its own rules when it leaves the EU. And while this issue may issue may seem esoteric, it is of considerable importance for the DAs.

The rules on how governments account for capital spending determine whether payment can be deferred or must be made immediately. The best-known mechanism for deferring payment is the Private Finance Initiative scheme, where the public sector avoids the risk associated with public funding of capital projects by substituting private finance and transferring risk to the private sector over a protracted period. The Eurostat manual helps how far risk has genuinely been transferred.

In Scotland, the Scottish Futures Trust was created to design such projects while also minimising the rents earned by the private sector from such schemes. Some are very much at the margin. For example, the Aberdeen Western Peripheral Route, initially classified to the private sector, was reclassified to the public sector by the ONS in 2015 based on the Eurostat regulations. Its cost was £470m. This change had a substantial impact on the government budget with the full £470m having to be paid on project completion, rather than over a period of 20 to 30 years.

Post-Brexit, the UK Government will determine how public sector debt is classified. In the absence of significant borrowing by the DAs, the UK Government is responsible for general government debt, including those debts incurred by DAs. It therefore is unlikely to permit significant variation in the rules regarding debt accounting across the constituent parts of the UK. Nevertheless, at present, Eurostat adjudicates on disputes as to how schemes are classified. In the future, the UK Government will have this role. To minimise inter-governmental conflict, there is a strong argument that the rules by which debt is classified also form part of the description of the UK market, since they potentially distort trade. Again, this issue is one that certainly merits further examination.

**Fiscal Powers**

The UK Government has devolved, or is in the process of devolving, some fiscal powers to the DAs. The Scottish Government, for example, has recently taken responsibility for the rates and bands of income tax and is in process of taking control over several disability-related welfare powers. The Welsh government has recently taken control over business rates, will soon have powers to determine stamp duty land tax and is expected to take control over the rates of income tax levied in Wales in 2019-20. To ensure “no detriment” to the UK budget, this process of fiscal devolution will be accompanied by adjustments to the Barnett formula. These adjustments will be neutral in the first instance, but involve some transfer of risk to the DAs in the future.

The nature of the risk transferred depends on the structure of the “block grant adjustment” that is applied to the Barnett formula. The risk that the DAs face is that their tax revenue may grow more slowly than the reduction in their block grant from the UK government. This will result in a decline in their budget relative to the outcome that would have been expected before the devolution of fiscal powers. On the other hand, if they are successful in implementing policies that boost tax revenues, their budget may expand.

---

The process of transferring fiscal powers was occurring independently of Brexit. However, the possibility of further powers being devolved as a result of Brexit provides an opportunity to examine the consistency and fairness of these transfers. The ‘fiscal frameworks’ that have been agreed between the Scottish and UK, and the Welsh and UK governments to accompany the transfer of fiscal powers differ significantly. This implies that the revenue risk faced by the Scottish government on the one hand, and the Welsh government on the other, are different.

The approach of the UK government has consistently been to deal with devolution on a bilateral rather than a multilateral basis. While it is true that the political pressure for devolution has varied between the constituent nations of the UK, the fiscal frameworks that are now being established have some similar features, but, as mentioned above are not the same.

Together, the City Deals, the Future Prosperity Fund and the transfer of fiscal powers to the DA’s present a confusing picture of devolution and regional assistance that lack any strategic overview of how to address problems of regional inequality and growth. Brexit may not have been the cause of these problems, but it now presents an opportunity for a more consistent approach to regional disparities within the context of the UK single market.
This Advice Paper has been signed off by the RSE’s EU Strategy Group.

Any enquiries about this Advice Paper should addressed to
Mr Paul Stuart (email: pstuart@theRSE.org.uk)

Responses are published on the RSE website (www.rse.org.uk).

The Royal Society of Edinburgh, Scotland’s National Academy, is Scottish Charity No. SC000470
Advice Paper (Royal Society of Edinburgh) ISSN 2024-2694