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Y Pwyllgor Materion Allanol a Deddfwriaeth Ychwanegol | External Affairs and Additional Legislation Committee
Y goblygiadau i Gymru wrth i Brydain adael yr Undeb Ewropeaidd | Implications for Wales of Britain exiting the European Union
IOB 47
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I welcome the opportunity to contribute to the work of the External Affairs and Additional Legislation Committee regarding the implications for Wales of the United Kingdom's withdrawal from the European Union in relation to European Structural and Investment Funds (ESIF).[1] This written submission focuses upon financial, programming, legal and policy implications of Brexit upon the programming of ESIF and on regional/spatial policy in Wales.[2] It refers mostly to the European Regional Development Fund (ERDF) and the European Social Fund (ESF), although elements will be relevant across the other funds which share some common provisions.

Key messages

[1] The European Regional Development Fund (ERDF), European Social Fund (ESF), European Agricultural Fund for Rural Development (EAFRD) and the European Maritime and Fisheries Fund (EMFF). The Cohesion Fund is a fifth ESIF but is not relevant for Wales as the UK is ineligible.
[2] This contribution draws extensively from an article *Woolford, J, 2016, Implications of Brexit for UK ESIF programming and future regional policy,* accepted for the upcoming issue of EStIF (European Structural and Investment Funds Journal, 2016 (Volume 4, Number 3), published by Lexxion Publisher Berlin/Brussels www.lexxion.eu/estif.

- The financial implications of Brexit will vary across the UK regions. As a net beneficiary of the EU and allocated €3 billion euros during the 2014-2020 programming period, the loss of ESI funds will be significant for Wales.
- The biggest vulnerability in relation to ESIF financial allocations and their potential loss to Wales relates to the *timing and content of Article 50 withdrawal negotiations.* The negotiation of an end date for programme eligibility and the extent to which the established regulatory procedures around N+3 and programme closure will be applied will be crucial.
- The level and timing of commitments to projects and expenditure on the ground is increasingly vital in ensuring Wales benefits as fully as possible from the funding envelope allocated, especially in light of the recent HMT funding guarantee.
- Uncertainties exist around budget availability for EU reimbursements following Brexit and the conditional nature of the HMT guarantee. It is unclear whether WEFO will make use of flexibilities around programme modification and project reprofiling to manage risk.
- Programme closure in the context of Brexit is additionally complicated by audit requirements that continue beyond the end of the programming period and hence EU membership.
- Legal requirements under ESIF regulations suggest that, *within the context of programme implementation*, the UK will still be subject to all relevant aspects of EU law for a period of at least three years following withdrawal from the EU.
- In terms of designating a future UK spatial policy, the debate can only be informed through the clear identification of the most successful targeting of localities, delivery models, funding priorities and types of initiatives to date – in the context of wider socio-economic policy and political developments. Some general observations are included.

Background

Under the Treaties the EU should aim at reducing regional economic disparities and strengthening economic, social and territorial cohesion. This should be achieved through

the ESI funds, which are allocated for a 7-year period under the Multi-Annual Financial Framework – the current programming period being 2014-2020.[3] Funding is designated at NUTS 2 level according to an EU common system of classification and GDP per capita in relation to the EU-28 average.[4] Since 2000, following a review and the modification of NUTS 2 boundaries, the Welsh regional designations have corresponded to the West Wales and the Valleys[5] / East Wales subdivision. The former has throughout this period been designated a 'less developed' (or Convergence/Objective 1) region, and the latter a 'more developed' (or Competitiveness/Objective 2) region.[6] The level of resources and types of activity funded reflect the different designations of the two Welsh regions.

Following the in/out referendum on EU membership on 23rd June 2016 and the vote to leave, the UK Government has stated its intention to trigger Article 50 of the TEU in March 2017. This would commence a two-year countdown period at the end of which the UK would automatically cease to be an EU member.[7] A March 2019 withdrawal from the EU has obvious implications for ESI funding allocated annually to UK regions until the end of 2020 and eligible for expenditure under EU regulations for a subsequent 3-year period.[8] The biggest vulnerability in relation to ESIF financial allocations and their potential loss to Wales relates to the *timing and content of Article 50 withdrawal negotiations.*

Financial implications

At UK level, the end of EU regional policy is likely to have minimal effect financially: the UK is a net contributor to the EU budget and the amount received under ESIF is small in relation to GDP – for example the ERDF and ESF combined equal less than 0.1% of UK

[3] http://ec.europa.eu/budget/mff/introduction/index_en.cfm#spendingplan

[4] Regulation (EC) No 1059/2003 of the European Parliament and of the Council of 26 May 2003 on the establishment of a common classification of territorial units for statistics (NUTS) amended by Commission Regulation (EC) No 105/2007. The NUTS classification is hierarchical; it subdivides the economic territory of the Member States into territorial units. NUTS level 1 territorial units (Wales) are subdivided into NUTS level 2 and subsequently into NUTS level 3 territorial units (local authority areas).

[5] West Wales and the Valleys incorporates Anglesey, Blaenau Gwent, Bridgend, Caerphilly, Carmarthenshire, Ceredigion, Conwy, Denbighshire, Gwynedd, Merthyr, Neath Port Talbot, Pembrokeshire Rhondda Cynon Taf, Swansea and Torfaen.

[6] East Wales incorporates the local authorities of Cardiff, Flintshire, Monmouthshire, Newport, Powys, Vale of Glamorgan and Wrexham.

[7] Unless either a withdrawal agreement sets a different date, or there is a unanimous decision of the 28 Member States to extend that time limit.

[8] Under the N+3 rule any part of the budgetary commitment that has not been defrayed and included in a payment claim to the Commission is automatically decommitted by the end of the third year following that of the budgetary commitment (n+3).

GDP.[9] However, EU receipts vary considerably across the UK and the financial implications would be territorially diverse: West Wales and the Valleys and Cornwall, the two UK regions categorized as 'less developed', are both net beneficiaries.[10] Over the 2014-2020 programming period the Welsh Government expects to receive more than 3 billion euros across the 4 ESI funds and two programme areas.[11] Whilst this represents only 0.4% of Welsh GDP, the amounts are significant in the wider UK regional/regeneration funding context.

It can be assumed that an end to UK contributions to the EU budget would coincide with the withdrawal of ESIF allocations to the UK. With Brexit, access to the full range of ESIF funding as well as the Connecting Europe Facility and the European Fund for Strategic Investments will be lost. The impact on financing from bodies such as the European Investment Bank has yet to be determined. Continued Welsh participation in EU Cohesion Policy could only be envisaged under the European Territorial Cooperation programmes where bordering non-Member States (and their regional/local governments) are able to participate. However, Wales would have to fund such activity from its own budget as participation by non-members is reliant upon their contribution of equivalent funding.[12]

Brexit in line with the timetable proposed by the Prime Minister will also result in a shortened programming period and early closure. *The negotiation of an end date for programme eligibility and the extent to which the established regulatory procedures around N+3 and programme closure will be applied to the departing UK will be crucial.* This will determine the exact amount of EU allocation likely to be forfeit at programme level but will also have significant impact on programming processes on the ground. Wales could stand to lose (2019 and 2020) ESI funding allocations equating to more than 850m euros.

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[9] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/355455/BIS_14_981__Review_of_the_Balance_of_Competences_between_the_United_Kingdom_and_the_European_Union.pdf

[10] Open Europe (2012) Off Target, The Case for Bringing Regional Policy Back Home, http://archive.openeurope.org.uk/Content/Documents/Pdfs/2012EUstructuralfunds.pdf

[11] Cornwall's allocation is considerably lower at 600 million euros.

[12] For example, the North Sea Region Programme and Northern Periphery and Arctic Programme include Norway and Iceland; the North West Europe programme includes Switzerland. Non-Member States participate under programmes such as INTERREG, INTERACT, and URBACT.

In determining this final date of eligibility it should be noted that expenditure in the EU budget must, in line with Treaty requirements, be in balance, whilst the ESIF regulations only require the European Commission to reimburse expenditure 'subject to available funding'.[13] Following UK withdrawal and the cessation of UK contributions, there is therefore some question as to whether the EU will be able to pay against commitments from the year in question *as well as* those from preceding financial years. A reduction in the EU's revenue could arguably oblige the UK, as part of the Brexit negotiations, to either continue contributing to the EU budget beyond its departure or else accept a reduction in future payment appropriations.

Programming implications

Recent announcements by Her Majesty's Treasury (HMT) have guaranteed funding for all ESIF projects signed before the UK leaves the EU.[14] In this context, *the level and timing of commitments to projects and expenditure on the ground is increasingly vital in ensuring Wales benefits as fully as possible from the funding envelope allocated.* The 2014-2020 Welsh programmes were launched late - towards the end of 2014 in the case of ERDF and ESF, mid-2015 for EAFRD and February 2016 for EMFF. Commitment levels however are relatively healthy, standing at more than £1 billion for the first 3 funds – 39% of ERDF was reported committed to operations at the last Programme Monitoring Committee, and 46% of ESF. Levels of spend (EU funds only) remain low at £115 million, well below 10% of allocations. Figures included use an exchange rate of £1:€1.25, which with current exchange rate movements could prove rather unrealistic. The drop in sterling since the EU referendum has as a consequence an increase in value of the programmes, and related match-funding requirements, which are denominated in euros.

Nevertheless, these figures disguise variations across the different priority axes that could be particularly relevant in the context of Brexit and an early programme closure. West Wales and the Valleys ERDF Priority 4 Connectivity and Urban Development, for example, foresees large capital infrastructure projects which will require a lengthy development and notification process to the European Commission, not allowing for

[13] TFEU Article 310.1; Common Provision Regulation Articles 77.1 and 135.5

[14] https://www.gov.uk/government/news/further-certainty-on-eu-funding-for-hundreds-of-british-projects; https://www.gov.uk/government/news/chancellor-philip-hammond-guarantees-eu-funding-beyond-date-uk-leaves-the-eu

possible construction delays. Figures provided at the last Programme Monitoring Committee show only 17% of the ERDF allocation committed.[15] *In the context of an as-yet undetermined final eligibility date, programme modification in favour of less risky revenue-based priorities and activities that can be quickly turned off would arguably be a less risky programming option.* A modification of the programmes or reprogramming would be subject to Commission approval. No information is available externally regarding the delivery timetables of approved projects – an element looking increasingly significant in the context of a shorter implementation period. WEFO have, to date, not publicly offered projects the possibility of 'reprofiling'.

Funding to date has, in line with the 'economic prioritisation framework' established by Welsh Government gone for the most part to 'backbone projects'. These are dominated by Welsh Government and Higher Education organisations (roughly 65%) and include a number of 'repeat' projects building on the back of previous funding. Organisations who were not included in the framework and hence have not been prioritised for funding look increasingly likely to miss out in a shortened programming period. In terms of short term scenarios, the HMT guarantee to substitute domestic funds for projects signed before the UK's formal exit could lead to a deliberate acceleration of programming which would need to be balanced against ensuring due diligence. Conversely, projects currently in the pipeline are, as time progresses, more likely to be reduced in size, scope and funding. It must additionally be taken into consideration that the HMT guarantee is conditional – it refers to project funding being honoured if it demonstrates *good value for money* and alignment with '*domestic strategic priorities'*.[16] No further clarification on these terms is provided yet this seems to allow for HMT, a new UK Government or Government Minister to take a different view to Welsh Government on projects approved in Wales. Financial guarantees from the UK government could be subject to political whims and events in a highly uncertain context.

An additional consideration must be the current regulatory requirement that all projects not 'in use' or 'functioning' at the point of the submission of closure documents will not be

[15] http://gov.wales/funding/eu-funds/2014-2020/programme-monitoring-committee/?lang=en
[16] https://www.gov.uk/government/news/further-certainty-on-eu-funding-for-hundreds-of-british-projects

eligible for reimbursement from the EU. In the case of this eventuality, past/previous expenditure for project delivery would have to be removed from payment requests as ineligible for reimbursement from the EU. The *total* costs would seemingly need to be met under the HMT guarantee, alongside those incurred subsequent to UK withdrawal.[17] Whilst 'phasing' projects across different programming periods or extending the deadline for 'non-functioning projects' is currently possible, a formal request from a departing Member State seems unlikely to be either requested or agreed.[18] Programme closure in the context of EU withdrawal is additionally complicated by audit requirements that continue beyond the end of the programme – document retention, revenue generation, use of resources paid back to financial instruments, durability, publicity, and obligations to pursue recoveries of misappropriated EU funds for example.

Legal implications

The ESIF regulations currently have direct application whilst the UK is a member of the EU; upon exit they will need to be transferred into UK law. The proposed 'Great Repeal Act' will repeal the European Communities Act 1972 but freeze all EU law into UK law, maintaining it in force pending a later decision whether to amend or repeal them.

Legal requirements under ESIF regulations suggest that, within the context of programme implementation, the UK will still be subject to all relevant aspects of EU law for a period of at least three years following withdrawal from the EU. ESIF programmes and projects must demonstrate compliance with 'all applicable Union law'[19] whilst 'all the Commission's and Member States' rights and obligations remain valid in respect of assistance to operations' throughout programme closure.[20]

This raises interesting questions if the UK moves to a looser relationship with the EU such as that of a member of the European Economic Area (EEA) where not all EU Directives are applicable. Directives on nature protection (Habitats and Birds Directives), and some

[17] However, in line with Article 120.6 CPR national public funding cannot exceed more 80% of eligible public expenditure under an individual priority axis.
[18] These provisions do not apply across the full range of projects: productive investments, projects under 5 million euros and those that cannot be divided into clearly identifiable stages are excluded.
[19] in line with Article 6 of Regulation 1303/2013 (Common Provisions Regulation - CPR)
[20] C(2013) 1573

on water protection (bathing water, shellfish waters, surface fresh waters and fish waters Directives) could legally be removed by the UK Government or one of the Devolved Administrations yet compliance still be required within the ESIF framework.

Likewise, should freedom of movement principles be revoked or EU migrants have their status significantly modified in the immediate post-Brexit period, ongoing ESIF projects may be hindered in their ability to ensure the 'promotion of equality and non-discrimination' in the operation of the funds.[21] Unless EU nationals are able to participate equally with UK citizens in ESF-funded training courses, for example, a project could be deemed to be in breach of its contractual and legal obligations.

Compliance with the principles of state aid and public procurement will also be complicated by a change in the UK's status. Whilst continued access to the Single Market would mean these legal frameworks would remain in place, a more significant modification of the UK-EU relationship could result in different legal frameworks being applicable to projects depending on the source of their funding. ESI funded projects would arguably be required to follow EU legal provisions with projects funded from other sources subject to alternative legal frameworks such as WTO.

The requirement for 'effective application of Union law' in the areas of environment, gender, state aid and public procurement compliance are now an ex-ante conditionality or pre-requisite of programming across ESIF. On that basis, it is questionable whether any modification could be made to these areas of law whilst the programmes were still operating without potentially risking financial and legal repercussions.

Policy implications

Regional disparities in economic performance in the UK are now greater than those found in any other European country[22] and the UK has very little constitutional or policy commitment to the reduction of economic disparities or policy levers to respond to regional economic shocks. EU Cohesion Policy has seemingly provided the most coherent territorial approach in the 90 years of spatial policy within the UK and provides

[21] Article 7 CPR
[22] http://www.regionalstudies.org/uploads/documents/SRTUKE_v16_PRINT.pdf

an important role in framing economic development.[23] Following Brexit, a number of scenarios could fill the 'policy vacuum'.[24] Whilst the Welsh Assembly and Ministers have a range of devolved powers to promote economic development[25] and could develop a Welsh regional policy, it seems unlikely based on financial resources and geographical scale. The UK Parliament retains the right to legislate in this area and could develop a UK-level territorial policy. In fact, the UK Government's position for a number of years has been to 're-nationalise' the policy with richer Member States funding their own policy to reduce regional disparities.[26] How should regions be designated in a future UK spatial policy and what should be the focus of the policy and eligible activities? The debate can only be informed through the clear identification of the most successful targeting of localities, delivery models, funding priorities and types of initiatives to date – in the context of wider socio-economic policy and political developments. This section offers some preliminary observations upon which further analysis could be based.

Firstly, in terms of overall performance the Welsh programmes have not proved 'transformational'. As Objective 1, Convergence and then a 'less-developed' region in the 2000-2006, 2007-2013 and 2014-2020 programming periods respectively West Wales and the Valleys had the highest levels of funding receipts. Nevertheless, GDP per head relative to the EU27 fell by 6.3 percentage points in the region between 2004 and 2010. In East Wales over the same period the decline was 17.7 percentage points. [27] Whilst it cannot be forgotten that the programmes operate in a broader socio-economic context and this period has coincided with one of financial crisis and austerity, higher funding levels in Wales have not led to greater performance or results against key economic indicators such as jobs created and new businesses[28]. In Wales, projects funded under the ERDF are estimated to have created 36,640 new jobs and 11,900 new businesses in

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[23] http://www.eprc.strath.ac.uk/news/20160620_Brexit_blog_post.pdf

[24] http://ukandeu.ac.uk/what-a-difference-a-decade-can-make-cohesion-policy-and-brexit/; http://sites.cardiff.ac.uk/wgc/files/2016/07/COHESION.pdf;

[25] See variously Governance of Wales Act 2006, Schedule 7; Welsh Development Agency Act 1975.

[26] Hunt, J, Minto, R and Woolford, J, 2016, Winners and Losers: the EU Referendum Vote and its Consequences for Wales, Journal of Contemporary European Research *(forthcoming)*

[27] The UK overall registered a decline of 12.2 percentage points https://www.gov.uk/government/consultations/review-of-uk-and-eu-balance-of-competences-call-for-evidence-on-cohesion-policy

[28] http://speri.dept.shef.ac.uk/wp-content/uploads/2016/05/Brief24-UK-regions-and-European-structural-and-investment-funds.pdf

the 2007-13 period. The equivalent figures for Scotland are 44,311 and 17,474 respectively despite a funding package of only 36% of the Welsh one.[29]

Secondly, in terms of types of interventions, it is notable that at EU level, and specifically amongst older Member States, regional policy has moved increasingly away from old-style infrastructure interventions and been re-orientated towards the knowledge economy. Academic research has consistently concluded that the choice of intervention is strongly correlated with the impact of the funding, with people-focused interventions having a greater impact than place-based infrastructure investment.[30] The OECD identifies human capital, and specifically reducing the reducing the proportion of people in a region with very low skills as the most important factor in supporting regional growth.[31] Nevertheless, more than 29% of funding under the West Wales and the Valleys ERDF Convergence programme for 2007-2013 was allocated to transport and telephone infrastructure. Equivalent allocations from other UK regions are considerably lower, although it is likely a final quantification exercise will be undertaken on the basis of actual expenditure. The funding of 'repeat' projects also leads to questions around the 'transformational' effect, additionality[32] and 'added value'[33] of programme interventions.

Academic research additionally highlights the impact of quality of government on delivery of the EU regional funds including wider territorial governance. One of the most recent policy reforms allowed for the use of territorial bottom-up instruments such as Community-Led Local Development (CLLD), which looks to boost the impact of EU funding at the local level through cooperation, engagement and cross-fund integration.[34] Despite a

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[29] The combined ERDF and ESF allocation to Scotland for 2007-2013 was 820 million euros compared to 2218 million euros for Wales .http://speri.dept.shef.ac.uk/wp-content/uploads/2016/05/Brief24-UK-regions-and-European-structural-and-investment-funds.pdf; http://www.gov.scot/Topics/Education/skills-strategy/progress/sg/economicimprovement/EuropeanStructuralFunds

[30]https://www.chathamhouse.org/sites/files/chathamhouse/public/Research/International%20Economics/1212bp_becker.pdf

[31] http://www.oecd.org/regional/regional-policy/promoting-growth-in-all-regions-9789264174634-en.htm

[32] Article 95.2 CPR states: Support from the Funds for the Investment for growth and jobs goal shall not replace public or equivalent structural expenditure by a Member State.

[33] "European added value is the value resulting from an EU intervention which is additional to the value that would have been otherwise created by Member State action alone" http://ec.europa.eu/budget/library/biblio/documents/fin_fwk1420/working_paper_added_value_EU_budget_SEC-867_en.pdf

[34]https://webgate.ec.europa.eu/fpfis/cms/farnet/et/implementing-clld-across-esi-funds-edinburgh-uk-8-10-december-2015

general policy trend towards local ownership, the Welsh programmes have arguably become increasingly centralized at the regional level since devolution. New territorial models for delivery were not incorporated into the 2014-2020 programmes despite their coverage of areas with some of the sparsest population densities in the UK and Europe. The potential benefits of these approaches could be considered in designing a more effective and popular regional policy for Wales post-Brexit.

There are other idiosyncrasies of the policy that are relevant: the Welsh regions designated under Cohesion policy are economically incoherent and utilised solely for the purpose of the policy. Moves to recognize or incorporate more functionally relevant areas such as the Cardiff city-region in the 2014-2020 period may lead to more territorially appropriate responses and interventions under the programmes and could inform any future policy development. A new economic development policy would also enable a focus upon the parts of Wales that were camouflaged within the NUTS 2 regional categorisations. The performance of the Powys economy has been more akin to that of a 'Less Developed Region' with a (falling) GDP per capita of 63% of the EU 27 average[35] in 2013, well below the East Wales average figure of 97%.

[35] Not including Croatia who joined in July 2013.