University of Glasgow | Adam Smith Business School

E·S·R·C ECONOMIC & SOCIAL RESEARCH COUNCIL

‘Wales, Devolution and Brexit’ seminar, in Cardiff on 6 November 2017

Public finance and public expenditure implications

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Plan of the Presentation

A. The fiscal irrelevance of the ‘Divorce Bill’, however toxic it is politically

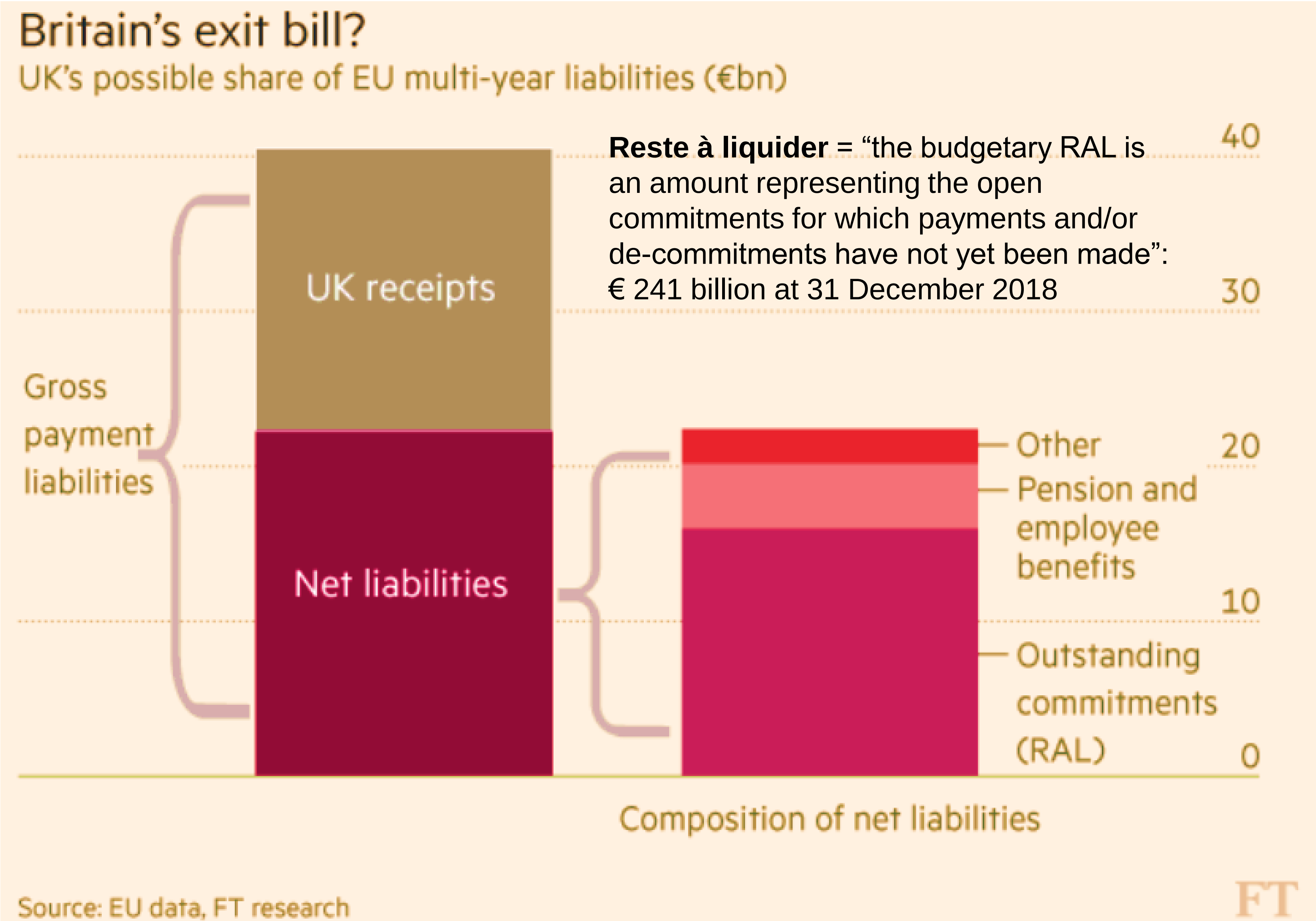
B. Implications of Brexit for UK public expenditure policy

C. Implications of Brexit for the public finances of the UK’s devolved nations

D. Grounds for optimism or pessimism

Graphic from *Financial Times*, 13 October 2016

Alex Barker ‘UK faces Brexit divorce bill of up to €20bn’



Reste à liquider = “the budgetary RAL is an amount representing the open commitments for which payments and/or de-commitments have not yet been made”: € 241 billion at 31 December 2018

A: The €60 billion EU Divorce Bill

- Reasonable to conclude that the emergence of the €60 billion figure from the Commission was politically motivated and not an ‘unauthorised’ leak. The Treasury frequently plants numbers in the *Financial Times*, something the Commission will have noticed
- The Divorce Bill is politically toxic but fiscally irrelevant. Paying it off as a lump sum would put the UK net debt/GDP ratio up from 87% to 90%, the ratio having been 48% in 2008. The toxicity stems in part from decades of the UK complaining about making ‘huge contributions’ to Brussels, when net contributions are about 1% of Total Managed Expenditure. There is no ‘Brexit dividend’ for public spending: the macroeconomic effects of Brexit on the public finances (eg from sterling depreciation) will be larger
- My personal view is that the UK should make a lump-sum payment, even one larger than €60 billion to avoid decades of entanglement with EU decisions affecting liabilities (eg pensions) and contingent liabilities (eg future writing-off of loans to off-budget EU entities and third parties). Then, any future financial relationship (eg Horizon 2020, security co-operation) could be clean and contractually based. This will be stated to be ‘politically impossible’

B: Brexit and UK public expenditure policy

- Hood and Himaz (2017) note that the present UK fiscal squeeze, though not deep on an annual basis, is the longest running for a century. Usually fiscal squeeze episodes last for two or three years, then the brakes come off
- Until after the 2015 UK General Election, George Osborne (then Chancellor) claimed that public services were not being adversely affected by austerity, a view that was not effectively challenged. The 2016 EU referendum and 2017 UK General Election provide evidence that the public mood has changed. Pressures for spending increases (NHS, education, defence) and tax cuts build up; the post-2008 repair job on UK public finances is far from complete
- This is a period of massive uncertainties, scenarios including:
  - Brexit galvanises the UK economy in the medium/long term, freed from EU regulation, with or without a state-shrinking agenda
  - Brexit does long-term damage to UK economic growth and productive capacity, thereby producing an affordability crisis for public spending
- Whichever scenario, UK public expenditure climate will be harsh in the short to medium term. Tax revenue generation faces multiple threats; the ‘revolt of the rich’ has territorial as well as interpersonal dimensions; and there is widespread technological disruption, yet stagnant measured productivity

C1: Implications for Devolved Public Finance

- The 1998 devolution settlement now seems a long time ago. Scotland has had the Calman and Smith Commissions, as well as the 2014 Scottish Independence referendum. Wales has had the Holtham and Silk Commissions, resulting in a revised devolution settlement. Northern Ireland has been more complicated, with Corporation Tax devolution figuring prominently
- The block-grant model (Barnett plus add-ons) looks less secure. For almost 20 years the UK Treasury has played the non-statutory formula reasonably straight. For complicated internal reasons, Scotland has sacrificed stability and predictability for legitimacy and self-esteem. This exposes the Scottish Government to macro-fiscal and revenue risks, coincidental with oil sector decline and Brexit. Will this lead to more fiscal accountability, or will the 'fiscal trap' ("powers designed to be unusable") interpretation prevail?
- This is relevant to Wales and Northern Ireland because of the tendency to converge on whatever is then the Scottish model
- As Holtham recognised, tax devolution is more problematic for Wales because of lower GDP and fiscal capacity per head and the proximity of population to the English border

C2: Sheep or Nurses?

- Of direct concern to all three devolved nations (the Northern Ireland Executive currently not functioning) is what happens after Brexit to what is currently EU spending in their jurisdictions
- The Scottish and Welsh Governments have jointly accused the UK Government of a ‘power grab’ in the field, for example, of agriculture which is more EU-subsidised there than in England. This is a reflection of the tension between (a) the necessity of a common framework across the UK, and (b) the fact that the UK Parliament and Government sees them as subordinate legislatures and governments, not as equal partners
- In the long-term, it is not clear whether present levels of subsidy will be maintained. Trade negotiations with the EU and international agreements might constrain subsidy policy. In the short-term, the subsidy money could be (a) held centrally by HM Treasury; (b) devolved as Annually Managed Expenditure outside the block; or (c) put into the Barnett-controlled block
- On past Treasury practice, existing spending would be transferred into the blocks, future changes in England then producing positive or negative Barnett consequentials. In future, subsidies for sheep would compete with salaries for nurses. This is the risk from ‘Barnetising’, not that existing spending would go down immediately to the Barnett proportions

D1: Grounds for Optimism or Pessimism

- Recent evidence of public co-operation between the Scottish and Welsh Governments is encouraging. As far back as Heald and McLeod (2002), I warned of the dangers to the devolution settlement coming from a failure to address Welsh concerns about the Barnett formula. With Northern Ireland neutralised because of quasi-direct rule, this co-operation is even more useful, given the lack of clarity about UK negotiating objectives
- The devolution settlement has acquired legitimacy over the last two decades and is politically more robust to deal with pressures coming from Westminster and Whitehall
- The pressures for fiscal transparency will continue to build up, though this can be politically uncomfortable for the devolved administrations. However, the UK has to have a serious discussion about the over-concentration of economic and population growth in London and the South East. There is ample evidence that the political reactions of ‘left-behind’ populations can have far-reaching consequences
- At some point, the incompatibilities of first-past-the-post elections to the House of Commons with proportional representation to the devolved legislatures will become indefensible

D2: Grounds for Optimism or Pessimism

- The transactional basis for the UK's EU membership no longer looks sustainable, in light of the integrationist tendencies, particularly within the Eurozone
- There may collusion between the UK Government and the European Commission to obscure the size of the Divorce Bill, by staging payments over many years and not reporting clearly. The *European Union (Withdrawal Bill)* would allow the UK Government to set up these payments as Consolidated Fund Standing Services, bypassing the Supply Procedure
- A big test will be whether the devolved administrations have the confidence to constructively use the tax powers they have made such efforts to obtain. Otherwise, these will atrophy
- The coincidence of factors makes predictions insecure:
  - The weak economic and fiscal recovery from 2008
  - Disruptive technology and its labour market and fiscal implications
  - Uncertainties about the UK's future trading relationship with the EU
  - Uncertainties about whether the UK will keep to the European social and economic model (already public expenditure/GDP ratio is relatively low), or there will be a fundamental transformation, accompanying Brexit, on the lines of minimal social and economic regulation and lower levels of public services and social protection