CYNGOR SIR *POWYS* COUNTY COUNCIL.

Cabinet
5th July 2016

REPORT AUTHOR:	**Councillor Wynne Jones**
SUBJECT:	**Initial Assessment of the Impact of the European Referendum's Outcome (Brexit)**
REPORT FOR:	**Information**

1. Summary

1.1 Following the outcome of the EU referendum on 23rd June it is important that Cabinet is brought up to speed on the current position and also the possible effects of 'Brexit'. The report will cover the current position, the possible impact on credit ratings and potential impact this has on the council's borrowing requirements. In addition inflation and interest rates may be affected as well as economic prospects. Finally it is important that Cabinet is aware of current grant funding provided by EU grants.

1.2 Whilst much has been said about the possible impact of Brexit on the economy and the public sector it is too early to be clear about the overall impact. This will become evident in future months and may take even longer. However it is prudent to assess and plan for possible impacts on our overall finances and this has commenced.

2. Background and Current Position

2.1 The European Union (EU) is an economic and political partnership involving 28 European countries. It is a "single market" allowing goods and people to move around free from tariffs as if the member states were one country. The EU has its own parliament and it now sets rules in a wide range of areas – including on the environment, transport, consumer rights and even areas such as mobile phone charges.

2.2 On 23rd June the Referendum resulted in a vote to leave the European Union by a margin of 51.9% to 48.1%. In Wales the vote was 52.5% to leave and in Powys this was 53.7%. The turnout was 71.8%, in Powys the turnout was 77%. The Referendum saw the largest turnout in a UK-wide vote since the 1992 general election.

2.3 The Welsh Government's Cabinet met on 27th June to discuss the outcome of the EU referendum and issued a statement that concluded by saying 'Whether you voted to remain or to leave, the

Welsh Government will do everything in its power to protect Welsh interests, strengthen our economy, and unify our nation.'

2.4 Withdrawal from the EU will not happen immediately and the process is set out in Article 50 of the EU's constitution. The first step would be for the UK government to notify the European Council of its intention to withdraw from the EU. Withdrawal can only be triggered by the UK Government. Article 50 does not set out when this notification needs to take place. The Prime Minister has announced that this will be a decision for his successor.

2.5 The two-year timeframe can be extended with unanimous agreement of all parties concerned. In the negotiations, the UK would be treated as a non-EU state for the purpose of Article 50. It would not participate in the discussions concerning the withdrawal negotiations in the European Council or the Council. This is what happened on Wednesday 29th June.

2.6 On completion of the negotiations the consent of the European Parliament to the draft withdrawal agreement is necessary after which it is signed and then concluded by the European Council.

2.7 The UK would still be a Member State during the withdrawal negotiations and would continue its participation until the withdrawal agreed entered into force two years (or more) after notification. Existing EU law would continue to apply in the UK and it would be bound by the principle of 'sincere cooperation'.

2.8 In the UK the withdrawal agreement would probably follow the usual procedures for treaty ratification: it would be laid before Parliament with a UK Government Explanatory Memorandum for 21 sitting days and debated before it could be ratified.

2.9 It would also be necessary to amend the relevant parts of the devolution legislation to remove the EU law.

2.10 The main areas to be confirmed are:

- How will the Welsh Government (and other UK devolved administrations) be involved in the formal negotiations?
- How will Welsh interests be addressed and reflected in the UK Government's negotiating position?
- What role will the Assembly play in monitoring and scrutinising the Welsh Government's engagement in this process and the UK Government's representation of Welsh interests and concerns?
- How will the Assembly organise its work and that of its committees to ensure effective engagement by Assembly Members in the process?

3. **<u>Alternative Models to EU Membership</u>**

It remains unclear what, if any, alternative model will be in place for the UK's relationship with the EU post Brexit however HM Treasury describes three options:

a. UK joins the European Economic Area (EEA), stays part of the single market and signs up to most of the EU rules.

b. UK negotiates a bilateral deal involving signing-up to some but not all EU rules.

c. UK has a simple World Trade Organisation (WTO) trade deal and is able to repeal all laws implementing EU law.

3.1 The above indicate that much remains to be done over coming months and years to clarify what the UK's relationship will be with the European Union.

a) <u>UK joins the European Economic Area (EEA), stays part of the single market and signs up to most of the EU rules.</u>

3.2 This is the 'Norway Model' that has been mentioned as a possible option. Norway is in the European Economic Area (EEA) but not in the EU. The EEA is an internal market providing free movement of persons, goods and services, and is made up of the 28 member states with Norway, Iceland and Liechtenstein. This is the model outside of the EU which is most integrated with the Single Market. These three countries make contributions to the EU budget. They must follow most of the rules of the Single Market, they have no vote or vetoes in how these rules are made. However this may not be the model that the British public voted for and the negotiations will no doubt look at various options.

3.2.1 It should be noted that non EU members of the EEA do not make contributions to or receive Common Agricultural Policy (CAP) funding. Although they are not generally eligible for European Structural Funding, Norway and Liechtenstein qualify for some cross-border and transnational programmes. The EEA Agreement ensures participation by Iceland, Liechtenstein and Norway in a number of other EU programmes.

3.2.2 It is not certain that the UK would be able to join the EEA.

<u>b) Negotiated bilateral agreements</u>

3.2.3 A number of countries have negotiated differing degrees of access to the EU's Single Market, bringing with them a certain number of the obligations of EU membership.

3.2.4 Switzerland's agreement with the EU goes furthest to replicating the terms of EU membership: both in terms of opportunities and obligations. In return for a partial access to the Single Market, Switzerland must accept the free movement of people, contribute to EU spending and comply with most of the rules of the Single Market.

Similarly to the non-EU EEA countries, Switzerland has no votes or vetoes on how Single Market rules are made.

3.2.5 Switzerland does not participate in CAP, is partially involved in Horizon 2020, and though not generally eligible for European Structural Funding, it participates in some cross-border and transnational programmes.

c) World Trade Organisation-only Model

3.2.6 The UK, along with all other EU Member States, is also a member of the World Trade Organisation (WTO). In the absence of alternative arrangements, the UK would use its WTO membership to provide the terms of its relationship with the EU. This is the only formal model of a future relationship which is currently available to the UK and that would not require further negotiations.

3.2.7 Under this model, UK access to the Single Market would be subject to the same tariffs as all 161 other WTO members that have not negotiated their own arrangements. Along with the limited access to the Single Market, this model brings with it minimal obligations to the EU.

3.2.8 WTO countries are not required to contribute to the EU budget, or accept free movement of people. Again, businesses trading exclusively under WTO rules wishing to sell to the Single Market are generally obliged to comply with its rules. WTO members do not have votes or vetoes on how these rules are made. WTO countries do not necessarily have direct access to EU funding streams.

3.2.9 **Implications for legislation in force**

3.2.10 The vote to leave the EU has no immediate legal effect on UK law. Until the UK withdraws from the EU it remains a Member State and all its obligations under the EU Treaties and EU legislation remain in force.

3.2.11 Withdrawal would take effect on entry into force of a formal withdrawal agreement. If no agreement is reached within two years from the UK's notification of withdrawal, and the European Council has not unanimously agreed to extend this period, withdrawal will take place automatically at the end of that two-year period.

3.2.12 Most EU legislation takes the form of Directives (which need to be implemented by Member States, including devolved legislatures) and Regulations (which are directly applicable, but may require enforcement legislation on the part of Member States). This legislation often provides the framework within which domestic legislation is made.

3.2.13 **Impact of a vote to leave on the Wales Bill 2016**

3.2.14 As the implications of withdrawal will be uncertain for some time, and EU law will continue to apply in Wales in the meantime, there is unlikely to be any immediate impact on the Wales Bill 2016.

3.2.15 The repatriation to the UK of powers upon withdrawal will inevitably have impact on the devolution settlement. If powers currently exercised at the EU level are repatriated to Wales, there would be significant implications for the Welsh Government in terms of policy development. Important negotiations would also be required in relation to the transfer of the corresponding budget, as well as that for regional development.

4. <u>**Impact of leaving the EU on devolved policy areas in Wales**</u>

4.1 <u>Agriculture and rural affairs (including animal welfare)</u>

4.1.1 Policies affecting Welsh farming and its food supply chain are determined largely by the EU through the Common Agricultural Policy (CAP), food safety and animal welfare legislation and also indirectly by the World Trade Organisation (WTO) rules.

4.1.2 The CAP is the EU's mechanism for providing direct support to farmers, for protecting the countryside and for supporting the development of rural areas.

4.1.3 The CAP runs for a seven-year period. Under the current round of CAP, 2014-2020, Wales will receive approximately £250 million of funding per annum in direct payments to farmers in addition to €655 million for its 2014-2020 rural development programme. Under the CAP each Member State receives an annual allocation for issuing direct payments to farmers.

4.1.4 The Welsh Government is directly responsible for implementing the CAP within Wales (and is required to comply with the various EU Regulations which set the legal framework for the policy. For farmers eligible for CAP this means the Welsh Government manages the direct payments they receive.

4.1.5 The second part of CAP – rural development – provides support to farmers and the wider rural economy, which for 2014-2020 is focused on competitiveness of farm business, diversification of activities, promoting high quality environmental projects, and encouraging wider community development in rural areas. Similarly to direct payments the Welsh Government is responsible for developing and delivering rural development schemes funded by the CAP in Wales.

4.1.6 The EU also sets the legal framework for the marketing, labelling and regulation of food and feed stuffs. This legislation falls within devolved competence and is almost entirely the responsibility of the Welsh Government.

4.2 <u>**Cohesion Policy (Structural Funds)**</u>

4.3 The central aim for the current EU Structural Funds programmes is to create an environment which will support economic growth and jobs.

4.4 Under the current round of Structural Funds, which runs from 2014 to 2020, Wales has been allocated almost £2 billion from the EU - with £1.6 billion going to West Wales and the Valleys and over £325 million to East Wales. In total, along with match funding, the current round of Structural Funds are expected to support a total investment in Wales of approximately £3 billion. In Wales the Welsh Government administers the funding, although the public, private and third sectors are all involved in project delivery.

4.5 The Structural Funds consists of two funding streams – the European Social Fund (ESF) and the European Regional Development Fund (ERDF).

4.6 The ESF programmes, worth nearly £642 million of EU funds for West Wales and the Valleys and some £162 million for East Wales, total investment (i.e. with match funding) is around £1.2 billion. ESF spending is aimed at supporting projects that are intended to help transform the prospects of the most marginalised and vulnerable in society, lead to increases in productivity and growth, and invest in the future of young people in Wales.

4.7 The ERDF programmes, worth some £960 million for West Wales and the Valleys and £162m for East Wales, are expected to drive a total investment of around £1.8 billion in Wales. ERDF spending is aimed at supporting research and innovation, increasing the availability of finance for small and medium-sized enterprises, funding investments in renewable energy and energy efficiency, as well as investing in roads, public transport and urban development.

4.8 The potential loss of some of this funding could impact on other capital funding streams from Welsh Government and could change funding allocations to Powys. However the potential impact remains uncertain until there is clarity following exit negotiations

5. Environment

5.1 A significant amount of current environment legislation is derived from European Law. Member States have, to date, generally supported an EU-led approach as many environmental issues and concerns have cross-border implications: for example, air pollution and quality, and invasive non-native species.

5.2 Since the 1970s, the EU has agreed over 200 pieces of legislation to protect the environment, covering a comprehensive range of policy areas, meaning that EU law underpins a significant proportion of environmental legislation within Wales (and the UK more broadly).

5.3 The vast majority of environmental policy and legislation in Wales is governed by legal frameworks and regulations set at a European level. This means that the approaches taken on environmental policy, unlike some other policy areas, are relatively consistent across the UK.

5.4 As a large amount of the European legislation is transposed into UK law a number of policies and regulations could initially remain unchanged. However, as environment is largely a devolved policy area different governments across the UK could take the opportunity to develop their own distinct approaches to policy.

5.5

6. Energy and climate change

6.1 The EU has ambitious climate action targets for 2020: a 20% reduction in greenhouse gas emissions (compared with the 1990 baseline), 20% of total energy consumption from renewable energy, and a 20% increase in energy efficiency. These are set out in the Renewable Energy Directive (2009) (which establishes an overall policy for the production and promotion of energy from renewable sources in the EU) and the Energy Efficiency Directive (2012). By 2030 the EU has set a target to cut greenhouse gas emissions by 40%, to achieve at least 27% of total energy consumption from renewable energy, and at least a 27% increase in energy efficiency.

6.2 Post Brexit it remains to be seen what policy will be in place to replace the current Directives.

7. Health and social care policy

7.1 Health and social care is devolved, with the Welsh Government responsible for delivery of health care services, through the National Health Service, and the promotion of health in Wales.

7.2 The EU competence in this area is more limited than in areas like agriculture, fisheries and the environment.

8. Education

8.1 As with health, the scope for EU intervention in education is more limited than in other areas.

9. Impact on Welsh public services

9.1 It is widely accepted that there is a direct link between whatever negotiated exit option is put in place for Brexit and its impact on the UK economy, tax revenues and public finances. This will only become clear as the negotiations progress.

9.2 How the UK Government decides to use any savings on its EU contribution would have consequences for Welsh public finances.

9.3 Of particular importance is whether the UK Government would use the Barnett formula to apportion the money around the constituent parts of the UK or whether some new mechanism would need to be found.

9.4 WLGA Finance Sub Group paper – Local Government Finance Issues, 7th July 2016

9.5 The WLGA has issued a paper that confirms that '..the current EU grant programmes which run from 2014 to 2020 are now well underway with many projects already launched or at an advanced stage of planning. Under these programmes Wales has been allocated almost £2 billion from the EU - with £1.6 billion going to West Wales and the Valleys and over £325 million to East Wales. Projects have been carefully planned to operate in an integrated way, delivering maximum benefits to local economies'.

9.6 The WLGA paper states it is not yet clear what impact leaving the EU will have on Welsh participation in the current round of EU funding. Any threat to projects, though, will result in a loss or reduction of economic opportunities across Wales and drastically diminish capital programmes.

10. **Powys EU Grants**

10.1 For Powys the main grant is part of the LEADER programme and is the Rural Development Plan 2014-2020, known as Arwain. This is funded via WG and is 50:50 funding. The amount is £5.1m and runs from February 2016 to December 2020.

10.2 It should also be noted that Powys has a section that supports the EU grants process and has been very successful in obtaining funding. The work of the team will be affected by Brexit and over the medium term this will effectively cease to be focussed on EU issues but until the UK's relationship is defined via the negotiations the precise position cannot be indicated.

10.3 There are four other grants which are in varying stages of application. These are from different funding streams. The breakdown is shown in the following table.

Powys EU Other Funding

		2017/18	2018/19	Total
Llandrindod Lake	Rural Community Development Project	38,400	89,600	128,000
Youth Services Cynnydd	European Structural Fund	287,100	287,100	574,200
Youth Services Cam Nesa	European Structural Fund	140,500	140,500	281,000
Workways	European Structural Fund	250,000	250,000	500,000
		716,000	767,200	1,483,200

11. **Interest Rates and Borrowing**

There is some uncertainty about the likely position for interest rates but some economists believe that the Bank of England's Independent Monetary Policy Committee (MPC) would have to cut interest rates if it is required to stimulate the economy. This was also the position that the Governor of the Bank of England stated on 30th June. However if the value of sterling remains low and forces up import prices it might point to a rate rise. Brexit may well boost the chances of the MPC keeping rates on hold or even lowering the rate.

11.1 The impact on Powys CC's borrowing will affect future plans because of a potential interest rate change. The council uses the Public Works Loan Board to finance its borrowing and the PWLB's rates have fallen to historically low levels in recent months. This is likely to remain in place and given the Council's loans tend to be fixed for the duration of the loan (up to 25 years) the impact on existing loans is very small. If rates fall further there may be opportunities to reschedule borrowing.

11.2 It is inevitable that there is uncertainty around interest rates and the potential volatility was evident on 30TH June when the pound fell by more than 1% after Bank of England governor Mark Carney hinted at fresh economic stimulus measures saying "some monetary policy easing" would be required in response to the Brexit vote.

11.3 Mark Carney said a deteriorating economic outlook means action from the Bank is likely during the summer. The Bank's key interest rate - currently at a record low of 0.5% - is its chief tool of monetary policy. .A cut in interest rates would have a knock-on effect on savings rates, and makes the pound a less attractive currency to hold and do business in. Further reductions would decrease the amount of interest we receive on our cash holdings. However this is no longer a significant amount because we tend to 'save' money by using the cash to delay borrowing. This approach will continue.

12. Credit Ratings

12.1 In the immediate aftermath of Brexit the UK's credit rating has changed from AAA to AA-.

12.2 So far this has not resulted in increased borrowing costs because at the same time there has been an increase in the sale of government bonds, which are seen as a safe investment in turbulent times, has resulted in lower interest rates for the Government.

12.3 Credit rating changes may increase the cost of government borrowing.

13. Central Government Grant (AEF) Funding and the Council's MTFS

13.1 If the UK economy shrinks in the short term, as predicted by most economists, there will be a corresponding reduction in tax receipts and increased unemployment benefits.

13.2 If this scenario happens this will put additional strain on public finances and therefore the overall level of funding for Powys would decrease. This may lead to a decrease in the AEF and we would need to revise our assumptions about the likely level of budget savings that Powys will need to make.

13.3 In this scenario the Medium Term Financial Strategy (MTFS) will need to be revised. However it is too early to assess the precise impact but planning for a variety of scenarios is a requirement. This may increase the level of savings required.

13.4 Key areas that would need to be changed would be the allowance for inflation, the assumed cost of new borrowing and as indicated above the level of income from central government may decrease.

13.5 Further evidence of the uncertain impact on public sector finances was provided on 1st July when the Chancellor abandoned his long-held goal of reaching a surplus in the UK's public finances by the end of the decade. The full implication of this won't be known for some time but will affect public finances at some stage. It should be noted that the surplus rule never applied until the Government had first run a surplus and it allowed for there being a deficit if the economy suffered a slowdown. It is possible there will be more austerity whilst running large deficits in the future.

14. **Powys Local Government Pension Fund**

14.1 All Local Government Pension Funds are revalued every three years. The revaluation was undertaken on 30th March 2016 with the result to be known in the autumn. This is a significant issue because it sets the employer's contribution from 1st April 2017 to 30th March 2020.

14.2 The Pension Fund has assets of approximately £500m with a spread of investments and holdings from cash to equities.

14.3 The Powys fund has 47% invested in equities at the 31st March 2016.This is the area most likely to be affected and was the case in the days immediately after Brexit. However the stock market has rallied and its losses due to Brexit had been recovered by 30th June.

14.4 The short term volatility is best dealt with by the fund managers who are paid by Pension Funds to do this. As a result the Strategic Director Resources had a conference call with the scheme's advisor the day that the result was announced to establish the potential risk post- Brexit. Some changes to investments were agreed in a second call on 30th June to maximise the return on Equities by selling a proportion of holdings and place this amount in other investments and cash. By increasing the level of cash this will allow the fund to react quickly to any opportunities that may arise.

14.5 It may be some time before the impact of Brexit on the Pension Fund becomes clear. At this stage it is impossible to predict what could happen to investments with any degree of accuracy. However, LGPS funds have the advantage of being long term investors and are well equipped to ride out short term volatility. Over the longer term there is more stability and consistent performance.

14.6 The LGPS is not changing. The LGPS is largely guided by UK rather than EU legislation and will all carry on in the current form.

14.7 The longer term strategy may or may not be different from the pattern over recent years. There are rebalancing mechanisms in place to maintain the long term strategy.

Local Member(s)

Not applicable

Support Services (Legal, Finance, Corporate Property, HR, ICT, Business Services)

Finance comments that the position will continue to be monitored

Statutory Officers

The Strategic Director Resources (Section 151 Officer) comments that it is important that the position is noted.

Members' Interests

The Monitoring Officer is not aware of any specific interests that may arise in relation to this report. If Members have an interest they should declare it at the start of the meeting and complete the relevant notification form.

Recommendation:	Reason for Recommendation:
That Cabinet: a. note the contents of the report; and b. requests an update on the position is provided in one month's time.	In order that Cabinet is made aware of the current implications of Brexit for Powys and receives regular updates

Relevant Policy (ies):	Not applicable		
Within Policy:	Y	Within Budget:	Y

Relevant Local Member(s):	

Person(s) To Implement Decision:	
Date By When Decision To Be Implemented:	

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Background Papers used to prepare Report:

Research Briefing
Wales and the EU: What does the vote to leave the EU mean for Wales?
National Assembly for Wales

Statement by Carwyn Jones AM

Local Government Finance Issues – WLGA Finance Sub Group

UK Economic Focus – Capita Economics March 2016