CABINET
11 OCTOBER 2016 **APPENDIX 2**

Policy Note: Impact of British withdrawal of membership from the European Union

SUMMARY
The following paper identifies the possible implications for economic development in the Tees Valley of the recent referendum decision for the withdrawal of British membership of the European Union ('Brexit').

The proposed movement away from full membership of the European Union (EU) will have impacts on the following economic development functions:

- **Funding/Investment support:** Tees Valley is currently the second largest recipient per head in England of European Structural Funds (£245 per head, Cornwall: £920). Unless replacement funds are secured there is potential for the loss of £131m (total allocation of £170m) of direct financial support to the Tees Valley region. However the recent announcement by HM Treasury of supporting all projects which have been 'signed off' prior to the Autumn Statement potentially means that Tees Valley's £14m Business Compass programme should secure funding;
- **Regulatory Environment:** Dependent on the type of trading relationship the UK has with the EU will determine the UK's ability to freely set the type and level of support on offer to businesses and the degree to which UK environmental policy may vary from European environmental regulations. There is however an opportunity to amend existing UK competition policy and provide additional support aimed at enhancing the productivity/international competitiveness of strategically important industrial sectors;
- **Exporting and foreign direct investment:** The North East (including Tees Valley) exports more goods to the EU than any other UK region. This position is further compounded by the high levels of Foreign Direct investment attracted to the region as a potential entry point to the Single European Market. There is a need to address two issues:
    - Ensure continued access to core European markets for priority sectors such as chemicals and advanced manufacturing; and
    - Develop new trading arrangements and support for Tees Valley firms in diversifying international trade activity to faster growing non-European markets.
- **Attraction and retention of talent:** At present, in-migration by European nationals is approximately 1,000 per year. Many people have concerns regarding high levels of immigration, particularly its impact on access to low skilled jobs. However, curbs on migration may lead to a short term reduction in the skilled workforce and exacerbate existing and projected skills gaps, particularly in priority sectors. In addition, it may lead to a reduction in the number of international students attending

Tees Valley's various higher and further education institutes. Aside from the financial bonus such students bring to the region, there may be a reduction in other in-kind benefits, including:

- The boost to external demand as a consequence of increased familiarity with locally produced goods;
- Increased tourism revenues for returnees and/or their families; and
- Increased international awareness of the Tees Valley as a place to live, work and play.

- **International knowledge transfer:** There is the potential that Tees Valley universities and research bodies may have restricted access to European research programmes such as Horizon 2020.

Recommendations:

It is recommended that the Combined Authority:

Funding:

- Secure from Central Government ring-fenced funding for the region comparable in scale and range of support to that previously supported under the European Structural and Investment Funds.

Regulatory Environment:

- Ensure that the emerging British Industrial Strategy recognises the strategic importance to national competitiveness of Tees Valley's priority sectors and develops additional support aimed at mitigating constraints to those strategically important industrial sectors.

Exporting:

- Consult with local businesses to assess the impact of Brexit on existing trade and identify emerging markets; and
- Identify target markets and develop additional wraparound support for emerging market opportunities.

Foreign Direct Investment:

- Establish sector strategies for key industries, developed in collaboration with business, with a particular focus on maintaining and developing the supply chain, to encourage investment in those areas which will most benefit industries in which the UK has existing strengths; and
- Implement policies that support an attractive investment climate, in particular investing in adequate new transport infrastructure, investing in sufficient generating

capacity to provide affordable power and ensuring the planning regime is fit for purpose.

Attraction and Retention of Talent:

- Work with local industry to assess emerging skills demands and to signpost skills gaps to Central Government to inform subsequent migration targets;
- Work with all local Higher and Further Education Institutes to ensure that sufficient numbers of foreign students can access further and higher education opportunities in the Tees Valley area; and
- In liaison with local authorities and the community and voluntary sector work with the local community and recent and long established migrants to signpost the scope and scale of emerging opportunities and how they can best access them.

International Knowledge Transfer:

- Work with local Universities and research bodies to assess current Horizon 2020 and other transnational programme commitments and identify any emerging constraints to future access.

REPORT

The following paper identifies the possible implications for economic development in the Tees Valley of the recent referendum decision for the withdrawal of British membership of the European Union ('Brexit').

The Single European Market

The most notable impact of British withdrawal relates to access to the Single European Market which can be defined as:

> '*The Single Market, initially created through the Single European Act of 1987, refers to the creation of an area in which there are no functional barriers to the free movement of goods, people, services and capital. Subsequent treaties have seen the addition of other areas, such as environmental, social and employment policy*[1]*.'*

The table below provides an overview of various options for accessing the Single Market, including:

[1] Institute of Economic Affairs: Directions for Britain outside the EU

	Free movement within EU of:							
	Goods	*Agri Goods*	*Services*	*People*	*Capital*	*Application of EU Law*	*Contribution to EU budget*	*Negotiate external trade agreements*
Status Quo[2]	*Yes*	*Yes*	*Yes*	*Yes*	*Yes*	*Yes*	*Yes*	*No*
EFTA[3]	*Yes*	*No*	*Partial*	*No*	*Yes*	*No*	*Partial*	*Yes*
EEA[4]	*Yes*	*Yes*	*Yes*	*Yes*	*Yes*	*Yes*	*Yes*	*Yes*
EUCU[5]	*Yes*	*No*	*No*	*No*	*No*	*No*	*Partial*	*Yes*
WTO[6]	*No*	*No*	*No*	*No*	*No*	*No*	*No*	*Yes*

Source: EU, EFTA, EEA, EUCU and WTO policy guidelines

The table indicates that any movement away from full membership of the European Union will have impacts on the following economic development functions:

- Funding/Investment support;
- Regulatory Environment;
- Exporting and foreign direct investment;
- Attraction of talent; and
- International knowledge transfer.

The policy implications of each of these factors will be discussed in turn:

Funding/Investment Support

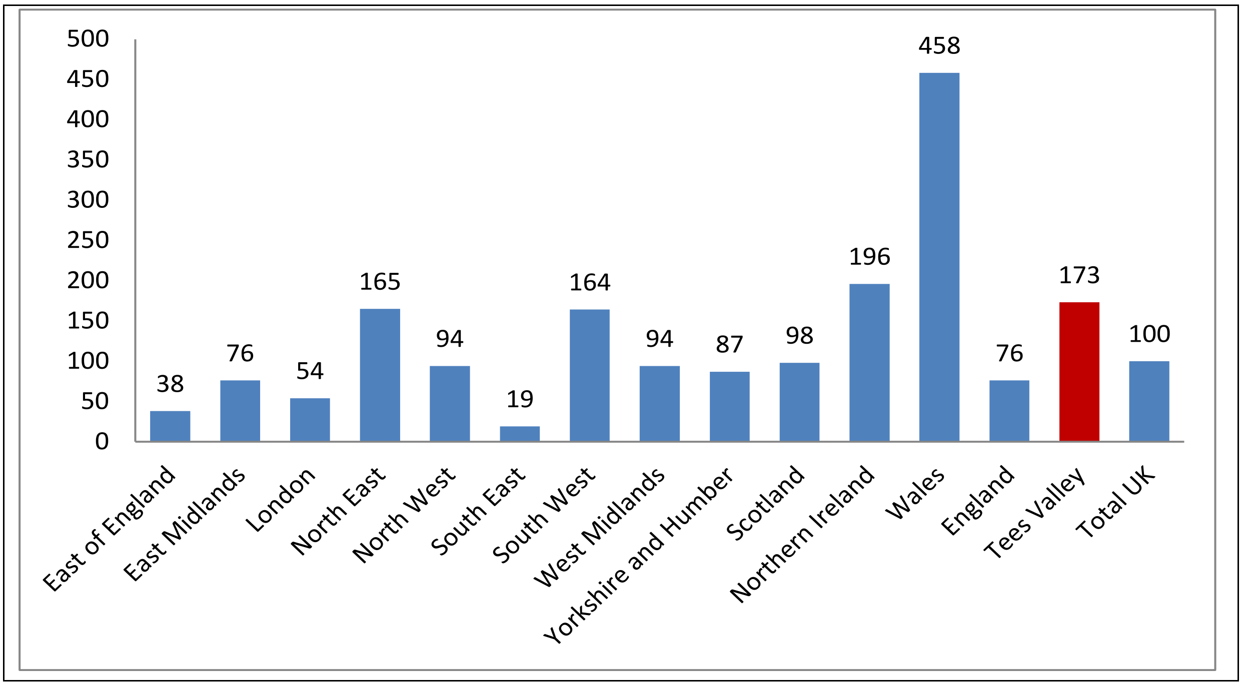
European Structural and Investment Funds (ESIF) support economic development across European Union (EU) member states and their constituent regions. The Structural funds were developed on the accession of the UK to the then European Economic Community (EEC) in 1973, with the aim of reducing economic and social inequalities between the nine national members at that time.

[2] Status Quo, full membership of the European Union
[3] Membership of the European Free Trade Association (EFTA): Countries include: Iceland Liechtenstein, Norway and Switzerland.
[4] Membership of the European Economic Area: Countries include: Iceland, Liechtenstein and Norway
[5] Membership of the European Union Customs Union (EUCU): Countries include: Andorra, Monaco, San Marino and Turkey
[6] Reliance on World Trade Organisation negotiations and tariffs

European structural funds are comprised of five funds: European Regional Development Fund (ERDF); European Social Fund (ESF); Cohesion Fund; European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund (EMFF).

The current total budget for EU structural funds is £377bn and the majority of funds are allocated to three funds: ERDF, ESF and the Cohesion Fund. The majority of EU structural funding that the UK receives is from ERDF and ESF. The UK does not receive funding from the Cohesion fund[7].

The chart below illustrates the per capita ERDF and ESF allocations by region relative to UK average (UK=100), 2014-2020 period:



Source: Sheffield Political Economy Research Institute (SPERI): British Political Economy Brief No. 24: UK regions and European structural and investment funds.

In the current programme period (2014-2020), Tees Valley was to receive £170m of support from the Structural Funds (European Regional Development Fund (ERDF), European Social Fund (ESF) and European Agricultural Fund for Rural Development (EAFRD)). The table below provides a breakdown of the 2014-20 allocation for the Tees Valley:

[7] The Cohesion Fund is aimed at Member States whose Gross National Income (GNI) per inhabitant is less than 90 % of the EU average.

Fund	Amount
ERDF	£94.4m
ESF	£64m
YEI (Youth Employment Initiative)	£10.4m
EAFRD	£1.1m
Total	£170m

Source: Tees Valley European Team (2016)

The ESIF Programme has the following performance targets which run up to the end of 2023:

- ERDF: 2,356 jobs created and 173 SMEs assisted; and
- ESF: 9,510 participants receiving training of whom 4,884 are long term unemployed.

To date £24.6m of ESIF funding has been either committed or spent of which £19.8m relates to the YEI programme. This leaves £145million uncommitted.

The region receives the second highest amount of EU structural funding per capita (£245) (Cornwall receives the highest amount of Structural funding at £920per capita) in England. The structural funds support both capital expenditure and revenue support for activities including: innovation, skills, business growth, farm diversification and area regeneration.

The seven year structural funding rounds currently allow local authorities to plan for the medium term beyond the annual local government funding settlement, four year comprehensive spending reviews and five year general election cycles. This allows local and regional policy makers to work with the private and third sectors to plan economic projects with a greater degree of certainty about funding compared to projects that are more reliant on domestic sources of public investment.

The loss of EU structural funds could have a significant impact on the 2,365 projected jobs to be created and the 173 SMEs to be assisted, as identified in the Operational Programme. The requirement for ERDF and ESF funding to be 'match-funded', means that the potential economic impact of losing structural funds would not simply relate to the loss of funds provided by the EU, but also the potential £105m of match funding from the private and public sector in Tees Valley. Many funding partners, particularly from the private sector, but also central government departments, may choose not to invest in projects without the security of knowing that 60% of the funding was being provided through EU structural funds.

Key Risk:

Potential loss of £131m (total allocation of £170m) of direct financial support to the Tees Valley region.

Method of Mitigation:

It is recommended that the Combined Authority secure from Central Government ring-fenced funding for the region comparable in scale and range of support to that previously supported under the European Structural and Investment Funds.

Regulatory Environment

The withdrawal of the UK from the Single European Market has implications on two areas of the domestic regulatory environment:

- UK competition policy may no longer be governed by European State Aid requirements; and
- UK environmental policy may vary from European environmental regulations.

Dependent on the type of trading relationship the UK has with the EU (i.e. European Free Trade Association (EFTA) membership European Economic Area (EEA) membership or access via World Trade Organisation rules) will determine the UK's ability to freely set the type and level of support on offer to businesses and the degree to which UK environmental policy may vary from European environmental regulations.

Tees Valley's current industrial composition is heavily concentrated in foreign owned enterprises in highly environmentally regulated companies (such as the process sector) which are primarily servicing the European export market. It is unlikely that there would be an appetite for significant variance from accepted European environmental regulations. There is however an opportunity to amend existing UK competition policy and provide additional support (principally related to energy costs, access to international markets and supply chain support) aimed at enhancing the productivity/international competitiveness of strategically important industrial sectors.

The UK Government is currently developing a new Industrial Strategy. It is essential that the Strategy recognises the importance of Tees Valley's priority sectors to national competitiveness and develops additional support aimed at mitigating constraints to strategically important industrial sectors.

Key Risk:

Uncertainty as to the emerging UK competition policy with regard to core economic development functions.

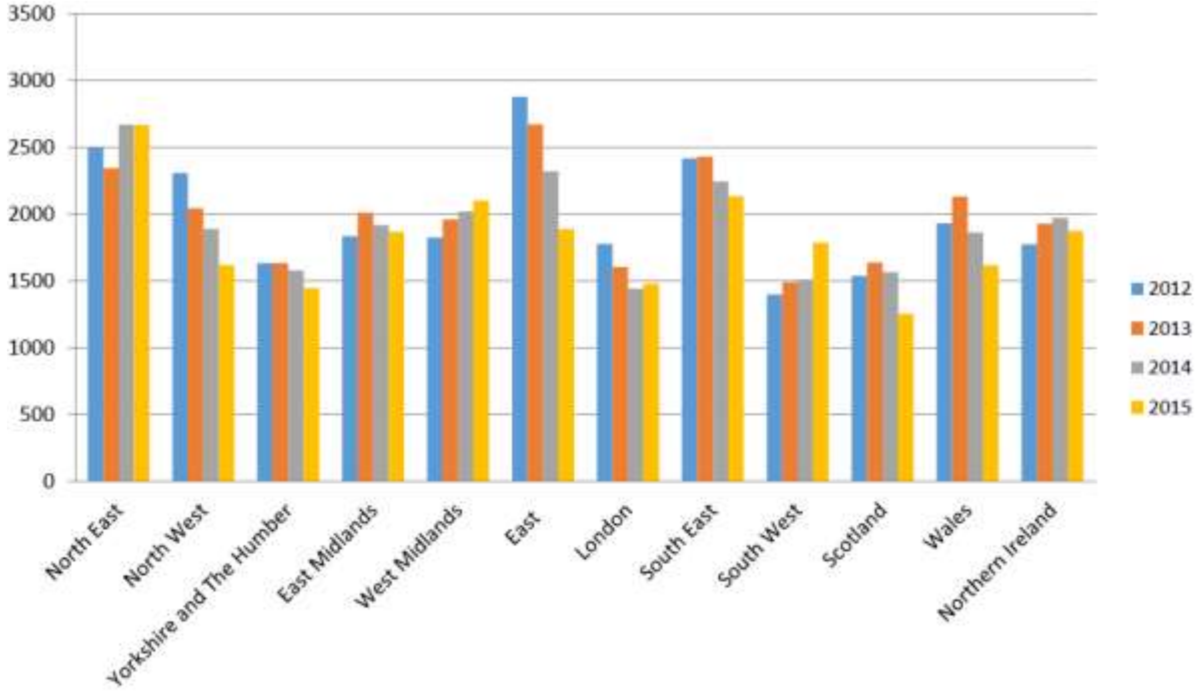
Method of Mitigation:

It is recommended that the Combined Authority ensure that the emerging British Industrial Strategy recognises the strategic importance to national competitiveness of Tees Valley's priority sectors and develops additional support aimed at mitigating constraints to strategically important industrial sectors.

Exporting

The EU is the UK's most important trading partner. The EU's market share of total UK trade fell steadily between 2002 and 2012 by 11 percentage points from 59% to 48%[8]. However, there are significant differences in the composition of local economies across the UK's regions and nations. These differences manifest in different trade patterns across the UK's regions and nations, including trade[9] with the EU

The chart below illustrates the per capita value of goods exports to EU by region (£m, 2015 prices):



Source: Sheffield Political Economy Research Institute (SPERI): British Political Economy Brief No.23: UK regions, the European Union and manufacturing exports.

The chart shows that the North East actually exports more goods to the EU than any other region, measured per head of population. The North East is the only English region to have consistently had a substantive goods trade surplus with the EU in recent years. The North

[8] UKTI 2013
[9] It should be noted that regional trade data is only available for trade in goods (principally manufactured products and commodities).

East overwhelmingly exports chemicals and cars to the EU. These are among the sectors with potentially the highest tariffs for imports in to the EU and means that the region could be very negatively affected. The North East Chamber of Commerce (NECC), notes:

> *"We have an export record which is the strongest in the whole country and this must not be compromised as the decision to leave becomes a reality. The Government must now secure the best possible ongoing relationship with Europe and the rest of the world to enable sustained business growth in our region.*
>
> *We also need to see measures to reassure businesses on issues such as access to overseas talent and the future of regional funding streams."*

There is a need for Central Government action to address two issues:

- Ensure continued access to core European markets for priority sectors such as Chemicals and Advanced Manufacturing; and
- Develop new trading arrangements and support for Tees Valley firms in diversifying international trade activity.

Key Risk:

Possible reduction in access to Single European Market (imposition of tariffs) could lead to reduction of principal export market for Tees Valley businesses.

Method of Mitigation:

It is recommended that the Combined Authority:

- Consult with local businesses to assess the impact of Brexit on existing trade and identify emerging markets; and
- Identify target markets and develop additional wraparound support for emerging market opportunities.

Foreign Direct Investment

A significant risk of the UK exit is a drop in the quantity of Foreign Direct Investment (FDI) coming to the UK. In 2015[10], 1,065 inward investment projects created 42,000 jobs across the UK (with the North East having 44 inward investment projects which created approximately 2,000 job).

The UK is the largest recipient of net FDI in Europe, receiving net inflows of over $62billion. The UK's attractiveness for FDI and its value as a gateway to Europe will remain strong (including liberalised energy and employment markets, ease of raising capital and ease of starting a business).

[10] Source UKTI Trade Figures 2012/13

In a 2013 survey of over 2,000 multinationals, 72% of companies interviewed in North America and 66% of those in Asia thought reduced integration with the EU would make the UK more attractive as a destination, against 38% of those interviewed in Western Europe (Ernst and Young 2013).

While it is not possible to say definitively the extent to which membership of the EU is a factor in inward investment decisions, it is undoubtedly a motivator. Furthermore, in the two years between the referendum and exit, the uncertainty created by the unknown trading relationship with the EU could cause businesses (both external and internal investors) to delay investment decisions until this is resolved.

Key Risk:

Possible reduction in access to Single European Market (imposition of tariffs) could lead to reduced appeal of Tees Valley as a key location for inward investment to access the Single European Market.

Method of Mitigation:

It is recommended that the Combined Authority deliver the following actions designed to mitigate the impact of Brexit on Tees Valley's FDI proposition:

- Establish sector strategies for key industries, developed in collaboration with business, with a particular focus on maintaining and developing the supply chain, to encourage investment in those areas which will most benefit industries in which the UK has existing strengths; and
- Implement policies that support an attractive investment climate, in particular investing in adequate new transport infrastructure, investing in sufficient generating capacity to provide affordable power and ensuring the planning regime is fit for purpose.

Attraction and Retention of Talent

There is significant pressure to use the UK's withdrawal from the EU to curb inward migration. At present, in-migration by European nationals is approximately 1,000 per year. Curbs on migration may have the following implications:

- **Short term reduction in skilled workforce:** It is difficult to assess a sectoral or skills breakdown for European nationals, but their sudden reduction may have negative labour market implications. This may be most pronounced in the priority sectors of the refreshed SEP which over the course of the next ten years will require an additional 25,000 jobs, 40% of which will be at NVQ Level 4 and a sizeable percentage of whom cannot be sourced locally; and

TEES VALLEY COMBINED AUTHORITY

- **Attracting and retaining international students:** Tighter migration controls may also lead to a reduction in the number of foreign students applying to Higher and Further education institutions across Tees Valley. As well as the loss of valuable student income (particularly to Durham University's Stockton Campus) to the local economy calculated at approximately £22-25k per annum[11], there may be a reduction in other in-kind benefits to the region, including:
  - The boost to external demand as a consequence of increased familiarity with locally produced goods;
  - Increased tourism revenues for returnees and/or their families; and
  - Increased international awareness of the Tees Valley as a place to live, work and play and networks of former Tees Valley students (i.e. making use of the international diaspora).

Perceptions of high migration into Tees Valley, compounded by aspects of the recent 'Brexit debate' may have exacerbated negative perceptions of migrants by the local community. In addition, recent and long established migrants themselves might have begun to assess an increasing 'chill factor'. Unless this is addressed it could make it more difficult to retain talent within the region.

Key Risk/s:

Problems in attracting and retaining talent within the Tees Valley.

Method of Mitigation:

It is recommended that the Combined Authority works with local industry to assess emerging skills demands and to signpost skills gaps to Central Government to inform migration targets.

It is recommended that the Combined Authority work with all local Higher and Further Education Institutes to ensure that sufficient numbers of foreign students can access further and higher education opportunities in the Tees Valley area.

It is recommended that the Combined Authority, in liaison with local authorities and the community and voluntary sector work with the local community and recent and long established migrants to signpost the scope and scale of emerging opportunities and how they can best access them.

[11] Source: The Costs and Benefits of International Students in Sheffield: Oxford Economics: January 2013.

International Knowledge Transfer

Innovation is central to enhancing Tees Valley's prosperity and the regional innovation ecosystem (in particular Universities and Catapults) has been largely supported by capital from the European structural funds but also revenue support from transnational programmes such as Horizon 2020.

Although the revenue support provided by the transnational programmes has proven useful, the real benefit to the UK and regional innovation ecosystem has been access to European wide innovation platforms (including European Universities, research bodies and SMEs). Presently Horizon 2020 is open to both European and non-European partners[12], such as the USA, Israel and Turkey.

Key Risk:

Reduction in access to European research, development and innovation networks.

Method of Mitigation:

It is recommended that the Combined Authority work with local Universities and research bodies to assess current Horizon 2020 and other transnational programme commitments and identify any emerging constraints to future access.

Economic Strategy and Intelligence Team,

Tees Valley Combined Authority,

August 2016

[12] Conditions for non European partners. They are free to take part in all submissions, but not always entitled to funding. Also depends on the focus of the call, some specifically require non EU partners.