Regional Aid Policies

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Abstract: This paper examines possible outcomes for regional policy in the UK following its withdrawal from the European Union. It argues that the existing Structural Funds are relatively small, but remain important for some locations. The evidence of their past effectiveness in reducing spatial inequalities or contributing to increased national growth is mixed. Any replacement for the Structural Funds should be aligned with current spatial interventions such as the "City Deals" and "Northern Powerhouse". The evidence for the existence of agglomeration economies suggests that a growth maximising policy should focus on the development of cities. On the other hand, political economy considerations suggest that reducing regional disparities may trump efficiency considerations, particularly where many of the regions gaining most from European support were also strong supporters of leaving the EU.

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Introduction

When the UK leaves the European Union, it will no longer have access to EU Structural Funds. These are the main source of regional aid from the EU to the UK. They comprise the European Regional Development Fund (ERDF) and the European Social Fund (ESF). Their main objectives are to reduce economic and social inequalities and to promote sustainable development in less affluent regions of the EU. A total of €282 billion has been allocated to the Structural Funds during the 2014-2020 budget round, of which €10.9 billion has been allocated to the UK. Should the UK leave the EU before 2020, the UK government has guaranteed that it will make good the shortfall in EU funding. There are no guarantees of continuation beyond 2020.

There is therefore some time for the UK Government to consider whether the Structural Funds should continue in their present form (though funded by the UK Government), be replaced by alternative schemes, or be discontinued. This decision will inevitably be informed by current views on the social and economic case for regional policy. Changes to Structural Fund policies will also interact with existing policies that affect the spatial distribution of economic activity in the UK, either intentionally, or as an unintended consequence. Further, the Structural Funds currently are administered separately by the nations that comprise the UK. The UK Government, if it decides to continue with regional support policies, will also have to determine the allocation of funds between the UK nations and the scope for policy variation across these territories.

The form of post-Brexit arrangement with the EU will also be relevant to decisions on the future of the Structural Funds. Any relationship that involves access to the single market is likely to require observance of EU state-aid rules. These require agreement with the EU on those "Assisted Areas" where government is permitted to provide direct aid (up to specified limits) to businesses. New policies that replace the Structural Funds would be required to limit eligibility to economic agents that operate within the agreed Assisted Areas. If the post-Brexit settlement does not involve single market access, then the UK would have more freedom to provide regional aid.

This paper seeks to address these issues. It begins by discussing the case for regional intervention in general. It goes on to describe the EU structural funds, their purpose and evolution. It then outlines the somewhat eclectic mix of current regional policies within the UK, noting that there is a significant divergence between the views of "traditional" regional economics and New Urban Economics (NUE) regarding the effectiveness of UK regional policy. The paper also addresses the political economy of spatial interventions in the context of various forms of devolved governance to nations, areas and cities. It concludes with a discussion of the U.K.'s post-BREXIT regional policy options.

The Case for/against Regional Policy

Regional policy is usually justified on the basis of increasing economic activity within specific parts of a nation state. Whereas disparities in income at the individual level are attenuated by the tax and benefit system, regional policy has rather focused on reducing disparities in regional competitiveness (Begg, Gudgin, G. & Morris, 1995). Thus, expenditure associated with regional policy is often focused on improving infrastructure, promoting innovation, supporting research and enhancing skills. From a political perspective, regional policy has been justified as a mechanism for increasing the cohesion of the nation state, or in the case of the EU, the overall cohesion of the member states and is administered on an EU-wide basis, where the focus is on the economic health of the regions that make up the member states, rather than the member states themselves.

However, there is no guarantee that such regional policy interventions are welfare maximising. Political economy considerations are likely to bias regional policy in favour of smaller regions, because of their frequently disproportionate political weight (Wiberg 2014). This counters the effects of agglomeration economies which suggest that trade will concentrate in larger regions resulting in a loss of welfare.

The net effect of regional policy on aggregate welfare will thus depend on the relative size of regions, their governance structure and voting systems. There is no guarantee that its effects will be positive, though some may argue that the cohesion arguments override the welfare considerations, particularly where the nation state itself is unstable. A narrow welfare analysis based on comparative statics may not capture the range of possible political and economic outcomes associated with differential regional economic performance.

The Structural Funds

The Treaty of Rome set a goal of reducing spatial disparities among and within the original member states by “reducing the differences existing between the various regions and the backwardness of the less favoured regions” (Treaty of Rome 1957). The Single European Act in 1987 introduced the notion of “economic and social cohesion” as a principle that supports policies which seek to redistribute between richer and poorer regions of the EU. The main policy instruments to support such provision are the European Social Fund (ESF) and the European Regional Development Fund (ERDF).

The ESF was set up in 1958 with the objective of increasing Europe’s human capital stock by integrating those currently excluded from the labour market and by promoting skills and equal opportunities. It emphasises partnership working - involving the EU, national and regional authorities as well as other social partners such as NGOs and workers' organisations. It requires co-financing as a signal of commitment from local stakeholders: co-financing rates vary between 50% and 85% of total project costs.

The ERDF was established in 1975. It was proposed by the UK, reflecting its concern that the European Union budget was dominated by support for agriculture. Its focus has changed over time and its "thematic concentration" during the 2014-2020 budget round is on providing funding to support innovation and research, the digital agenda, small and medium-sized enterprises and the low-carbon economy.

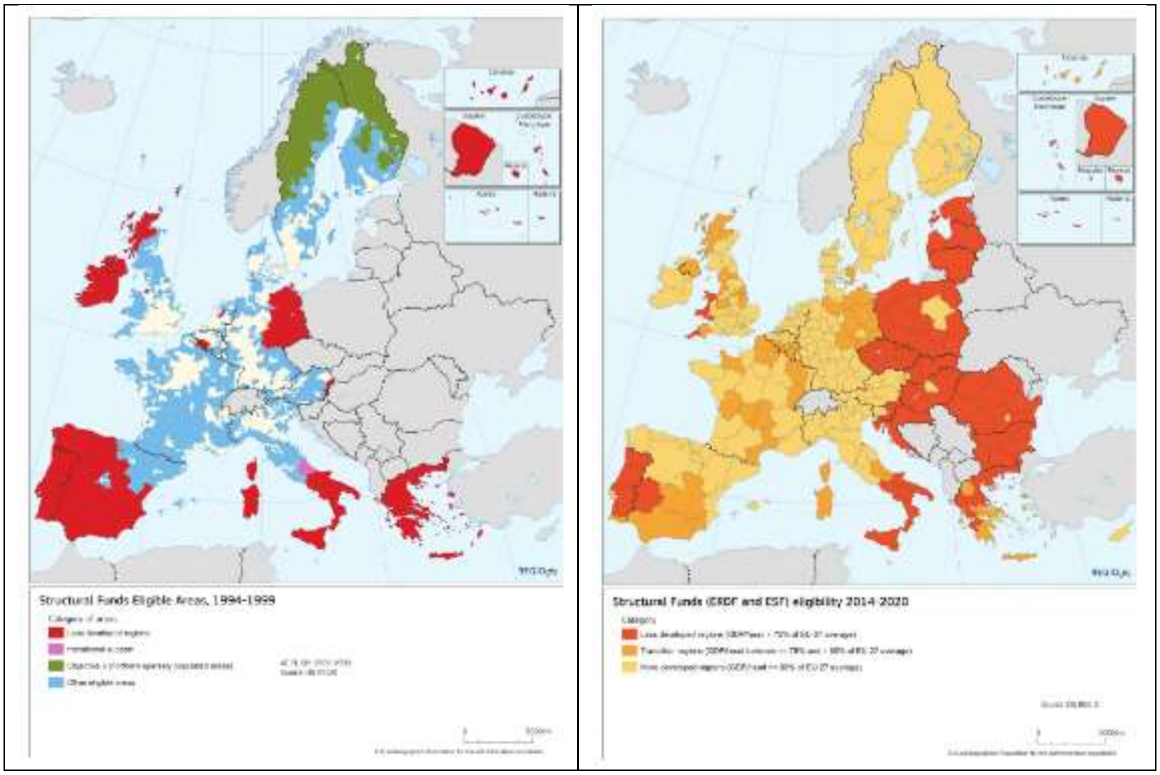
Eligibility for Structural Fund support

Those areas eligible for Structural Fund support have changed as relative economic conditions have fluctuated and new members have joined the EU. Figure 1 shows the maps of Structural Fund eligibility for 1994-1999 and 2014-2020. For the 2014-2020 round, eligibility for support from the Structural Funds is determined by per capita GDP relative to the European average. "Less-developed" regions are defined as those whose GDP per head is less than 75% of the European average; "transition" regions are those with GDP per head lying between 75% and 90% of the European average; the rest comprise the more developed regions. The most obvious change between 1994-1999 and 2014-2020 is the shift in support towards the "Accession States" in Eastern Europe which have joined the EU since 2000. As for the UK, the most notable changes between 1994-1999 and 2014-2020 are the absence of the Scottish Highlands and Northern Ireland from the 2014-2020 map and the inclusion of West Wales and Cornwall, which now qualify as less-developed regions.

Level of financial support from the Structural Funds

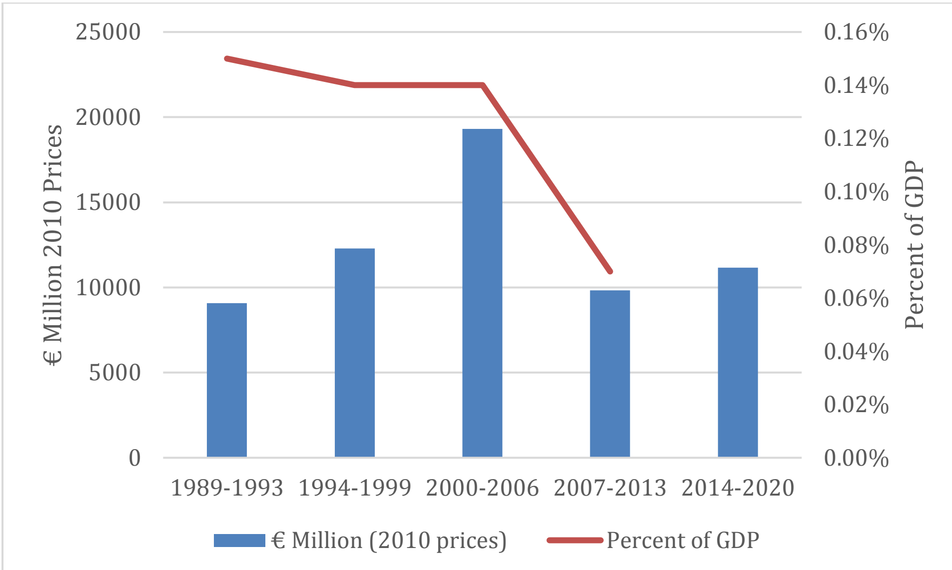
The financial support received by the UK from the ESF and the ERDF is shown in Figure 2, both in € millions in constant 2010 prices and as a share of UK GDP (averaged over the relevant budgetary round). The real value of Structural Fund payments to the UK increased significantly between 1989 and 2006. Thereafter, EU enlargement and pressure to reduce the size of the EU budget, much of which came from the UK, led to a significant reduction. As a share of GDP, Structural Fund spending dropped to around 0.06% of GDP over this period. Given that total UK government spending averaged 46.6% of GDP over the same period, it is clear that EU Structural Funds comprise only a very small proportion of UK public spending.

Figure 1: Structural Funds Eligible Areas 1994 – 1999 and 2014 – 2020



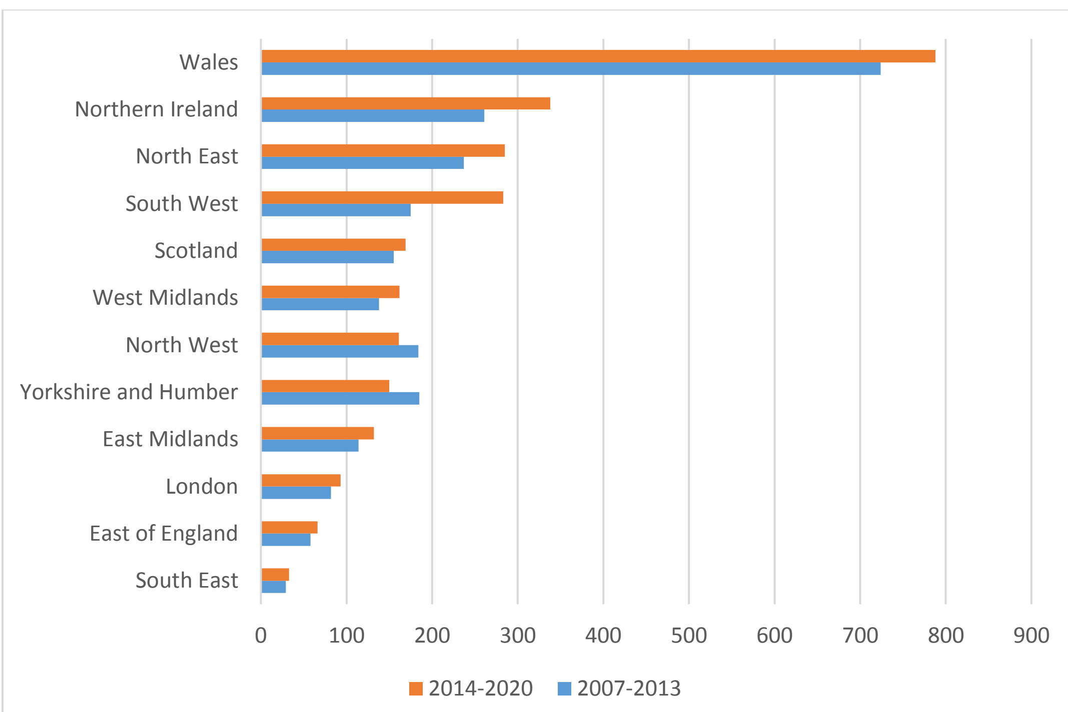
Nevertheless, because eligibility for Structural Funds is geographically limited, the impact on government spending in “less-developed” and “transition” areas is more significant. The distribution of Structural Fund spending by region within the UK for the 2007-2013 and 2014-2020 budget rounds is shown in Figure 3. If the UK Government decides to discontinue the Structural Funds after 2020, Wales, Northern Ireland, the North-East and South-West of England will be the main losers. The principal loser will be Wales where total funding for the 2014-20 budget round is almost £800 per head, more than double that in any other region or nation.

Figure 2: Resources received by the UK from the Structural Funds 1989-1993 to 2014-2020



Source: Charles (2016) [Table 16.2, P256]

Figure 3: Structural Fund Per Capita Spending by Region in the 2007-2013 and the 2014-2020 Budget Rounds



Source: SPERI (2016)

Although the EU process for determining Structural Fund eligibility is transparent, the EU does not control allocations *within* member states. These are determined by the member states themselves. The UK Government's principal decision is the allocation between the nations that comprise the UK. The allocations in the 2014-20 budget round were challenged by some of the local authorities in the north of England on the basis that they were overgenerous to Scotland, Wales and Northern Ireland. However, the UK government decisions on these allocations were upheld by the Supreme Court.

Loss of the Structural Funds would imply the loss of the only form of regional economic support in the UK that is area-based and relies on an objective and simple measure of economic disadvantage (per capita income relative to the EU average). Although this is a crude measure of need, it is transparent and is applied consistently across the UK. Other methods for allocating government funding to the U.K.'s regions and nations are more opaque. For example, spending allocations to education, health and local government are based on complex "needs assessment" formulae that are open to manipulation. For example, recent changes to the schools funding formula in England will lead to substantial changes in spending per pupil across its regions (Coughlan 2016).

Grants to the Scottish Parliament and the Welsh and Northern Ireland Assemblies are determined by the Barnett Formula. This is an incremental mechanism which does not reflect current needs. It has been heavily criticized, particularly in Wales and England, for providing higher levels of support to Scotland and Northern Ireland than can be justified by objective measures of need.

Policy objectives for the Structural Funds have changed over time, but, since they are allocated to regions whose per capita income falls below the relevant thresholds the expectation is that increased economic activity deriving from Structural Fund projects reduces spatial divergence both within countries and across the EU. The UK objectives for the use of the funds in the current budget round, agreed with the EU, are:

1. improving labour market and education policies;
2. reducing the risk of social exclusion;
3. promoting research investment and the competitiveness of the business sector;
4. promoting an environmentally friendly and resource-efficient economy

Removal of the Structural Funds post-BREXIT may weaken commitments to these priorities at both the regional and national level. There is no guarantee that the UK Government, no longer constrained by EU objectives, will continue to support these objectives over the same areas that currently qualify for support. However, given that the UK is a net contributor to the EU budget, funding could, in principle, be increased. This would require the UK Government to be convinced of the benefits of continuation of the Structural Funds relative to alternative uses of this funding. We therefore now consider the evidence for the value of past Structural Fund policies.

Effectiveness of Structural Fund policies

How effective have the Structural Funds been in achieving the objective of narrowing regional disparities? A recent assessment for the UK (Polverari et al. 2014) claimed that:

"the evidence on the benefits derived from cohesion policy implementation in the United Kingdom is … not conclusive. The small scale of the funding relative to UK GDP and the use of co-fund domestic policies and spending programs makes it difficult to identify additionality and the specific contribution of the Funds. On the one hand, the performance of UK assisted areas over the past two programme periods has been mixed and no significant catching up can be observed. On the other hand, research has highlighted several areas where EU structural funds have resulted in economic development activity being expanded, beyond what would have taken place in the absence of EU funding".

The report claims that EU member states derive benefits from Structural Fund spending in other countries due to trade effects. These benefits would likely disappear unless the UK's post-Brexit agreement includes continued (and presumably reciprocal) access to public contracts in EU countries.

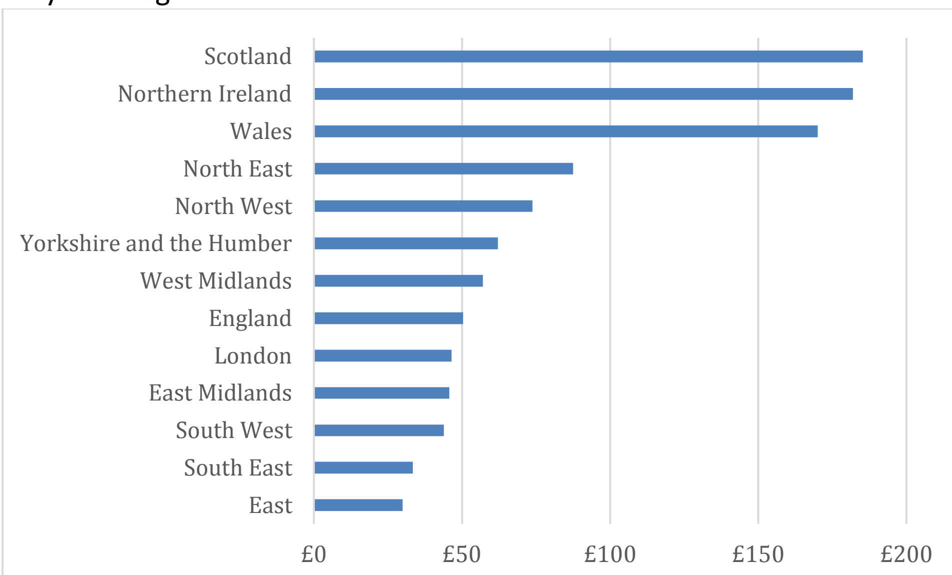
At the EU level, Becker et al. (2013) using a method designed to identify whether regions which qualify for "Objective 1 Structural Funds" have significantly higher per capita income growth and investment. They conclude that "*Only about 30% and 21% of the regions – those with sufficient human capital and good-enough institutions – are able to turn transfers into faster per-capita income growth and per-capita investment.*" Their support for the effectiveness of the Structural Funds is conditional on regional "absorptive capacity" (in terms of human capital and institutions).

Although, there are many caveats that should be associated with this evidence, it does not provide strong empirical support for the notion that the Structural Funds have had a substantial positive effect on regional economic activity. The Becker et al results indicate that the ability to effectively absorb such funding is an important guide to its efficacy.

Current UK Regional Policy

The current batch of policies intended to influence the spatial distribution of economic activity across the UK comprise a mixture of initiatives. Together, they comprise only a small proportion of UK government expenditure. In 2014-15, from a total of £602 billion spent on public services, only £4.8 billion was directed towards "economic development and economic affairs" – the category of public spending which includes a variety of forms of support for industrial development which inevitably have a spatial dimension. There was wide variation across the UK in this form of support to local economic development. Figure 1 shows public expenditure per head on economic development and economic affairs by country and region for 2014-15.

Figure 4: Expenditure per Head on Economic Development and Economic Affairs by Country and Region 2014-15



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Source: HM Treasury (2016) Public Expenditure Statistical Analysis

Public spending per head on economic development and economic affairs across England is substantially lower than in Scotland, Wales and Northern Ireland. Some of the difference can be explained by EU support, particularly in Northern Ireland and Wales. Nevertheless, the contrast between England and the Celtic nations is remarkable. Raising spending per head in England to the average of the Celtic nations would cost around £7 billion.

Low levels of spending in England are partly explained by the much less prominent role played by local economic development agencies than is the case in Scotland, Wales and Northern Ireland. The disbandment of the Regional Development Agencies in 2010 and their replacement by Local Economic Partnerships (LEPs), was part of a significant centralisation of industrial policy in England (Peck et al 2013). Although ostensibly a response to the "localism" agenda, which stresses the importance of basing local development strategies around local assets and capabilities. The oversight of the LEPs by the Department of Business Innovations and Skills and their limited powers weakened the scope for locally designed economic development interventions.

Some specific policies designed by BIS involve LEPs as partners, though the associated funding belies the publicity that they receive. They include the *Regional*

Growth Fund, which is intended to stimulate enterprise and support areas heavily dependent on the public sector. It spent £2.6 billion between April 2011 and March 2015, but was discontinued following the 2015 spending review. Also available in England only are *Enterprise Zones* which offer reductions on business rates, simplified planning, high-quality broadband and capital allowances in selected areas. There are 48 Enterprise Zones. The evidence that enterprise zones generate a net increase in economic activity is weak. For example, Boarnet and Bogart (2002) argue that the introduction of enterprise zones in New Jersey had no net effect on employment or on property values. *Devolution deals* are transfers of powers from central government to English local authorities. These have mainly been presented as mechanisms for making government more local and accountable rather than necessarily driving economic growth. By November 2016, 11 such deals had been arranged. Funding comprises a mixture of loans and grants from a variety of bodies, making it difficult to assess the overall costs of devolution deals.

City deals are collaborative agreements between a range of bodies including the UK Government, local government, the devolved authorities outside England, and other private and public sector partners. Their objective is to stimulate growth in, and devolve power to, the larger UK cities. Between July 2012 and August 2014, 26 City Deals were agreed. UK government has committed to spend £2.3 billion over 30 years to fund 40 programs. This is an extremely modest level of funding, even in comparison to the Structural Funds. In addition, their complexity means that evaluation of these deals will be extremely due to the difficulty of constructing a plausible counterfactual.

Devolution deals involve the transfer of powers, funding and accountability for policies and functions previously undertaken by central government. Specific arrangements vary in each case, as they are negotiated and agreed separately, based on local proposals. The UK government and the parliaments in its constituent nations also pursue spatially specific policies aimed at increasing economic activity in designated areas. In contrast to the clear rules used to allocate Structural Funds, these policies are more opaque. Rather than being centrally funded, area-based programs where funding is linked to economic disadvantage, these are programs designed to increase the scope for local decision-making. They involve increased local control over property taxation and spending. Their lack of transparency, and the associated difficulty of conducting rigourous evaluation of their effectiveness has been criticised, for example, by the Select Committee on Communities and Local Government:

> *"We also believe that the Government's approach to devolution in practice has lacked rigour as to process: there are no clear, measurable objectives for devolution, the timetable is rushed and efforts are not being made to inject openness or transparency into the deal negotiations."* (UK Parliament, 2016)

Regional Selective Assistance (RSA), a policy which began in the 1970s, is now only available in Scotland. It gives grants to incumbent and inward investors and is managed by Scottish Enterprise and Highlands and Islands Enterprise. In 2014-15, it allocated £57.8 million and claimed to create or safeguard 9000 jobs. *Welsh Government Business Finance o*ffers discretionary financial support to eligible businesses in certain business sectors and certain strategically important projects outside these across Wales. *Selective Financial Assistance* provides support for investment in Northern Ireland by indigenous and foreign owned companies that create, maintain or safeguard employment. The scheme aims to achieve higher levels of business growth, leading to long-term high quality employment.

The current relatively weak commitment to regional policy contrasts starkly with the approach to regional intervention during the 1970s. At that time, policies were principally aimed at reducing relatively large regional unemployment rate disparities. While current UK regional policies implicitly target supply failures in the regional economy, the 1970s interventions were primarily Keynesian in nature in that they focused on increasing demand. Measures included labour subsidies (the Regional Employment Premium), capital grants and subsidies to firms (Regional Selective Assistance), and controls over firm location (Industrial Development Certificates). Their subsequent removal was partly due to a general switch from demand-side to supply-side interventions and also from EU rules which precluded regional policies that were implicitly forms of state aid.

As a proportion of GDP, expenditure by the UK Government on regional policy declined from 0.4% in the early 1980s to under 0.1% in the 1990s (Taylor and Wren, 1997). This was partly offset by increased support for regional interventions from EU Structural Funds. While the UK government tended to oppose increased spending on agriculture, the largest component of the EU budget, it was more supportive of expanding the Structural Fund budget, where it was, at least initially, one of the main beneficiaries.

There was a partial revival of interest in regional policy during the 1990s, largely on the grounds of the contribution that regional policy could make to *national* growth objectives. It was believed that Regional Selective Assistance had been relatively successful in increasing inward investment. In addition, the process of applying for EU funding had convinced local and regional stakeholders of the value of designing regional development strategies. Persuaded by this argument, the 1997 Labour government established Regional Development Agencies in each of the English regions. These fell victim of the first round of austerity cuts in 2010 and were replaced by the LEPs with fewer resources and powers.

One justification for the rundown in regional policy is that spatial equity is in conflict with national growth objectives. For example, Martin (1998) argues that

".. policymakers may face a trade-off between aggregate growth at the level of countries and convergence between regions inside a country. Efficiency concerns and the objective of maximising growth at the country level may require spatial concentration of economic activities which itself leads to regional divergence"

This argument is aligned with views associated with researchers in the recently developed fields of New Economic Geography and New Urban Economics. These have focused on agglomeration economies - productivity increases associated with geographical concentrations of economic activity. If these agglomeration economies exist, policies to support the growth of cities would constitute a more efficient use of public funds than general area-based support. These arguments have found support within HM Treasury:

"Theory and evidence suggests that allowing regional concentration of economic activity will increase national growth. As long as economies of scale, knowledge spillovers and a local pool of skilled labour result in productivity gains that outweigh congestion costs, the economy will benefit from agglomeration… policies that aim to spread growth amongst regions are running counter to the natural growth process and are difficult to justify on efficiency grounds, unless significant congestion costs exist" HM Treasury (2007)

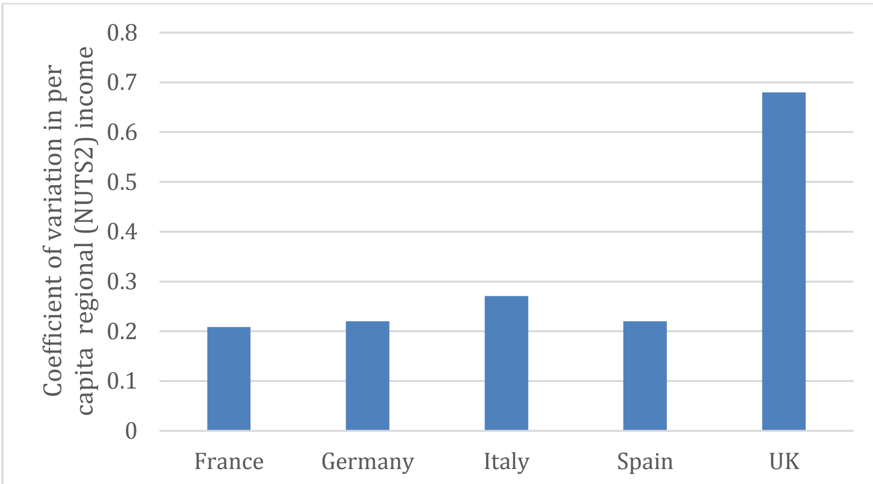
Recent evidence on total factor productivity in British cities (Harris and Moffat 2012) gives a somewhat more nuanced picture. Productivity in cities tends to be higher than in their hinterlands, but the effect of agglomeration varies across manufacturing and service sectors, which may indicate differential congestion effects.

Nevertheless, a general acceptance of the importance of agglomeration somewhat undermines the traditional approach to regional policy because it questions their effectiveness in fostering national economic growth. This is a crucial debate which will have a major influence on how regional policy evolves in the post-BREXIT era. Yet the political economy of regional interventions may work against this argument. Political pressures to reduce regional disparities may be more compelling than the case for further agglomeration and higher national growth. In the next section we examine the size of these disparities.

Regional Disparities in the UK

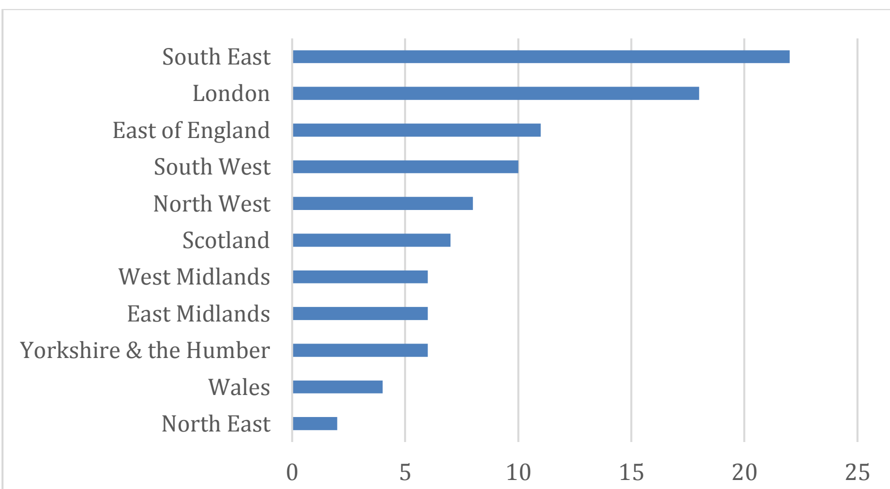
All countries experience some spatial variation in economic indicators. For many labour market indicators, such as unemployment and activity rates, outcomes for the UK vary less and have better average outcomes than in other large European economies. However, the UK is an outlier in spatial income and wealth inequality. Figure 6 shows the coefficient of variation in regional per capita income in 2014 for the EU's five largest economies. Its value for the UK is more than double that in any of the other economies, suggesting that regional differences in income in the UK are much larger than those in the other large European countries.

Figure 6: Coefficient of Variation in Regional Per Capita Income 2014



Source: Eurostat

Figure 7: Proportion of Households in the Top Wealth Decile by Region and Country

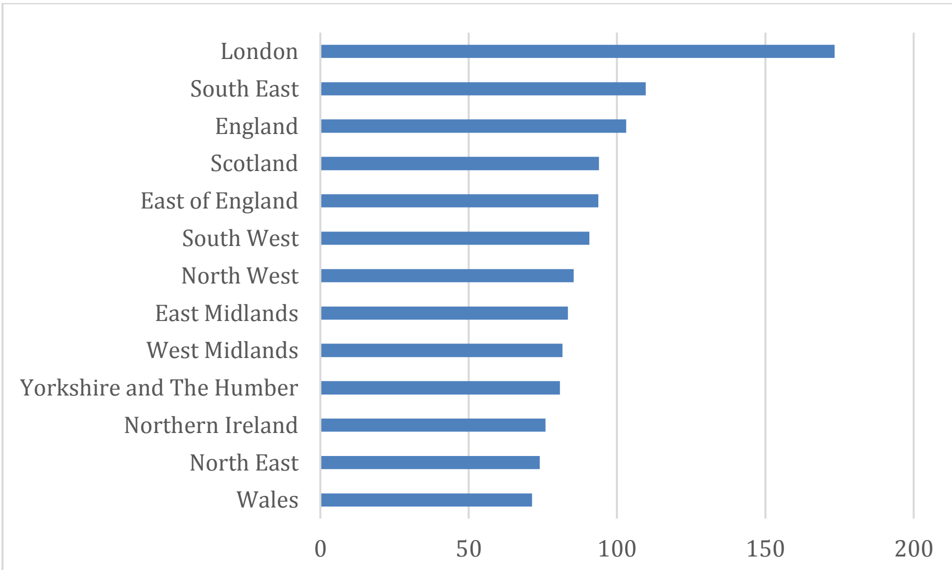


Source: ONS Wealth and Asset Survey 2012-2014

The UK also exhibits very large variations in average wealth by region. Figure 7 shows the proportion of households in the top wealth decile by region and country in 2012-2014. The proportion of households in the South East in the wealthiest 10% is 11 times greater than that in the North East. Some of the regional variation in wealth is explained by spatial variation in property prices, but differences in income also drive variation in the value of pensions, financial assets and physical assets.

There are also wide variations in regional gross value added (GVA) per capita (Figure 8) across the UK. Output per person in London is more than double that in Wales.

Figure 8: Regional GVA Per Head (UK=100)



Source: ONS (2016)

The "regional problem" that the UK now faces differs substantially from that experienced in the 1970s. Rather than being concentrated in labour market participation and unemployment, they are now reflected in substantial divergence in income, wealth and productivity. It is not therefore clear that the policies which were used to address the difficulties faced some decades ago are still appropriate. Differences in income and wealth are more appropriately dealt with by the tax and benefit system rather than by general regional interventions that inevitably carry significant deadweight loss. And differences in productivity are more suited to supply-side interventions, with beliefs about the size of agglomeration economies likely to provide an important input to policy design.

Conclusion – Post-Brexit Options for the UK

Our analysis has established that:

1. Structural fund expenditure in the UK is relatively small in relation to overall public expenditure, but highly concentrated in areas such as Wales and Cornwall.

2. The evidence on the effectiveness of structural aid expenditure in terms of raising levels of per capita income and investment is mixed.

3. Any regional policy will interact with other spatially selective public expenditure programs, including recent initiatives to devolve power to regions within England and the Celtic nations. There is little evidence thus far of the effectiveness of these policies. Indeed, their design is likely to render their evaluation highly problematic in the future.

4. The arguments that regional aid can contribute to national growth and/or to reduced regional disparities are contested. The New Urban Economics tends to support the case that there are increasing returns to agglomeration and that spatially selective policies aimed at poorer areas will reduce economic efficiency. Further, the evidence that they reduce regional inequalities of income is also contested.

Given these findings, what are the options for UK regional policy post-BREXIT?

There is a commitment to maintain funding until 2020 will provide some short-term relief for agencies counting on continuation of these monies. However, beyond 2020 and assuming that BREXIT involves leaving the single market and the customs union, regional policy options for the UK include:

1. Discontinue the Structural Funds and rely on existing regional initiatives to deliver regional priorities. This approach would be consistent with the NUE arguments and help close the U.K.'s structural budget deficit, albeit in a relatively small way.

2. Continue with the Structural Funds, following EU practice in determining area eligibility and levels of funding. Although politically, there may be a loss aversion case for maintaining existing policy structures, this hardly seems a plausible strategy. If those who voted in favour of BREXIT were well informed, then it might seem unlikely that a continuation of EU determined policies would be acceptable. One difficulty with this argument is that those areas which receive the highest levels of Structural Funds per person, such as Wales and Cornwall, were also strongly supportive of BREXIT

3. Maintain existing levels of funding to support spatial economic policies, but realign them with existing UK regional policies. This would involve a switch from a uniform, transparent regime where funding is distributed centrally based on observable criteria to one which is largely responsive to requests for greater local autonomy. Thus, for example, central government funding for City Deals might be enhanced. However, these policies can only be supported if they yield positive results from more rigourous evaluation procedures

4. Return to Keynesian policies designed to increase demand in areas experiencing high levels of unemployment or inactivity. Such a return to the 1970s is unlikely to find favour in policy circles, partly because differences in unemployment and inactivity rates are now small compared with that era, while differences in market income and wealth have tended to increase in the recent decades. And although working age benefits have fallen in real terms since 2010, these are better targeted on low income families than general area-based subsidies.

Two final points are worth making:

1. If the UK continues to follow a lax monetary policy combined with a tight fiscal policy, opportunities for increased funding for regional policy will be limited. Though monetary policy does have regional effects, particularly through its effect on the spatial distribution of wealth, reacting to these is not part of the Bank of England's remit. The chief economist at the Bank has acknowledged that asset purchase schemes may have widened regional wealth inequalities, particularly through their effects on the property market, but he argues that it is the responsibility of government, rather than the Bank, to counter these effects (Haldane 2016).

2. The potential losers from redirecting the Structural Funds to other public spending priorities include a variety of stakeholders including not only local authorities, but also the Scottish Parliament, Welsh and Northern Irish assemblies. These are likely to contest such reductions in their funding and argue that they should be able to control the distribution of any replacement funding. Difficulties in rebutting these arguments may well lead to sub-optimal allocation of regional support across the UK and difficulties in establishing robust evaluation criteria. It may also be difficult for a government which negotiates BREXIT to cut regional policy support in areas which voted heavily in favour of BREXIT.

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