

BREXIT AND THE EU BUDGET: THREAT OR OPPORTUNITY?

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SUMMARY

Brexit could affect EU public finances through multiple channels. One-off effects such as the ‘divorce bill’ receive much attention today, but structural effects could be more important for the EU in the medium term. Without the UK, the EU budget would face a permanent funding gap.

” THE BREXIT GAP
(...) WOULD AMOUNT TO
APPROXIMATELY €10
BILLION PER YEAR”

We estimate that the ‘Brexit gap’ in the budget would amount to approximately €10 billion per year. The EU Member States need to decide whether to adjust to this shortfall by (1) increasing national contributions, (2) cutting spending, or (3) a combination of the two. We draw up scenarios that illustrate the consequences of each option for individual countries.

We discuss the implications of these scenarios for the negotiations about the EU’s next multi-annual financial framework (MFF) starting in 2018. We expect hard bargaining as Brexit would entrench existing divisions between net contributors and net beneficiaries of the EU budget.

- Increased contributions would likely be resisted by net contributors, who would have to shoulder most of the burden. Countries that currently benefit from a ‘rebate on the rebate’ would be among the most affected.
- Budget cuts are unappealing to those countries that currently profit from EU cohesion policy and the Common Agricultural Policy.

The bargaining strength of the two groups will depend on their members and on the legal framework.

- There is a key group of countries whose net contribution per capita is close to balance (including France, Ireland, Italy, and Spain). They could either support spending cuts or a rise in contributions.
- The question: “What happens if there is no agreement on a new MFF by 2020?” could become highly controversial. The relevant legal provisions are vaguely worded and depend on the timing of Brexit.

Brexit offers an opportunity for reforming the EU budget. Net contributors could agree to increasing contributions in exchange for a deep reform of the expenditure side of the budget. An even more ambitious option would be to simultaneously overhaul the EU’s revenue sources based on the proposals of the ‘Monti Report’.

If the EU cannot agree on either of the above solutions, Brexit might pose a threat to the EU budget. The Member States might be tempted to balance the budget by cutting vulnerable but essential ‘non-allocated’ spending (e.g., on infrastructure or research), increasing contributions and introducing additional rebates to secure the agreement of the most affected net contributors. This would entrench an inefficient and obscure system for many years to come.

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INTRODUCTION

It is widely accepted that the British decision to leave the European Union (EU) was influenced by the debate about the EU budget. The Leave campaign's claim that Brexit would free up 350 million British pounds per week for the British National Health Service was hugely successful. But is the opposite also true? Will British withdrawal have a decisive influence on the EU budget?

In this study, we estimate how Brexit would impact the EU's public finances and highlight political implications. We draw up four scenarios that outline how the EU could react to the expected budget shortfall after Brexit. We also provide estimates of how the individual Member States might be affected by the different options.

The objective is not to provide exact figures. This would be a premature effort, given the high uncertainty surrounding the activation of Article 50 and subsequent negotiations. Instead, we aim to capture the key challenges and dynamics that await the EU budgetary negotiations. Our focus lies on structural effects and specifically on the upcoming negotiations about the next Multiannual Financial Framework (MFF), which will start in 2018.

“WE AIM TO CAPTURE THE KEY CHALLENGES AND DYNAMICS THAT AWAIT THE EU BUDGETARY NEGOTIATIONS”

Overall, we find that Brexit could have a quite significant, although not devastating, impact on the EU budget and would likely deepen the existing cleavage between ‘net contributors’ and ‘net recipients’. This poses a number of tough challenges for the EU but could also support efforts to reform the current system.

1. Through which channels could Brexit affect EU public finances?

There is no doubt that Brexit will affect the EU budget. In fact, the outcome of the Brexit referendum has already had an impact on the 2016 annual budget. The strong recent depreciation of the British pound against the euro has translated into a major reduction of the UK's contribution in euro values for 2016¹, forcing the Commission to find a way to compensate for this loss². But the repercussions for EU finances will be more significant once Brexit becomes a reality. There are two types of effects: one-off and structural.

1.1. One-off effects of Brexit

There are a number of possible one-off effects. The division of the EU's assets and liabilities between the UK and the remaining EU27 is one example³. As the EU has more liabilities than assets⁴, this division will probably translate into a payment to be made by the UK to the EU – something that the press has popularised under the name of ‘divorce bill’. The amount of this ‘bill’ is very difficult to estimate and will entirely depend on Brexit

1. Member States' contributions to the EU budget are expressed in euros, but countries not belonging to the euro make the payments in their own currency on the basis of the exchange rate set on 31 December of the previous year. If the exchange rate varies during the year, the country's contribution expressed in euros will change accordingly.

2. The Commission has proposed to compensate this gap with revenue from fines. See [Draft Amending Budget No 6 to the General Budget](#).

3. The EU's assets basically consist of financial assets (loans, cash), pre-financing amounts and properties and equipment. The EU's main liabilities include pension rights, future payment obligations related to multi-annual projects, borrowing operations (e.g. through the EFSM mechanism), provisions made to cover risks taken through loans and other financial instruments, and pending invoices.

4. According to the EU's consolidated accounts, in 2015 the value of the EU's assets was €154 billion, whereas the EU's liabilities amounted to €226 billion.

negotiations. According to the Financial Times, it may range between €20 and 60bn⁵. From a budgetary perspective, the outcome of these negotiations is important as it will determine the extent to which the UK will participate in paying for outstanding commitments (the so-called 'RAL') pending after Brexit. Since the UK rebate is paid to the UK government with a one-year delay, the rebate corresponding to the year Brexit takes place may also be included in the calculus of the 'divorce bill'.

If the UK leaves the EU in mid-2019 (that is, before the end of the current Multiannual Financing Framework)⁶, Brexit will also entail a loss for the 2020 EU annual budget equivalent to the UK's total or partial yearly net contribution, which has amounted to around €10bn on average during the last five years (see section 3). The magnitude of the loss will depend on the outcome of Brexit negotiations. The UK could face domestic pressure to stop all payments right after exiting the Union or even before, but the likelihood of this happening is very low. The likely response from the EU27 would be to stop transfers to UK beneficiaries (regions, farmers, researchers) and the UK government will need some time to replace existing EU funding schemes with its own funding. Besides, a unilateral UK decision to stop payments would be interpreted as an aggressive move in Brexit negotiations, and would worsen the UK's ability to obtain gains on more important issues, e.g., better access to the single market, good treatment of UK citizens in Europe or favourable terms in a future UK-EU trade agreement. All in all, what seems more likely to happen is that the EU27 and the UK reach an agreement by which the UK commits to honouring part of the commitments taken under the current MFF in exchange for a progressive phase-out of EU transfers to the UK.

A Brexit before the end of 2020 would oblige the EU27 to revise the current MFF in order to adjust it to the total or partial loss of the UK's contribution⁷. The content of such a revision could become hotly contested, even more so if we consider that the MFF regulation does not provide exact guidelines for adjustment. Furthermore, the changes to the MFF may have important implications for later negotiations (we will return to this topic in section 4). It is also worthwhile noting that, in case of no agreement on how to adjust the 2020 annual budget to Brexit, the levels of spending corresponding to the 2019 budget would be maintained and the gap would be automatically filled through an increase in national contributions⁸.

TABLE 1 ► Channels through which Brexit could affect EU public finances

	ONLY IF BREXIT HAPPENS BEFORE 2020	BREXIT HAPPENING BEFORE OR AFTER 2020
One-off effects (short-term)	Total or partial loss of the UK's net contribution in the 2020 budget	UK not paying the 'RAL' pending after 2020
Structural effects (medium-term)		Permanent funding gap equivalent to the amount of the UK's net contribution (or lower in case of 'soft Brexit')
		Major reduction of the EU budget in absolute terms if the Council maintains stance to keep EU budget at 1% of EU GNI
		Abolition of the UK rebate and 'rebates on the rebate'
		Changes in the dynamics of budgetary negotiation in the EU Council

Source: Authors' own representation.

5. "UK faces Brexit divorce bill of up to €20bn", *Financial Times*, 12 October 2016; "UK faces Brexit bill of up to €60bn as Brussels toughens stance", *Financial Times*, 15 November 2016.

6. This would imply that the UK government activates Article 50 before March 2017 (as announced by Theresa May) and that there is no extension of the two-year period for negotiation.

7. Art. 20 of the current MFF regulation: "Should a revision of the Treaties with budgetary implications occur between 2014 and 2020, the MFF shall be revised accordingly."

8. Art. 315 TFEU stipulates that, "if, at the beginning of a financial year, the budget has not yet been definitively adopted, a sum equivalent to not more than one twelfth of the budget appropriations for the preceding financial year may be spent each month in respect of any chapter of the budget."

1.2. Structural effects of Brexit

” STRUCTURAL EFFECTS
(...) ARE POTENTIALLY
MORE IMPORTANT
FOR THE EU”

Apart from these one-off effects, Brexit will have a significant impact on the size, composition and financing of the post-2020 MFF. These structural effects are less salient today but are potentially more important for the EU.

- First of all, Brexit will translate into a permanent funding gap for the next MFF, which could be equivalent to the amount of the UK's net contribution or lower, depending on the terms of the Brexit agreement (see section 3).
- Second, and potentially more disruptive, the exit of the UK and the corresponding decrease in the EU's Gross National Income (GNI) may entail a significant decrease of the EU budget in absolute terms, if the EU Council maintains its position for a budget no higher than 1% of EU GNI.
- Third, the end of the UK rebate will automatically trigger the elimination of the so-called “rebates of the rebate” enjoyed by Austria, Germany, the Netherlands and Sweden, and may eventually lead to more substantive changes in the system of own resources.
- Finally, Brexit will change the dynamics of negotiation in the EU Council. Not only will the removal of the UK's net contribution alter other Member States' net contributions, but the exit of one of the most vociferous net payers may affect the internal dynamics within the coalition of net contributors.

The remainder of the paper will take a closer look at these more permanent, medium-term effects of Brexit on the EU budget.

2. How large would the annual “Brexit gap” be? Data and assumptions

With the departure of the UK, the EU budget would lose one of its largest net contributors. It would certainly face a “Brexit gap”, but the size of budget shortfall is still a matter of debate. The British net contribution has proven to be volatile in the past, so any estimate can only provide a rough idea.

BOX 1 ► Data and assumptions

For data on revenue and expenditure, we rely on publicly available expenditure and revenue data provided by DG BUDGET and update it according to the recently ratified 2014 Own Resource Decision⁹. The dataset has several advantages. It records actual spending (which often deviates from projections), data is available at country level, and it provides details on the different spending areas. Of course, using recorded instead of planned spending means that data is currently only available until the end of 2015. On balance, however, we believe that the advantages outweigh the disadvantages, especially since any forecast is highly uncertain under the current circumstances.

In order to construct a “normal budget year” that can serve as a base for our simulations, we take the average of the years 2014 and 2015, thus evening out one-off effects. The preceding years are not included because they were part of a previous MFF and changes in the budget headings make them hard to compare. This is an approach also adopted by similar studies¹⁰.

We base our calculations on the following assumptions:

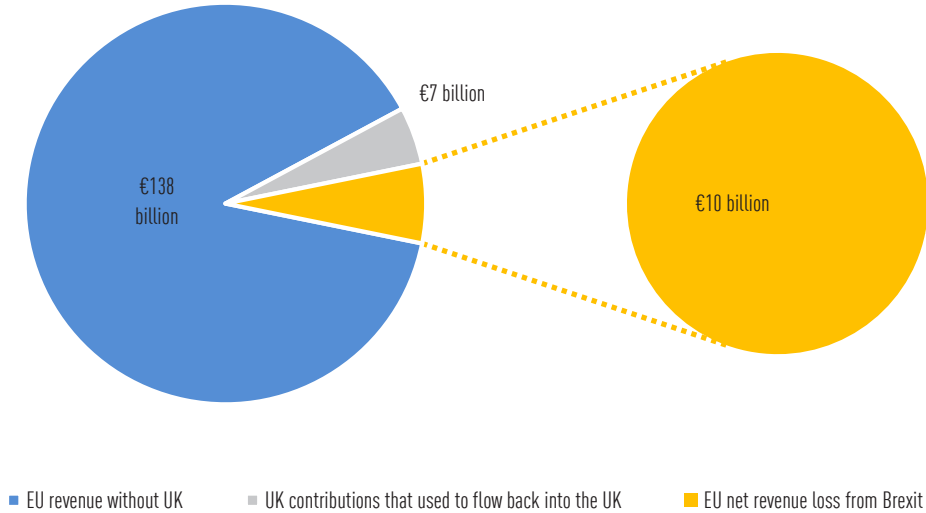
- There are no British national contributions to the EU budget (VAT- and GNI-based), nor is any revenue deriving from TOR (Traditional Own Resources) collected in the UK.
- There is no EU expenditure in the UK (unless stated otherwise).
- The ‘rebates on the UK rebate’ will automatically disappear with the end of the UK rebate. The other corrections (reduced VAT call rate, lump-sum corrections) are extended beyond 2020.
- Effects from inflation and exchange rate fluctuations are not taken into account.

With this in mind, how large could the “Brexit gap” be? On the one hand, the EU would save money as it would spend around €7 billion less per year on projects in the UK. On the other hand, it would collect €3 billion less via its Traditional Own Resources (TOR) and would lose €14 billion in direct contributions from the UK government. Overall, it would have to cope with a yearly revenue loss of €10 billion. Over the course of a normal seven-year MFF, this amounts to around €70 billion. If the EU wanted to keep its budget at the current level and use the money currently spent in the UK on other projects, the gap would amount to €17 billion per year or €119 billion over the course of an MFF.

9. European Commission, “EU expenditure and revenue 2014-2020”, 2016.. For an overview of the budgetary implications of the ratification of the 2014 Own Resources Decision, see [Draft Amending Budget No 5 to the General Budget 2016](#).

10. Böttcher, Barbara, and Laura Rosenberger, “EU budget: Who’s to pay for Brexit?”, *DB Research Chart in Focus*, August 26, 2016. Matthews, Alan, “Impact of Brexit on the EU budget”, 10 September 2016.

FIGURE 1 ► How large would the yearly Brexit gap be?



Source: Authors' calculations based on European Commission data.

2.1. Possible revenue from soft Brexit

The real cost to the budget could be smaller. If the UK maintained access to some EU initiatives and programmes (soft Brexit) it would likely keep paying into the EU budget, although the contribution would be reduced. In order to estimate the impact, it is useful to take a look at the case of Norway. The country pays around 0.25% of its GDP per year through various mechanisms for its partial integration into the European project (see box). For the UK, this would result in a gross contribution of €5.9 billion per year.

BOX 2 ► Norway's annual contributions to the EU (timeframe 2014-2020)¹¹.

- Grants to poorer EU Member States to reduce social and economic disparities: €391 million¹²
- Participation in EU programmes such as Horizon 2020, Erasmus+, CEF digital, Galileo and Copernicus: €447 million
- Smaller projects (e.g. cooperation with the EU in the field of justice and home affairs, Schengen, INTERREG): €31 million
- Overall: ca. €870 million (0.25% of Norway's 2015 GDP)

Reliable data on the Norwegian net contribution are hard to find. However, we can get an estimate of the British future net contribution if we assume that the UK will cooperate with the EU on the same topics as Norway. If we then add up the annual transfers the UK receives from these programmes, the total amounts to €1.3 billion (see table 2). Consequently, the UK would pay some €4.6 billion net.¹³

11. Data from Norway Mission to the EU, "Norway's financial contribution", 10 August 2016, and from the European Commission's AMECO database.

12. This money is channelled to poorer EU countries via the European Economic Area (EEA) and Norway Grants scheme and does not form part of the EU budget. We include it in the calculation nevertheless, because the payments are part of the overall agreement that grants Norway market access.

13. Other studies arrive at a higher result. For example, the Centre for European Reform calculates that a Norway-style membership would lower the UK net contribution to 7.2 billion British pounds, while the "Swiss option" would lower it to 4.4 billion British pounds. Springford, John, *et al.*, *The economic consequences of leaving the EU. The final report of the CER commission on Brexit 2016*. 21 April 2016, p. 111.

TABLE 2 ▶ Annual transfers received by the UK from selected EU programmes, average 2014-2015, rounded to million €.

	2014	2015	AVERAGE
Galileo	65	37	51
Copernicus	18	11	14
Horizon 2020	1210	748	979
Erasmus+	121	104	112
EaSI	6	7	7
CEF digital	2	1	1
INTERREG	78	71	74
Creative Europe	20	20	20
Total	1519	999	1259

Source: Author's representation based on European Commission data and Creative Europe UK desk annual reports.

2.2. Possible revenue from hard Brexit

If the UK left the EU without an agreement (“hard Brexit”), the revenue shortfall might still be somewhat mitigated. Trade between the UK and the other would revert to WTO rules, but it would not simply stop. Consequently, the tariff income of EU Member States would rise. This would benefit EU finances, which receive 80% of this income. Assuming that the trade volume remains constant even in the face of tariffs, Núñez Ferrer and Rinaldi estimate that the additional income could be as high as €4.6 billion, reducing the net loss to about €5.5 billion¹⁴. However, high tariff income would only shift the problem to national level. EU Member States would likely see their national budgets shrink because trade barriers would disrupt production networks and ultimately reduce economic growth.

2.3. Summary

Our estimates for the Brexit gap in the EU budget range from €5 to €17 billion per year. The exact size depends on a number of highly uncertain developments. We base our scenarios below on what we consider to be the most likely case: a loss of the British net contribution to the EU budget that translates into a yearly budget gap of €10 billion. When comparing this structural shortfall to one-off payments, it is important to remember that it accumulates over the years.

3. Scenarios: Adapting the budget to Brexit

Broadly speaking, we see three ways for the EU to adapt to the €10 billion revenue shortfall. It can (1) compensate for the shortfall by raising Member State contributions, (2) cut spending or (3) combine spending cuts and increased contributions. At the latest, these options will become relevant during the negotiations for the next MFF, but the debate could start sooner if it becomes clear that the UK will leave the EU while the current MFF is still in force. We discuss the options in three scenarios. In a fourth scenario, we explore what could happen if there was no agreement on a new MFF before the end of 2020.

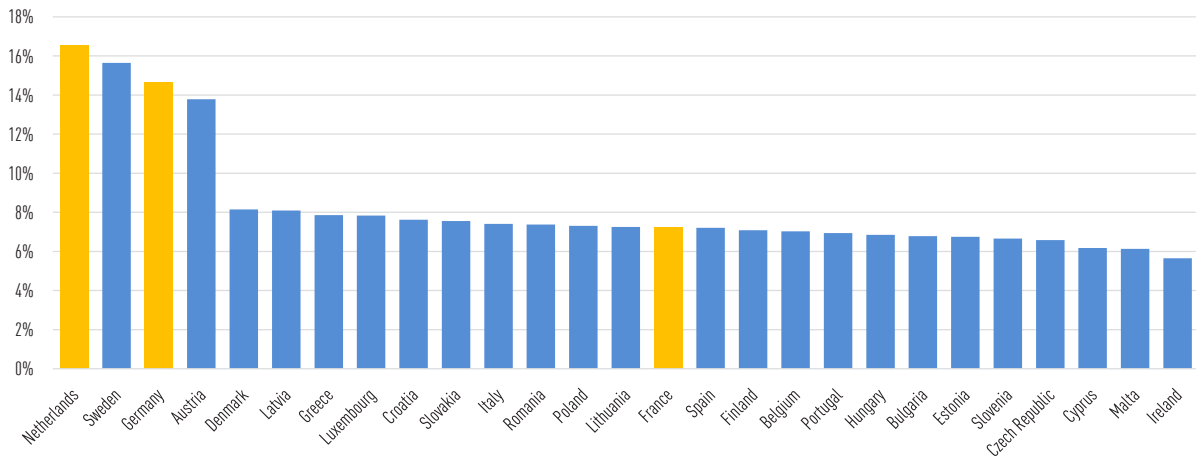
14. Jorge Núñez Ferrer and David Rinaldi, “The Impact of Brexit on the EU Budget: A non-catastrophic event”, CEPS Policy Brief No. 347.

Before describing the scenarios in more detail, it is important to note that all of them will entail an increase of the EU budget in relative terms (as a % of EU GNI). This is because Brexit would reduce EU GNI by approximately 17%, the UK economy’s relative weight in the EU. But the UK’s net contribution is only about 7% of the EU budget due to the rebates it receives. As we will discuss in section 5, this may have important implications in the negotiation of the next MFF, given that the European Council’s stance over the last decade has been to keep the EU budget at 1% of EU GNI. We briefly consider in scenario 2 what it would take to maintain a stable GNI ratio.

3.1. Scenario 1: Increasing contributions

If the Member States decided to maintain the level of spending for the remaining EU27 constant (that is, reduce the size of the current MFF only by the amount of EU transfers to the UK), they would need to raise €10 billion in additional revenue. Where could the money come from? Raising income from traditional own resources and the VAT resource would be difficult because it would require a reform of the Own Resources Decision, which can only be changed unanimously and would need to be ratified by all national parliaments. Plans to generate additional revenue based on the proposals of the ‘Monti Group’ face the same hurdles. In view of the tight Brexit schedule, it seems more likely that the Commission would increase national GNI-based contributions instead¹⁵. It could do so by simply raising the uniform call rate on GNI.

FIGURE 2 ► Increase in contributions compared to 2014-15



Source: Authors’ calculations, based on European Commission data.

Figure 2 illustrates the effect on national contributions (VAT-based and GNI-based). It is obvious that all Member States would have to pay significantly more, but the effects are unevenly distributed. The countries with the largest increases are those currently benefitting from rebates on the UK rebate. The Dutch yearly contribution would rise by as much as 16.5% (or €760 million), while Germany would pay the highest additional amount in absolute terms (€3.5 bn). The non-rebate countries would see contributions rise by 5-8%, with France being most affected in absolute terms in this group (€1.5 bn). The fact that all contributions would increase substantially and that the largest net contributors in particular would be hit hardest means that this scenario would be politically very difficult. The introduction of additional rebates could alleviate the problem, but would run counter to years of efforts to simplify the EU’s financing. In relative terms, the budget would increase to 1.16% of GNI.

15. This is not to say that a ‘grand bargain’ featuring a joint reform of EU revenue and expenditure would be impossible. We briefly discuss this option in section 5.

The cost of maintaining EU28 spending levels

A variant of scenario 1 would be to maintain the current EU28 spending level and redirect the money that the UK receives from the EU budget to other areas. As mentioned above, the gap in this case would amount to €17 billion per year. If filled via higher contributions, this would lead to increases by as large as 20-25% for the rebate countries and 11-15% for non-rebate countries. In relative terms, the budget would increase to 1.22% of GNI, very close to the 1.23% ceiling fixed in the Own Resources Decision.

3.2. Scenario 2: Spending cuts

”€10 BILLION REPRESENTS A LARGE CUT COMPARED TO WHAT THE EU SPENDS ON ITS MOST POPULAR PROJECTS”

In view of the difficulties that an increase in contributions could bring, it might seem appealing to keep them constant and instead balance the budget by cutting spending¹⁶. But as figure 3 illustrates, €10 billion represents a large cut compared to what the EU spends on its most popular projects. This becomes especially clear when looking at those programmes that are widely perceived as providing real added value at European level. €10 billion roughly equal:

- the entire budget for European foreign policy (“Global Europe”), plus the budget heading “Security and Citizenship”, which includes a wide variety of topics, such as EU action on immigration, consumer protection, and culture, or
- the entire EU research framework (“Horizon 2020”) plus the Fund for Asylum, Migration and Integration, or
- all EU spending on competitiveness and growth without Horizon 2020, including popular initiatives such as Erasmus+ and spending on large infrastructure programmes, plus all spending on Security and Citizenship, or
- a 20% cut in the EU’s funds for cohesion policy (“Structural and Cohesion Funds”), or
- a 20% cut in the budget of the Common Agricultural Policy (CAP).

While in practice spending cuts would be distributed over several programme areas, there can be no doubt that they would be painful. They would make it necessary to restructure the budget completely or find innovative ways to shrink the size of the largest budget headings.

The cost of maintaining the relative size of the EU budget

It is noteworthy that, even after these deep cuts, the relative size of the EU budget would rise slightly, from 1.02% to 1.08% of EU GNI. The increase reflects the fact that the UK contributes more to EU GNI than to the EU budget. Maintaining the current ratio of 1.02% would require spending cuts worth more than €23 billion per year. In order to keep Member State contributions stable in absolute terms, the €10 billion cut would be sufficient.

16. Some redistribution would still occur, due to the expiration of the rebates on the rebate, but the amounts involved would be much smaller.

FIGURE 3 ▶ How large is the “Brexit gap” compared to EU programmes?

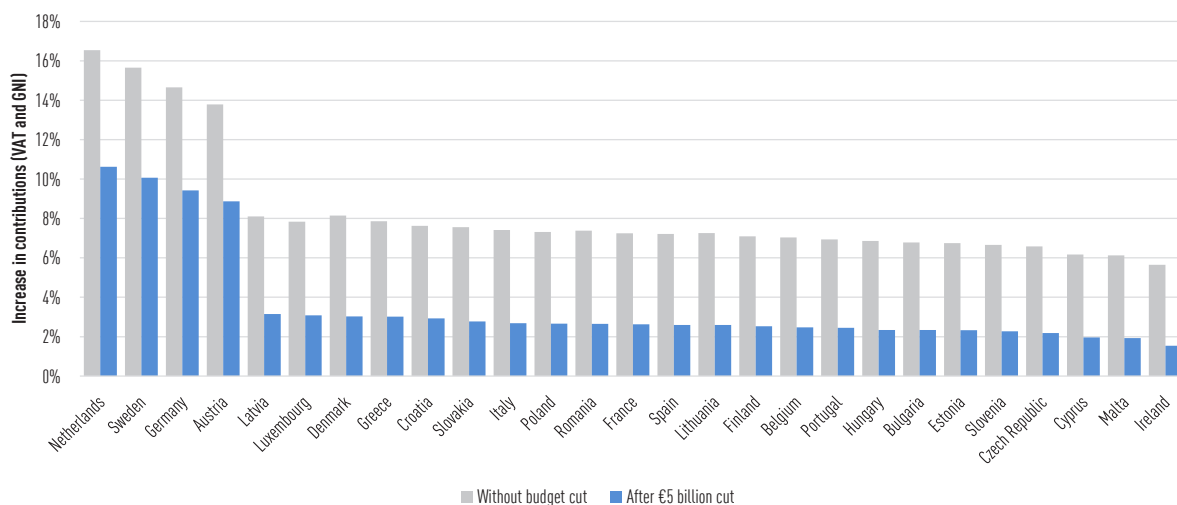


Source: Authors' calculations, based on European Commission data.

3.3. Scenario 3: Combination of increased contributions and budget cuts

A compromise could consist of simultaneous budget cuts, for example worth €5 billion, and contribution increases that make up for the remaining shortfall. As figure 4 shows, the budgetary implications for most countries would be limited. However, the distribution of the additional burden would be even more unequal than in other scenarios, as the expiration of rebates would play a larger role in relative terms¹⁷. The relative size of the EU budget would rise to 1.12 % of GNI.

FIGURE 4 ▶ Who would pay for filling half the Brexit gap?



Source: Authors' calculations, based on European Commission data.

¹⁷ This is because the expiration of the rebates on the rebate leads to a redistribution of the financial burden among Member States. This effect does not depend on the size of the Brexit gap. Consequently, the smaller the budget shortfall is, the larger the redistribution effect appears in relative terms.

3.4. Scenario 4: No agreement

” THE 2020 SPENDING LEVELS WOULD BE MAINTAINED UNTIL AN AGREEMENT ON THE MFF IS REACHED”

What would happen if none of these options was acceptable to all Member States? The answer to this question could shape Member States' negotiating power in the upcoming MFF negotiations (see chapter 5). The next MFF will almost certainly be negotiated among the EU27. If they fail to reach an agreement at the end of 2020, Article 312.4 of the Treaty on the Functioning of the European Union (TFEU) stipulates that “the ceilings and other provisions in place for the final year of the expiring MFF shall be extended until such time as that act is adopted”. In practice, this means that the level of spending for 2020

would be maintained until an agreement on the MFF is reached. Whether this benefits net contributors or net recipients depends on the timing of Brexit.

If the UK leaves in 2019 or 2020, the spending levels for 2020 could be much lower than today as Brexit would trigger a revision of the current MFF (see section 2). Since the corresponding regulation only states that the MFF should be adjusted ‘accordingly’ in case of Treaty change, there is ample room for interpretation¹⁸. Would spending be lowered by 17%, the UK's share in EU GNI? Would it be lowered by €17 billion, the UK's gross contribution to the budget? Would it be lowered by €10 billion, the UK's net contribution? Would the spending level be maintained to better respond to the various challenges facing the EU today? Any decision would need to be unanimous, and common sense dictates that it would need to be taken while the current MFF is still in force.

An interesting precedent on how to adjust the MFF to changes in EU membership is Croatia's accession in 2013¹⁹. Whereas the Commission and the European Parliament called for an increase in the size of MFF to adapt to the entry of a poorer new Member State, the Council argued that any additional expenditure requirements from Croatia's accession should be fully financed from redeployments or reductions of other ceilings. The compromise that was finally struck involved on the one hand a series of re-allocations to keep the overall commitment ceiling constant (thus respecting the Council's position), and an increase in payment ceilings for 2013²⁰.

If the UK leaves in 2021 or later, the levels of spending for 2020 would be roughly as projected today (although the exact size of the budget will depend on the annual budgetary negotiations between the Council and the European Parliament as well as on the possible recourse to flexibility instruments in previous years). Failure to reach an agreement on the MFF would lead to the situation described in scenario 1: spending levels would remain roughly the same as before Brexit²¹ and the resulting gap would be corrected through an increase of Member States' GNI-based contributions given their role as ‘residual’ revenue²².

18. See Art. 20 of the current MFF regulation: “Should a revision of the Treaties with budgetary implications occur between 2014 and 2020, the MFF shall be revised accordingly.”

19. Art. 10 of the MFF regulation for 2007-13 states that “the financial framework shall (...) be adjusted to take account of the expenditure requirements resulting from the outcome of the accession negotiations”. The current MFF regulation contains a very similar provision (Art. 21).

20. See European Commission, *EU public finance*, 5th edition, Luxembourg: Publications Office of the European Union, 2014, pp. 93-94.

21. We assume that the exit of the UK and the corresponding signature of the withdrawal agreement will automatically imply the end of EU budgetary legal obligations vis-à-vis UK recipients. Thus, spending would be maintained except for transfers to the UK recipients, as in scenario 1.

22. The GNI resource is the ‘residual’ revenue in the EU budget. Whereas the proceeds from traditional own resources and the VAT-based resource are determined by call rates fixed in the Own Resource Decision, the call rate for the GNI-based resource is determined by the additional revenue needed to finance the budgeted expenditure not covered by other own resources.

TABLE 3 ► Overview of the scenarios

SCENARIO	EU BUDGET (% OF GNI)	EFFECT
Average EU revenue (2014-15)	1,02%	
Scenario 1: Increase contributions to fund Brexit gap	1,16%	8% increase in contributions
Scenario 1b: Increase contributions to fund current spending	1,22%	15% increase in contributions
Scenario 2: Cut budget to fund Brexit gap	1,08%	€10 billion budget cut
Scenario 2b: Cut budget to 1% of GDP	1,00%	€23 billion budget cut
Scenario 3: Combine cuts and contributions	1,12%	€5 billion budget cut 4% increase in contributions
Scenario 4: No agreement before 2021		Budget for 2020 is extended until a new MFF is adopted

Source: Authors' calculations, based on European Commission data.

4. Implications for the next MFF negotiations

While the scenarios above are hypothetical, they could have real implications for the upcoming MFF negotiations starting in 2018. These negotiations involve the Commission, the European Parliament and the Council, but 'de facto' they are largely intergovernmental, with the final deal being adopted by the European Council by unanimity after receiving the consent of the European Parliament²³. Member States have multiple interests in the negotiation but traditionally they focus above all on reaching the best possible deal in terms of net budgetary return, i.e. the difference between their contributions to the budget and money received from it. While it is widely accepted that this approach cannot capture the actual gains from European integration²⁴, it still shapes most Member States' strategies decisively and determines the formation of negotiation coalitions²⁵.

Figure 5 illustrates what future negotiating coalitions could look like. On the x-axis, it shows Member States' current net balance position²⁶. On the y-axis, it shows how much each country would be affected by an increase in contributions after Brexit. A clear pattern emerges. Today's net contributors would pay even more if contributions were raised. They would therefore likely push for budget cuts or a comprehensive reform of EU spending priorities. The alignment of interests is especially strong among Denmark, Germany, the Netherlands, and Sweden. Today's net recipients would be largely unaffected by higher contributions and are therefore likely to lobby for maintaining the EU27 spending level after Brexit.

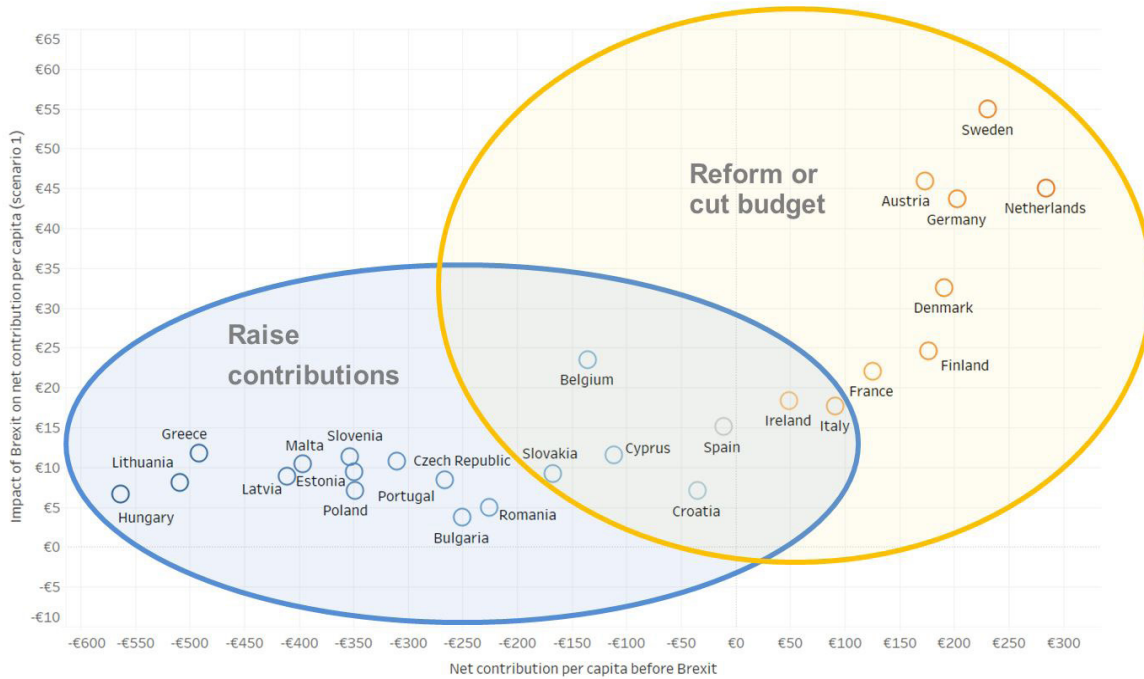
23. The European Parliament needs to give its consent to the Council's position, meaning that it may approve or reject the Council's deal but cannot insert amendments. If used wisely, however, the right of consent can win the Parliament some leverage (in the past MFF negotiations, for instance, the Parliament conditioned the approval of the MFF to the setting up of a high-level group on own resources).

24. For example, net balances cannot take into account gains from increased trade, security etc. For a detailed account, see Jacques Le Cacheux, "The poisonous budget rebate debate", Notre Europe Studies & Research N°41, November 2005.

25. When the current MFF was discussed, for instance, Member States split into two coalitions: The "Likeminded Group" representing net contributors, and the "Friends of Cohesion Policy", representing net recipients. See Uilenreef, A. "Multiple Bilateralism" within the European Union: The Dutch Coalition-Building Network during the Budget Negotiations. *Journal of Common Market Studies*, 54(2), 426-443, 2016, p. 431.

26. We calculate net contributions by subtracting total EU spending taking place in a country from its total contributions to the EU budget. The assumption is that most Member States will tend to use a calculation that includes all revenue and spending, even though it can be argued that the European Commission's "operating budgetary balances" (which exclude TOR and administrative spending) are a fairer measure from a conceptual point of view.

FIGURE 5 ► Possible coalitions in the MFF negotiations under scenario 1 (increase in national contributions)



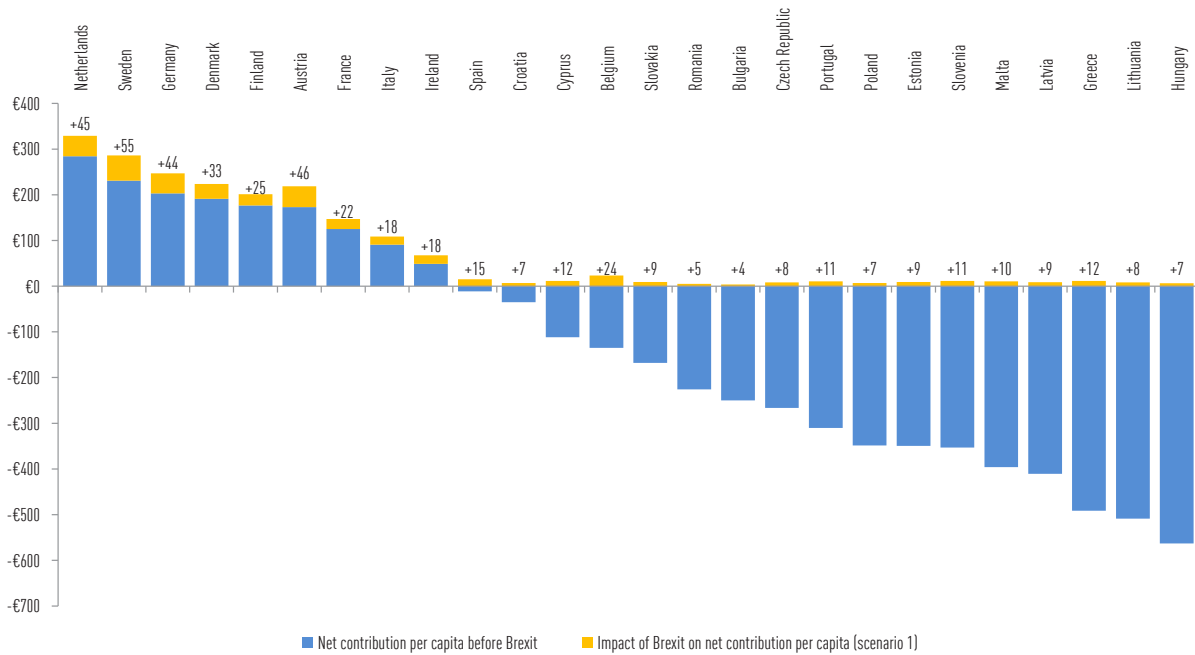
Source: Authors' calculations based on European Commission data and on scenario 1 ("increasing contributions").

Note: Net contributions calculated by subtracting total EU spending taking place in a country from its total contributions to the EU budget.

The relative strength of these different coalitions will likely depend on two factors. First, the alternative to a negotiated agreement plays an important role. As mentioned above, a failure to agree on a new MFF would automatically lead to an extension of the current budget ceilings. This would mean increased contributions unless otherwise agreed before 2020. One could argue that this would in principle reinforce the negotiating position of net recipients vis-a-vis those of net contributors. In practice, however, a non-agreement scenario would be highly disruptive and not necessarily perceived as a good outcome for net beneficiaries. Many legal acts setting the conditions for eligibility, and criteria for allocating the different EU spending programmes expire in 2020. If they were not extended, the stalemate could result in major legal and financial uncertainty and problems with the disbursement of EU spending.

Second, a shift in the balance between net contributors and net recipients seems possible, though not inevitable. Today, there is a middle group of countries that is relatively close to balance in per capita terms, including France, Ireland, Italy, and Spain (see figures 5 and 6). They could either support a budget reform or a rise in contributions, and their position could be decisive in shaping the next MFF. Brexit could tip the scales in favour of reform. Spain could join the net contributors, and countries like Ireland and Italy could become firmly established in the group. Smaller countries like Cyprus and Croatia would come closer to net balance. Compared to the old "Likeminded Group", the result would be a broader and, in the absence of the UK, softer coalition in favour of reforms or cuts.

FIGURE 6 ▶ Could Brexit shift the balance between net recipients and net contributors?



Source: Authors' calculations based on European Commission data and on scenario 1 ("increasing contributions").

A strong coalition of net contributors might push for limiting the budget to 1% of EU GNI. However, this would entail drastic spending cuts (see scenario 2). Alternatively, net contributors could accept a moderate increase in contributions in exchange for reforms to the EU spending policies.

Another option could be a 'package deal' that would not only restructure expenditure but also introduce new revenue sources. Net contributors may be more open than in the past to the introduction of one or several new own resources and the subsequent reduction of the GNI-based revenue if the latter leads to a fairer distribution of the financial burden. A package deal could be based on an agreement that the phasing-in of a new resource system is subject to progress on the expenditure side²⁷.

Is there a coalition for far-reaching expenditure reform?

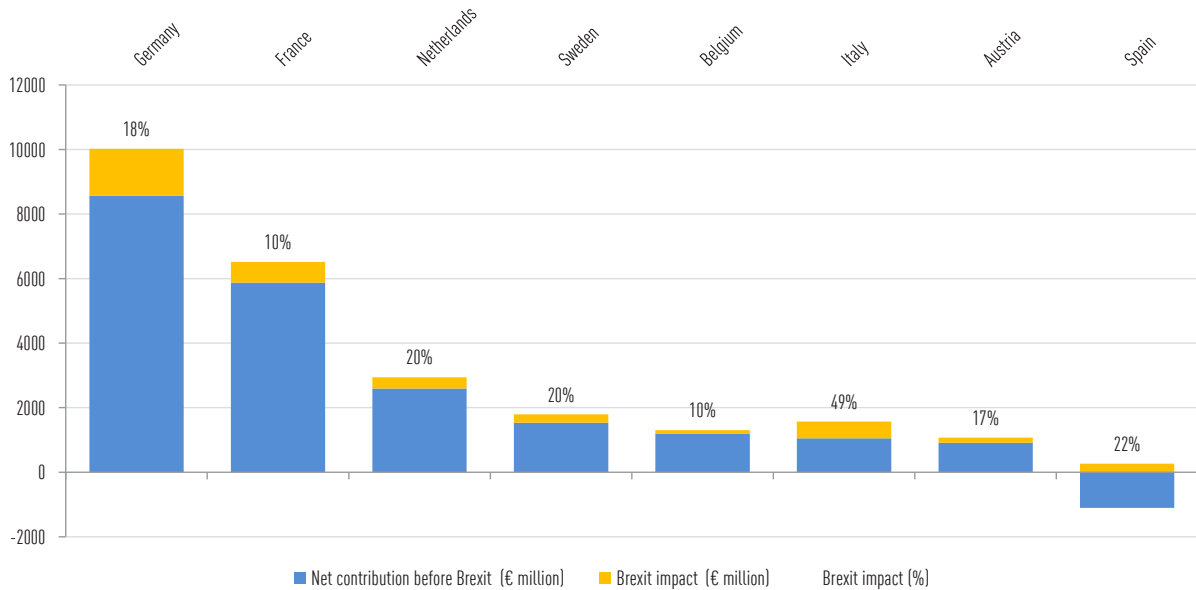
What are the prospects for a major budget reform? In order to paint a more detailed picture of the type of changes that seem possible, it may be useful to take a look at Member States' net balances in the two areas that together account for 70% of EU spending, namely the Common Agricultural Policy and the Structural and Cohesion Funds.²⁸

Figure 7 shows how a contribution increase after Brexit could influence gains and losses from Structural and Cohesion Funds. It is especially interesting to note that France is among the largest net contributors to cohesion policy today and that its position would deteriorate further by around €360 million. In the case of Italy, the relative increase is especially large at 25%. Finally, Spain would still be a net recipient after Brexit, but only barely. Overall, among the large EU Member States there is potential for a coalition in favour of reducing spending through an overall reform of EU cohesion policy.

27. Jorge Nuñez Ferrer, Jacques Le Cacheux, Giacomo Benedetto and Mathieu Sainer, "Study on the potential and limitations of reforming the financing of the EU budget", study commissioned by the European Commission on behalf of the High Level Group on Own Resources, June 2016.

28. We calculate the net balance in a specific policy area by comparing a country's receipts from a programme to its share in financing it. Since the revenue side of the EU budget is not assigned to specific items of expenditure, we calculate an estimate by assuming that a country contributes according to its share in EU GNI. For a detailed description of the methodology, see Alan Matthews, "Impact of Brexit on CAP budget net balances for remaining Member States", 5 August 2016.

FIGURE 7 ▶ Impact of Brexit on Structural and Cohesion Funds

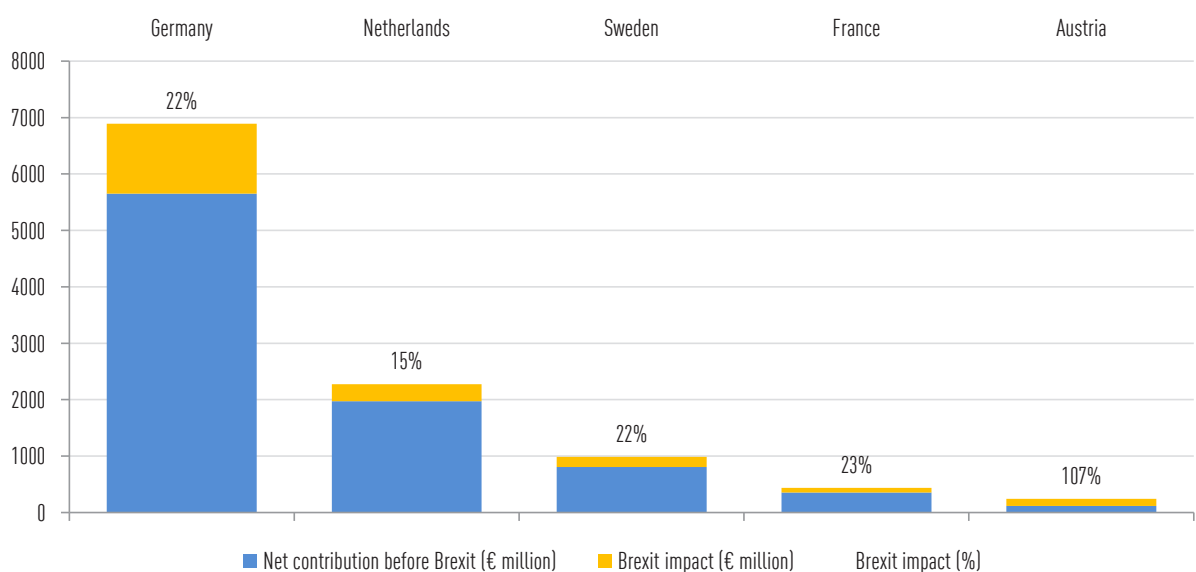


Note: Chart only includes countries with a likely high absolute and relative Brexit impact (deterioration of net balance by more than €100 million and more than 5%)

Source: Authors' calculations based on European Commission data.

With regards to the Common Agricultural Policy, the impact of higher contributions would be distributed among fewer countries (see figure 8). Germany alone would see its net contribution to the CAP rise by around €1.2 billion. More generally, the countries most affected by Brexit in this area are probably those that are already more open to a reform of the CAP's financial model. The only exception and potential surprise is France, which has traditionally been a strong defender of the CAP but is a net contributor today and would pay even more after Brexit. However, it is highly uncertain whether French domestic politics would allow the next president to agree to a large revision of the CAP direct payment scheme.

FIGURE 8 ▶ Impact of Brexit on the Common Agricultural Policy



Note: Chart only includes countries with a likely high absolute and relative Brexit impact (deterioration of net balance by more than €50 million and more than 5%). Changes introduced by the 2014 Own Resources Decision are not taken into account.

Source: Authors' calculations, based on European Commission data and Matthews, Alan, "Impact of Brexit on CAP budget net balances for remaining Member States", 5 August 2016.

CONCLUSION: WHAT TO EXPECT?

Although much is still uncertain, it is clear that Brexit will deal a shock to the EU budget. There is no easy way to fill the “Brexit gap” of around €10 billion per year, especially because a unanimous decision is required to do so and neither contribution increases or budget cuts will be palatable to all Member States.

”NET CONTRIBUTORS COULD AGREE TO INCREASING CONTRIBUTIONS (...) IN EXCHANGE FOR A DEEP REFORM OF THE EXPENDITURE SIDE OF THE BUDGET” This spells trouble for the negotiations concerning the next MFF. They are likely to be even tenser than usual because Brexit entrenches the existing differences between net contributors and net recipients. Today’s largest net contributors would be hit hardest by an increase in contributions, while today’s net recipients would be relatively unaffected. Budget cuts, on the other hand, would likely hurt net recipients by reducing spending on the two largest budget titles, namely the CAP and cohesion policy. The alternative – cutting spending on areas such as research, pan-European infrastructure or migration – would yield only small savings and would be devastating for the EU’s efforts to create more European added value.

We see two possible solutions to this challenge:

- Net contributors could agree to increasing contributions further in exchange for a deep reform of the expenditure side of the budget. A new budget would not necessarily need to be larger but it would need to be more flexible, more performance-oriented and more focused on areas providing clear added value at European level.
- The EU could be granted additional income through a new own resource or through a complete overhaul of its revenue sources. The latter could, for example, include a carbon tax, a harmonised corporation tax, a financial transaction tax, or a value-added tax raised directly by the EU²⁹. This seems like an unlikely standalone solution, especially in view of the tight schedule, but it could be part of a ‘grand bargain’ scheme that includes a joint reform of EU revenue and expenditure.

If neither of these two solutions prevails, the EU will likely keep on muddling through by agreeing on a compromise that funds one part of the Brexit gap via budget cuts and the remaining part via contribution increases. Additional rebates could be introduced to secure the agreement of the most affected net contributors, entrenching an inefficient and obscure system for many years to come.

Four countries could play a key role in deciding which of these paths to follow. Spain and Ireland could join a coalition of net contributors after Brexit, which may shift the balance between the two groups. Italy stands to profit less from cohesion policy and might support a reform in this field, while France is now a large net contributor to the CAP. While net balances do not dictate Member States’ stance on budgetary reform, experience shows that they do shape it.

Overall, Brexit can be either an opportunity or a threat to the EU budget. It depends entirely on the Member States; whether they try to protect their guaranteed returns and resort to destructive cuts in non-allocated spending (such as spending on research or infrastructure), or if they use the momentum to create a better EU budget.

29. For a more detailed discussion of the options, see the report of the high-level group on own resources led by Mario Monti. It is due to be published in late January 2017.

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