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Research for AGRI Committee - Possible impact of Brexit on the EU budget and, in particular, CAP funding

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Workshop on
'Implications of 'Brexit' for the EU agri-food sector and the CAP: budgetary, trade and institutional issues'

Research for AGRI Committee - Possible impact of Brexit on the EU budget and, in particular, CAP funding

STUDY

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Policy Department for Structural and Cohesion Policies

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Abstract

This note assesses possible consequences of Brexit for the EU budget and the Common Agricultural Policy. It discusses the importance of the 'Brexit bill' and the loss of the British net contribution. Furthermore, it describes how the EU budget and spending on the Common Agricultural Policy can be adjusted to the new situation and estimates how the different options would affect EU Member States and their net balances.

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CONTENTS

LIST OF ABBREVIATIONS

AMIF	Asylum Migration and Integration Fund
CAP	Common Agriculture Policy
COMAGRI	Committee on Agriculture and Rural Development
EAGF	European Agriculture Guarantee Fund
EARDF	European Agriculture Rural Development Fund
EIB	European Investment Bank
ESIF	Europan Structural and Investment Fund
ISF	Internal Security Fund
MFF	Multiannual Financial Framework
OBB	Operating Budgetary Balance
OR	Own Resources
ORD	Own Resources Decision
RAL	Reste-a-Liquider
TFEU	Treaty on the Functioning of the European Union
TOR	Traditional Own Resources

LIST OF TABLES

LIST OF FIGURES

EXECUTIVE SUMMARY

This in-depth analysis assesses possible consequences of Brexit for the EU budget and, in particular, the Common Agricultural Policy (CAP).

- We discuss how the negotiations about the 'Brexit bill' could affect the current and the post-2020 Multiannual Financial Framework (MFF), and CAP spending in particular.
- We analyse how Brexit affects the EU budget structurally and how the EU can adjust to the expected budget shortfall.
- We offer a quantitative assessment of the impact of Brexit on CAP net balances, including different adjustment scenarios and estimates of their impact on the remaining Member States.

The Brexit bill

Negotiations about the so-called 'Brexit bill' or 'financial settlement' will determine the extent to which the UK pays its share of the financial obligations jointly undertaken by EU countries while the UK was member of the EU.

- At the moment of writing, **negotiations on the Brexit financial settlement are in deadlock**. The EU has published its position on the matter but the UK has so far refused to detail which obligations it recognises.
- **The implications of the Brexit bill negotiations for CAP spending depend not only on the overall size of the bill agreed but on the type of financial obligation covered**. If the UK accepts to contribute to the EU budget until the end of MFF but does not cover RAL pending in 2020, both EARDF and EAGF spending will be preserved until 2020 but negotiations about the next MFF will be complicated by an unexpectedly large amount of RAL.

The Brexit gap

We estimate that Brexit will leave a **permanent shortfall of €10.2 billion per year** in the EU budget. This gap has to be filled either through higher national contributions, spending cuts, a combination of both, or the introduction of new Own Resources.

- According to our calculations, **an increase in contributions disproportionally affects some of the EU's largest net contributors** such as Germany, The Netherlands and Sweden. In part, this is because they currently benefit from a 'rebate on the rebate' on their contributions that will no longer apply once the UK leaves. Brexit not only increases the financing burden on the EU-27, it also changes how the burden is shared.
- The Brexit gap can also be addressed by reducing spending. It is, however, important to stress that the required savings are substantial compared to many EU programmes. Therefore, **large spending categories like CAP are likely to come under pressure if the EU budget is cut**.
- There is no default method for adapting the current MFF to the departure of a Member State.

Brexit and the CAP

We estimate that **the British net contribution in the field of CAP amounts to €3 billion annually**. However, spending cuts after Brexit could exceed that sum if other EU programmes are prioritised. We outline how the CAP can be adjusted to Brexit and what the implications for Member States are:

- **Higher contributions affect today's biggest net contributors the most.** If the current CAP spending levels are maintained after Brexit, Member States' contributions to the CAP must increase by €3 billion. We estimate that in this scenario, large net recipients like Poland and Greece are almost unaffected. Austria, Germany, The Netherlands and Sweden lose the most in relative and in absolute terms. Generally, net contributors pay for the lion's share of the shortfall, which increases imbalances in the CAP.

- **Reducing CAP spending puts a higher burden of adjustment on CAP net recipients.** Our estimates suggest that cutting expenditure by a relatively small amount like €3 billion has a mixed effect. Among the largest losers in this scenario are CAP net contributors like Germany and The Netherlands, but also net recipients like Spain and Poland.
  If CAP expenditure is cut by €10 billion, net contributors gain. At the same time, the losses of net recipients are significant in this scenario, not only in absolute terms, but also compared to government spending in relatively poor countries like Bulgaria.

Conclusions and recommendations

- **There is no pain-free way of adjusting CAP spending to the Brexit gap.** However, the budgetary impact of the different reform options is in most cases limited when compared to general government spending.

- **The EU should be careful about linking the agreement on the Brexit bill to an agreement on a future and hypothetical transitional period**, as proposed by the UK. Moving to the second phase without any clear agreement on the Brexit bill could enable the UK to use money as a bargaining chip when negotiating the future relationship between the EU and the UK.

- **The EU's first priority in the Brexit bill negotiations should be to minimise the adverse financial impact of Brexit on the current and future MFF**. If concessions are needed, they can come from other elements of the deal such as the UK's participation in EU bodies and funds, payment for pensions and other employees' benefits or payment for contingent liabilities.

- **Bargaining about budget cuts and contribution increases should not be limited to one spending area**, but include the entire system of EU finances. For example, net contributors might be more willing to accept further increases in their payments if the overall budget is reformed.

- While Brexit can provide the narrative for a profound reform in the architecture of the CAP, aimed not only at reducing overall CAP spending but at rendering CAP more effective and sustainable, a major revision of CAP might not be feasible before 2022 or 2023, with implementation starting in 2024 or 2025.

1. INTRODUCTION

KEY FINDINGS

- EU expenditure is planned through **annual budgets** and **Multiannual Financial Frameworks (MFF).** MFFs are adopted unanimously by the European Council whereas annual budgets are subjected to qualified majority voting.
- Most EU expenditure is entered into the budget through differentiated appropriations. **The stock of unpaid commitments at a given point of time is known as 'RAL' or *reste-à-liquider*.**
- The EU budget is mostly financed by **national governments' GNI-based contributions**. The UK enjoys a permanent rebate on its contribution, granted in the Own Resource Decision (ORD). Austria, Germany, the Netherlands and Sweden have been granted a rebate based on the British rebate.

1.1. Objectives and methodology

This in-depth analysis assesses possible consequences of Brexit for the EU budget and, in particular, the Common Agricultural Policy (CAP). It provides input for the workshop 'Implications of Brexit for the EU agri-food sector and the CAP: budgetary, trade and institutional issues', organised by the Committee on Agriculture and Rural Development (COMAGRI) and the Policy Department B of the European Parliament. The note includes:

- **A discussion of the main issues at stake in the negotiations about the so-called 'Brexit bill'** and the implications of different outcomes for the current and post-2020 Multiannual Financial Framework (MFF) and for CAP spending in particular.
- **An analysis how Brexit affects the EU budget structurally** and how the EU can adjust to the expected budget shortfall.
- **A quantitative assessment of the impact of Brexit on CAP net balances**, including different adjustment scenarios and estimates of their impact on the remaining Member States.

We define the net balance as a Member State's VAT- and GNI-based contributions to the EU budget minus total EU spending in the country. We do not take into account Traditional Own Resources (TOR) because they are direct EU revenues that are merely channelled through Member States. Furthermore, unlike the European Commission's 'operating budgetary balances' (which exclude administrative spending), the net balances we report are not supposed to be a measure of fairness, but rather an indicator of Member States' material interests.

In accordance with the terms of reference provided by the European Parliament, the analysis of the impact of Brexit on CAP spending is based on the current CAP budget for 2014-2020 and the institutional framework adopted by the European Institutions concerning the Brexit negotiations. This note does not take a position on the question what the appropriate level of CAP spending is and it does not evaluate possible options for reforming CAP.

1.2. Basic features of the EU budgetary system

The EU budget has some particular features that distinguish it from national budgets. A crucial distinctive aspect is the fact that it is expenditure-led (resources are raised to match what is needed to cover the agreed level of EU expenditures). This, together with the fact that the EU budget is mostly financed through Member States' direct transfers, explains the existence of various mechanisms and rules aimed at guaranteeing budgetary discipline and ensuring an orderly development of expenditure over time.

1.2.1. Annual budgets and the Multiannual Financial Frameworks (MFF)

EU expenditure is planned through annual budgets and Multiannual Financial Frameworks (MFF) covering a period "of at least five years". MFFs are not multi-annual budgets. They do not set actual expenditure figures but provide a framework for financial programming and budgetary discipline that has to be respected by annual budgets. In particular, **the MFF sets the maximum annual amount of resources ('ceilings') that the EU can allocate ('commitments') to each category of expenditure ('heading'). It also set an overall annual ceiling for payments.**

The MFF is a legally binding act agreed unanimously by the European Council and approved by majority in the European Parliament. It can be amended in response to "unforeseen circumstances" but any revision of the MFF needs to be adopted following the same procedure. Art 312.4 of the Treaty on the Functioning of the European Union (TFEU) also stipulates that, if there is no agreement on the next MFF at the end of the previous financial framework, "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".

Based on the MFF, **the EU adopts annual budgets. They are proposed by the Commission and adopted by both the Council and the European Parliament through a procedure which is similar but shorter than the EU´s ordinary legislative procedure**[1]. In particular, the Council adopts annual budgets with a qualified majority (and not with unanimity as is required for the MFF). Annual budgets correspond to the calendar year and must be agreed by the end of the preceding year. If no agreement is reached in time, the previous annual budget is rolled over on a monthly basis (the Commission is authorised to continue equivalent spending on a monthly basis through the system of 'provisional twelfths')[2]. Annual budgets can be modified through draft amending budgets, which are subject to the same procedures for adoption as the annual budget.

1.2.2. Differentiated appropriations: commitments and payments

EU expenditure is usually expressed in two different figures: **commitment appropriations** (legal pledges to provide funds, provided that certain conditions are fulfilled) and **payment appropriations** (cash or bank transfers to the beneficiaries). Annual commitments and payments often differ. This is particularly the case for cohesion programmes, as commitments are entered into the budget during the initial year of implementing the programme and payments are stretched over various years. Differentiated appropriations

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1 See Article 314 of the Treaty on the Functioning of the European Union (TFEU) for a detailed description of the annual EU budgetary procedure.

2 Art 315 TFEU, "*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 in accordance with the provisions of the Regulations made pursuant to Article 322; that sum shall not, however, exceed one twelfth of the appropriations provided for in the same chapter of the draft budget*".

give rise to **outstanding commitments** (also known by its French acronym **RAL**[3]), which is the total amount of appropriations that the EU has committed to pay but not yet paid at a certain point in time. Outstanding commitments represent a budget liability for the EU.

It is also important to note that there are a few categories of EU expenditures for which this rule does not apply and commitments and appropriations coincide (**non-differentiated appropriations**). This is the case in particular for most spending under the European Agriculture Guarantee Fund (EAGF)[4].

1.2.3. Own Resources, corrections and the balanced-budget rule

The budget of the European Union is financed by so-called 'Own Resources', other revenue[5] and the surplus carried over from the previous year. Own Resources can be defined as "revenue allocated irrevocably to the Union to finance its budget and accruing to it automatically without the need for any subsequent decision by the national authorities"[6]. There are three main categories of Own Resources:

- **Traditional Own Resources (TOR)**, which comprise customs duties and agricultural levies collected by Members States on behalf of the EU (13% of total EU revenues in 2015).
- **Member State's VAT-based contributions**, derived from the application of a uniform call rate to a notionally harmonized VAT base determined uniformly for the Member States (12% of total EU revenues).
- **Member States' GNI-based contributions**, resulting from the application of a uniform call rate to total EU GNI, to match the total volume of resources to the total volume of expenditure (69% of total EU revenues).

Own Resources are defined and fixed in a Council Decision (the Own Resources Decision – ORD)[7]. This Decision is conceived in principle to cover the same period as the respective MFF. In practice, however, **ORDs do not have an expiration date and continue to be valid until a new decision enters into force**. Since ORDs are approved unanimously by all Member States and ratified by all Member States' national Parliaments, a long time can pass until a new ORD enters into force.

The ORD also includes various provisions granting particular corrections to certain Member States. The most important one is the correction in favour of the United Kingdom, popularly known as **the UK rebate**. This provision allows the UK to be reimbursed 66 % of the difference between its contribution and what it receives back from the EU budget. The formula to calculate the UK rebate is complex and it has been amended a number of times[8]. In particular, in 2007, it was decided that EU structural and cohesion expenditure allocated to

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3 *Reste à Liquider.*

4 Only a tiny part EAGF expenditures, implemented through direct management (e.g. financing of actions to promote agriculture products and the establishment of agricultural accounting information or survey systems) are entered as differentiated appropriations. See Art. 169 of Regulation No 966/2012 on the financial rules applicable to the general budget of the Union ("Financial Regulation").

5 Other revenue includes contributions from non-EU countries to certain programmes, interest on late payments, fines, and other diverse items. They represent a minor part of total EU revenues (6.9% in 2015).

6 Monti, Mario et al (2016), *Future financing of the EU. Final report and recommendations of the high level group on own resources*, Brussels, p. 20.

7 Council Decision of 26 May 2014 on the System of Own Resources of the European Union (2014/335/EU, Euratom).

8 The subject is discussed in detail in D'Alfonso, Alessandro (2016), *The UK 'rebate' on the EU budget. An explanation of the abatement and other correction mechanisms*. European Parliamentary Research Service Briefing, February 2016.

new Member States - including spending from the European Agriculture Fund for Rural Development (EAFRD) - would be excluded from the calculation of the rebate. This adjustment was meant to ensure that the UK would help finance the costs of EU enlargement.

The UK rebate for year N is financed by higher contributions from the remaining EU Member States in year N+1. The additional payments are calculated based on the share they contribute to the EU's GNI-based own resource. However, four countries (Germany, the Netherlands, Austria and Sweden) pay only 25 % of their normal financing share. This correction is popularly known as the **'rebate on the rebate'.**

The ORD includes several other corrections which only apply for the period 2014-2020. In particular, some countries benefit from gross reductions in their GNI-based contributions in specific years[9] and Germany, the Netherlands and Sweden benefit from a lower VAT call rate, which reduces their VAT-based contribution to the EU budget.

Finally, it should be noted that the GNI-based own resource plays a special role, not only because of its relative importance (it accounts for almost 70% of the total income) but because it is the EU's residual revenue source. A uniform GNI call rate is fixed each year as part of the budgetary procedure, and it is determined by the additional revenue needed to finance the expenditure not covered by the other resources (VAT-based payments, TOR and other revenue). In this way, **the GNI resource ensures that Art. 310 TFEU is respected, which stipulates that "revenue and expenditure shown in the budget shall be in balance".**

1.2.4. Ceilings – maximum amounts to spend

The EU budget is subject to various ceilings. **The MFF sets annual ceilings for commitment appropriations under each heading and overall annual ceilings for commitments and payments**. The ORD establishes an annual own-resource ceiling for payments, which is the maximum amount of own resources the EU may raise during a year to cover annual appropriations for payments.

The MFF establishes annual ceilings on payments both in absolute terms and as a percentage of the EU's estimated GNI. Each year, the Commission recalculates this percentage on the basis of the latest available GNI forecasts and publishes it in the MFF technical adjustment. This serves to check that the EU's total estimated level of payments is below the annual Own Resources ceiling established by the ORD, which is currently fixed at 1.23 % of the EU's GNI.

Since the mid-2000s, Member States' largest net contributors to the EU budget have insisted on the need to keep the size of the MFF at 1% of EU GNI. **This 1% 'political ceiling'**, which is usually interpreted as applying to payment appropriations[10], has weighed heavily on the last two MFF negotiations.

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[9] Art 2.5 Own Resources Decision: "For the period 2014-2020 only, Denmark, the Netherlands and Sweden shall benefit from gross reductions in their annual GNI-based contribution of EUR 130 million, EUR 695 million and EUR 185 million respectively. Austria shall benefit from a gross reduction in its annual GNI-based contribution of EUR 30 million in 2014, EUR 20 million in 2015 and EUR 10 million in 2016".

[10] During the 2007-2013 MFF negotiations, the 1% GNI position was first interpreted as relating to commitment appropriations and at a later stage in the negotiation to payment appropriations (see European Commission, EU Public Finances, 5th edition, p.82). In the latest MFF negotiation, the request from Member States' net contributors was to stabilise spending in real terms at the 2013 level, which was in practice equivalent to keep payment appropriations at 1% of EU GNI (even if, in the end, pressure to lower payments from some Member States led to the establishment of payment appropriations below the 1% GNI target).

2. THE IMPACT OF BREXIT ON THE EU BUDGET

KEY FINDINGS

- Brexit could have a number of **different budgetary consequences** for the EU. Apart from leaving a permanent gap in the EU budget, the departure of the UK may alter the dynamics of budgetary negotiation in the Council. The removal of the UK rebate can also open the door to a reform of the EU's financing system.
- The **implications of the Brexit bill negotiations for CAP spending will depend not only on the overall size of the bill agreed but on the type of financial obligation covered**. If the UK accepts to pay its annual contribution to the EU budget until the end of MFF, both EARDF and EAGF spending will be preserved until 2020 but negotiations about the next MFF will become more difficult.
- Brexit is likely to leave a **structural shortfall (or 'Brexit gap') of about €10 billion per year** in the EU budget that has to be balanced by higher contributions or lower spending.
- We estimate that an **increase in contributions would disproportionally affect some of the EU's largest net contributors** such as Germany, The Netherlands and Sweden. In part, this is because they currently benefit from a 'rebate on the rebate' on their contributions that will no longer apply once the UK leaves
- **The Brexit gap can also be addressed by reducing spending**. It is, however, important to stress that the required savings are substantial compared to many EU programmes. Therefore, **large spending categories like the CAP are likely to come under pressure if the EU budget is cut.**
- **There is no default method for adapting the current MFF to the departure of a Member State**. Since any modification requires unanimity, it seems possible that the current MFF remains unchanged and the European Commission covers the shortfall by increasing GNI-based contributions if needed.

Brexit, if it occurs, affects the EU's public finances in several ways. First, negotiations about the so-called **'Brexit bill'** or 'financial settlement' will determine the extent to which the UK pays its share of all financial obligations jointly undertaken by EU countries while the UK was member of the EU (see section 2.1). Second, **Brexit will leave a permanent shortfall in the EU budget estimated at €10 billion per year**[11]. This gap will have to be filled either through increasing Member States' GNI-based contributions, spending cuts, a combination of both or the introduction of new Own Resources (section 2.2).
Brexit may have further effects on the upcoming MFF:

- The departure of the UK may **change the dynamics of negotiation in the Council**. The UK government played a crucial role in the final stage of the last MFF negotiations, forcing a significant reduction in the overall ceiling for payments.
- Brexit will lead to an **increase the size of the EU budget in relative terms (as a % of EU GNI).** This is because it reduces EU GNI by approximately 17% (the British economy's relative weight in the EU) but the UK's net contribution is only about 7%

[11] We already estimated a budget gap of €10 billion per year in Haas, J. and Rubio, E. (2017), *Brexit and the EU budget: Threat or Opportunity*, Jacques Delors Institute, Policy Paper 183, January 2017. The paper was based on 2014-2015 data, but the inclusion of data for 2016 has not changed this estimate.

of the EU budget due to the rebate it receives. Under these circumstances, maintaining the EU budget at 1% of EU GNI (which was the Council's stance in the last two MFF negotiations) appears difficult.

- Brexit will **end the UK correction mechanism and the related rebates**. This opens the door for proposals to remove all corrections in the EU financing system[12] and abolish or reform the VAT-based own resource (on which the calculation of the UK rebate is based)[13].

2.1. One-off effects: The 'Brexit bill'

The 'Brexit bill' or 'financial settlement' refers to the expected payment the United Kingdom has to make to the EU to honour its share of the financial commitments jointly undertaken by EU countries while the UK was member of the EU. It does not refer to any potential future payment related to a possible transition period between Brexit and a future EU-UK partnership agreement.

The financial settlement is being discussed in the first phase of Brexit negotiations. Following the 'phased approach' the EU requires the UK to recognise the existence of this obligations and expects to reach an agreement on general principles concerning the nature and composition of this payment and the methodology to calculate it. This agreement is one of the conditions for moving to the second phase of the negotiations, in which the future EU-UK relationship and transitional arrangements will be discussed, together with the exact amount of the financial settlement.

At the moment of writing, negotiations about the Brexit bill are in deadlock. The EU presented its negotiation position on the financial settlement in a paper published in June 2017[14], While the Commission's paper does not name a specific figure, **the Financial Times estimates that, based on the EU negotiating position, the bill could amount to between €91 and €113 billion, corresponding to a net payment of €55-75 billion after considering the share of EU spending that flows back to the UK**[15].

The EU position paper lists the different financial obligations and liabilities to take into account and proposes a methodology to calculate the amounts for the different items and the UK's share of these obligations. According to the EU, the financial settlement should include the payment of financial obligations derived from the EU budget as well as financial obligations related to the settlement of British participation in EU bodies (the European Investment Band, the European Central Bank) or specific EU funds and facilities (such as the European Development Fund, or the Facility for Refugees in Turkey). These latter ones can be technically tricky and complex to define, but the most contested claims are those related to financial commitments derived from the EU budget.

Generally, the EU expects the UK to pay for these commitments according to its share in financing the EU budget after the application of the UK rebate, which is approximately 12.5%[16]. Taking into account the UK rebate in the calculation of the Brexit bill is logical from

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[12] European Commission (2017), *Reflection paper on the future of EU public finances*, COM(2017) 358 of 28 June 2017.

[13] Monti, Mario et al (2016), op.cit.

[14] European Commission Task Force for the preparation and conduct of the negotiations with the United Kingdom under Article 50 EU, *Position Paper "Essential Principles on Financial Settlement¨*, TF50 (2017), 2/2, 12 June 2017

[15] Barker, Alex, "Brussels hoists gross Brexit 'bill' to €100bn", *Financial Times*, 3 May 2017.

[16] 12.5% is the average of UK's net contributions during 2014 and 2015.

a legal point of view, as the right to this rebate is granted in the Own Resource Decision, the same legal act that states the UK's obligation to contribute to the financing of the EU budget.

The Commission's paper lists five types of financial commitments derived from the EU budget:

1. **Outstanding budgetary commitments or 'RAL' (*reste à liquider*).** The EU expects the UK to cover part of the spending commitments that have been authorised in past EU annual budgets but have not yet been executed at the moment of withdrawal. RAL amounted to €238.3 billion at the end of 2016[17]. Assuming that RAL increases at the end of the MFF, this implies that at least €29.7 billion would have to be paid by the UK at the moment of withdrawal.

2. **Financial programming for the period between the withdrawal date and the end of the MFF.** The EU also asks the UK to contribute to the payment of EU spending obligations linked to the 2014-2020 MFF but not yet committed in an annual EU budget at the moment of withdrawal.

   This is the most contested claim according to some experts[18]. Initially, the Commission's Article 50 Task Force proposed to include only some long-term spending obligations linked to the MFF in the Brexit bill. More specifically, the Commission argued that the UK should contribute to the financing of those spending commitments recognised as EU liabilities in the consolidated accounts of the EU. These are commitments derived from the signature of a contract or grant agreement with a beneficiary, such as a national or regional authority (e.g. the signature of Operational Programmes) or a private promoter (e.g. GALILEO, COPERNICUS or long-term infrastructure projects financed by the Connecting Europe Facility). In 2016, the consolidated accounts of the EU reported €298 billion of such long-term legal commitments (more than 90% of them related to ESIF spending). Assuming the same amount at end-2108, this would imply an amount of approximately €37.2 billion to be paid by the UK.

   After exchanges with national capitals, the Commission's initial position toughened[19]. Various Member States insisted on making the UK liable not only for long-term legal commitments identified in consolidated annual accounts, but for all planned EU spending under the 2014-2020 MFF. **In practice, this implies asking the UK to maintain its annual net EU budget contribution until the end of MFF** (approximately €10 billion per year in net terms[20]) **and cover its share of the RAL on 2014-2020 commitments pending in 2020**, which is expected to reach €254 billion (British share: €31.7 billion)[21]. In total, €51.7 billion would have to be paid by the UK.

   There are strong legal and political arguments to support the EU position. By adopting the MFF in 2013, the UK government committed to financing the EU's long-term budget for the whole period. Most 2014-2020 spending commitments constitute legal obligations for the EU even if they are not part of an annual budget and not included in consolidated accounts, as they derive from EU legal acts setting out the rules and specific amounts allocated to each programme. The UK can counter that the MFF regulation obliges Member

[17] European Commission, DG budget (2017), *Report on budgetary and financial management. Financial year 2016,* Brussels.

[18] Barker, Alex, "FT breakdown: the €100bn Brexit bill", *Financial Times, 3 M*ay 2017

[19] Barker, Alex, op.cit.

[20] Notice that the UK would continue to benefit from all EU spending programmes until the end of MFF.

[21] European Commission (2016), *Commission Staff Working Document Accompanying the document: Communication from the Commission to the European Parliament and the Council, Mid-term review/revision of the multiannual financial framework 201-2020, An EU budget focused on results*, 299 final, Brussels.

States to adjust the MFF in the event of an enlargement (Art. 21) and that thus, 'a contrario', the remaining EU27 should adjust the MFF ceilings and reform legal acts to reflect the fact that one of the biggest net contributors is leaving. However, enlargement differs from withdrawal in that it is a decision taken by unanimity by all EU Member states, not imposed by one of them to the others.

3. **EU liabilities which are not balanced by corresponding assets**. The EU also asks the UK to pay its share of EU liabilities that are recorded in the consolidated accounts and are not balanced by corresponding assets, such as pensions and other employee benefits, payables or financial liabilities not derived from EU borrowing. These are relatively minor amounts. In 2016, liabilities from pensions and other employee benefits amounted to €63.8 billion overall (British share: €7.9 billion) and payables amounted to €40 billion (British share: €5 billion).

4. **Contingent liabilities**. Contingent liabilities are potential liabilities that may or may not fall due depending on the outcome of an uncertain event in the future. They relate mainly to EU guarantees given to the EIB in the context of EFSI, the EIB external lending mandate or other financial instruments (€25.5 billion in 2016) and EU borrowing to finance financial assistance programmes (€54.9 billion 2016). There is a discussion on how to include these liabilities in the calculation of the financial settlement. The EU prefers a British lump-sum payment upfront to cover them in case they materialise in the future, and to reimburse the UK over time if they do not. Another option could be to share the costs from contingent liabilities as they arise in future.

5. **Specific costs related to the withdrawal process**. The EU's paper asks the UK to carry all the specific costs related to the withdrawal process, such as the costs of moving EU agencies located in the UK.

As mentioned above, there is still no agreement on the financial settlement. Through different public speeches, members of the UK government have formally recognised that the UK has financial obligations to the EU but there has not been a public statement detailing which obligations it recognises. Recently, Prime Minister Theresa May promised in her 'Florence speech' on September 22 that no EU country will be required to pay more or receive less over the remainder of the current MFF as a result of Brexit. **Ms May has not provided an exact figure but her words have been interpreted as an offer amounting to €20 billion**[22], which roughly corresponds to the payment of UK's annual net contribution to the EU budget from the expected date of withdrawal (mid- 2019) until 2020.

The €20 billion offer is seen as insufficient by EU negotiators. It leaves out many of the financial obligations mentioned above (pensions, contingent liabilities) and it does not recognise the payment of a share of RAL pending in 2020. It is also worth pointing out that Theresa May's offer has been presented as a sort of implementation payment linked to a two-year transitional period and not as the settlement of past debts. While this is a good strategy to 'sell' the bill to the UK public opinion, **the EU should be careful about linking the agreement on the Brexit bill to an agreement about the transition towards a new EU/UK relationship.** Moving to the second phase without any clear agreement on the Brexit bill would enable the UK to use money as a bargaining chip.

Finally, **from the point of view CAP spending, it is not irrelevant which type of financial obligation is covered.**

[22] Parker, G. and Barker, A. "Theresa May prepares €20bn EU budget offer", *Financial Times*, 19 September 2017.

- If the UK pays its share of the RAL at the moment of withdrawal (in principle, mid-2019) but does not contribute to the financing of the EU after this date, CAP spending (both pillar 1 and 2) in 2019 and 2020 may be under threat.
- If the UK pays a part of the RAL at the moment of withdrawal as well as a share of outstanding legal commitments recorded in the consolidated accounts of the EU, EARDF funding for 2019 and 2020 will be preserved but EAGF spending will be threatened.
- Finally, **if – as seems to be the intention of May - the UK only recognises its duty to maintain the annual contribution to the EU budget for the last two years of the current MFF**, **both EARDF and EAGF spending will be preserved until 2020 but negotiations about the next MFF will become more difficult**. The remaining EU27 will have to assume the UK's roughly €31 billion share of RAL and share the costs among themselves, on top of having to adjust the EU budget to the permanent shortfall left by Brexit (see next section).

2.2. Structural effects: The 'Brexit gap' and the different scenarios to adjust to it

While Brexit may or may not threaten planned spending in the current MFF, it is almost certain that it will have a lasting impact on future MFFs. **Since the UK pays more into the EU budget than the EU spends in the UK, Brexit will leave a structural funding gap in the finances of the EU27.** The outcome of the Brexit bill negotiations, decisions concerning a possible transitional period and the budgetary arrangements linked to the future EU-UK partnership will determine the size of the gap, but it seems safe to assume that the British net contribution post-Brexit will be lower than it is today. Anything else would likely be unacceptable for the UK.

The exact size of the gap not only depends on the type of Brexit (soft or hard, clean or transitional), but on several additional factors. For example, the UK's net contribution to the EU budget has been volatile in the past and forecasts by the British Office for Budget Responsibility suggest that it could decrease in 2017, but increase markedly afterwards[23]. This would imply a larger budget shortfall. At the same time, Brexit could also lead to new revenue, e.g., from increased customs duties if tariffs are reinstated between the EU-27 and the UK (although this would simultaneously depress trade volumes and the overall effect on national budgets might well be negative)[24].

In light of the uncertainties, it seems reasonable to keep matters simple. We assume that the EU will receive no contributions from the UK after Brexit. Consequently, we estimate the 'Brexit gap' by subtracting the revenue raised in the UK from EU spending in the UK. In order to account for yearly fluctuations, we use the 2014-16 average. Over this period, **the UK has contributed an average of €17.4 billion annually**, around one-eight of the EU's total revenue. Revenue raised via the VAT-based and the GNI-based own resource accounts for 80% of the amount. Customs duties (TOR) collected in the UK, which account for the remaining 20%, are not strictly speaking a part of the British national contribution to the EU budget, but we still include them since they will no longer be collected after Brexit. On the

[23] Keep, Matthew (2017) : *The UK's contribution to the EU budget*, House of Commons Library Briefing Paper No. CBP 7886, p. 9.

[24] Núñez Ferrer, Jorge and Rinaldi, David (2016), *The Impact of Brexit on the EU Budget: A non-catastrophic even,* CEPS Policy Brief No. 347.

other side of the ledger, **the EU spent €7.2 billion annually on programmes in the UK** in 2014 and 2015. According to these figures, **Brexit will leave a structural gap of €10.2 billion per year in the EU budget**[25]. The EU will have to increase revenue or cut spending to adjust to this gap.

We estimate the effect of Brexit on Member States by first calculating each country's current net balance (see section 1.1) and then comparing it to the balance that is expected if contributions increase or EU spending decreases. We use the European Commission's 'operating budgetary balances' dataset that records actual revenue and spending (instead of projections)[26].

2.2.1. Scenario 1: Higher contributions

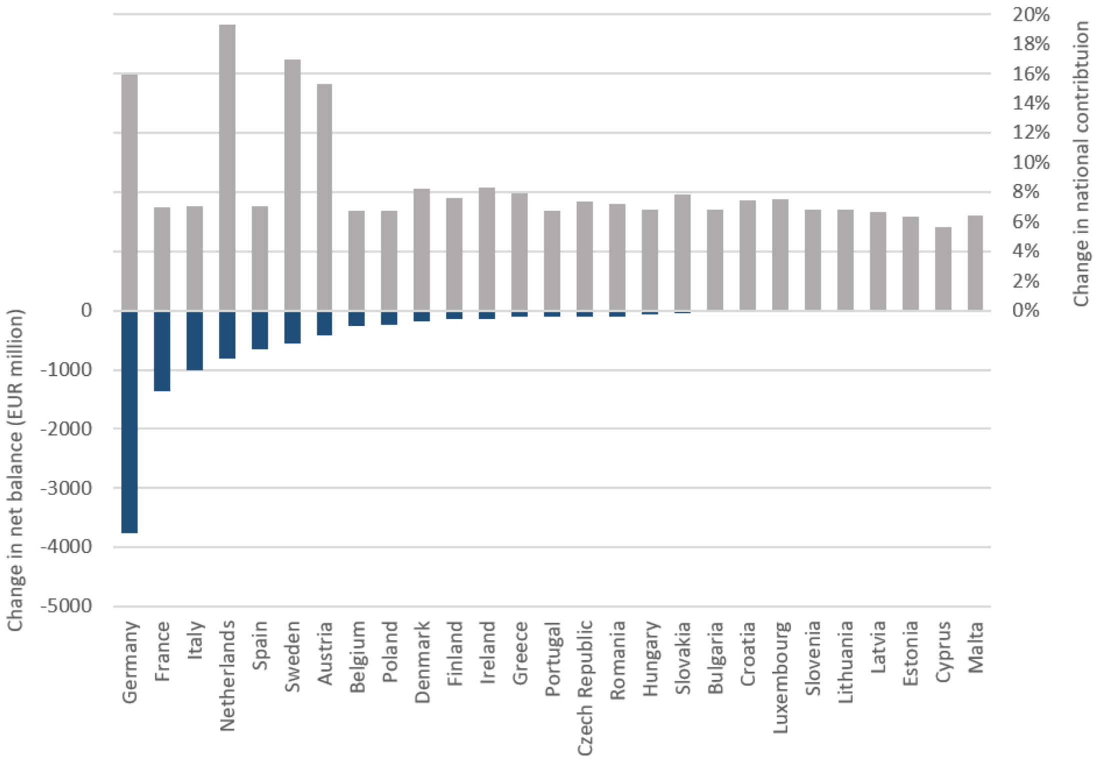
If spending in the EU-27 is maintained, revenue needs to increase by approximately €10 billion in order to balance the budget. The GNI-based Own Resource is used to raise the additional funds (see section 1.2.3). As a result, **wealthier countries can expect to see a larger deterioration of their net balances**. In relation to their current contributions, most Member States are evenly affected. They can expect an increase of between five and eight per cent compared to their current gross national contributions (see figure 1).

However, **Brexit not only increases the financing burden on the EU-27, it also changes how the burden is shared**. A disproportionally large increase can be expected for Austria, Germany, The Netherlands and Sweden. This is because of the way the UK rebate is financed today. All Member States contribute to financing the rebate, but the aforementioned countries have secured a 'rebate on the rebate' that limits their contribution (see section 1.2.3). After Brexit, the UK rebate and its associated rebates can no longer apply. A larger portion of revenue is financed according to countries' relative wealth (GNI key). This effect alone could redistribute around €1.7 billion (or €15 per capita) from the four former rebate countries to the others.

[25] For further details, see Haas/Rubio 2017.

[26] For a more detailed description of the data, see section 3.3 and Haas/Rubio 2017.

Figure 1: The impact of a €10 billion increase in contributions on Member States' net balances.



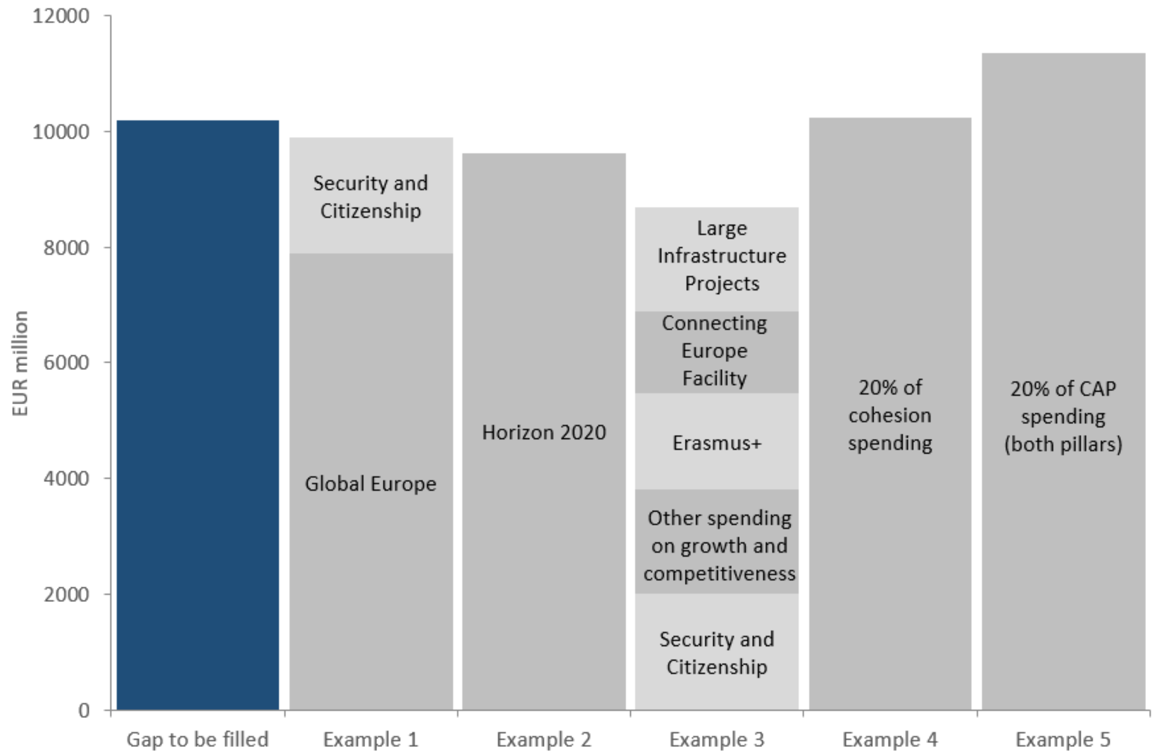
Source: Authors' calculations based on European Commission data on expenditure and revenue by Member States (operating budgetary balances), as reported in EU Financial Reports for 2014-16.
Note: A Member State's national contribution consists of the revenue generated by the VAT- and the GNI-based Own Resource.

2.2.2. Scenario 2: Lower spending

The Brexit gap can also be addressed by reducing spending. The distributional consequences are likely to be very different from the scenario described above. If contributions remain broadly unchanged (except for the rebates) and spending falls, **the net balances of those Member States that receive the most EU funding today deteriorate**, while the effect on net contributors is muted. However, beyond these general considerations, the impact depends entirely on how the cuts are distributed between the different budget headings.

It is, however, important to stress that **the required savings would be substantial compared to many EU programmes**. Figure 2 illustrates this point. Since smaller EU programmes would be devastated by deep cuts, **large spending areas such as Structural and Investment Funds and the CAP are likely to come under pressure in this scenario**.

Figure 2: Spending cuts in comparison



Source: Authors' representation based on European Commission data and Haas, J. and Rubio, E. (2017), Brexit and the EU budget: Threat or Opportunity, Jacques Delors Institute, Policy Paper 183.

Even after deep cuts, Brexit increases the relative size of the EU budget slightly, from currently 1% to 1.05% 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 (in line with net contributors' traditional request to keep the EU budget at 1% of EU GNI) would require spending cuts around €16 billion per year. However, the situation becomes less problematic if the currently strong economic growth in the EU continues.

2.2.3. Scenario 3: No agreement

It is worth noting that **there is no default method for adapting the current MFF to the departure of a Member State**. The MFF regulation for 2014-2020 states that the MFF should be adjusted 'accordingly' in case of Treaty change (Art. 20)[27] or enlargement (Art. 19)[28], but says nothing about the unprecedented event of a Member State requesting to withdraw. Even if we assume that Art. 20 is applicable to withdrawals, there is ample room for interpretation what 'adjusting' the MFF means[29]. Since any modification requires unanimity, it seems possible that the current MFF remains unchanged and the European

[27] 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."

[28] Art. 21 of the current MFF regulation: "If there is an accession or accessions to the Union between 2014 and 2020, the MFF shall be revised to take account of the expenditure requirements resulting therefrom".

[29] An interesting precedent concerning the different interpretations on how to adjust the MFF to changes in EU membership is Croatia's accession in 2013. Both the Commission and the European Parliament called for an increase in the overall level of commitments to adapt to the entry of Croatia, but the Council rejected this interpretation and called for redeployments between ceilings to cover any additional expenditure requirements from the accession. In the end, the compromise was to keep the overall ceiling for commitment untouched but increase the annual payment ceilings for 2013 (See European Commission, EU public finance, 5th edition, Luxembourg: Publications Office of the European Union, 2014, pp. 93-94).

Commission covers the shortfall by increasing contributions via the GNI resource if necessary[30].

It may also happen that an 'ad hoc' solution is found to fill the gap during the current MFF (e.g. a two-year UK-EU transitional agreement, involving the payment of UK net contributions in 2019 and 2020) but that Member States fail to reach an agreement on the post-2020 MFF. In this case, 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 will be maintained until an agreement on the new MFF is reached[31].

2.2.4. Other possible scenarios

Apart from the scenarios outlined above, there are other ways to adjust to the Brexit gap. For example, Member States could combine budget cuts and contribution increases. **Another option is the introduction of new Own Resources that make up for the budget shortfall**. Some options, such as a CO2 levy, might generate revenue without adding to national contributions.

The introduction of new Own Resources could be part of a 'package deal' that includes reforms on the expenditure side, as proposed by the report by the High Level Group on Own Resources published in December 2016[32]. However, a comprehensive deal of this sort is difficult to envisage by 2020. Even if the elimination of the UK rebate opens the door to reforms on the revenue side, the introduction of one or multiple new revenues requires a lot of political bargaining and the approval of new Own Resource Decisions usually takes a long time. The current ORD was proposed by the Commission in September 2011 and was approved almost three years later, in May 2014. Assuming that the Commission makes a proposal for a new ORD in spring 2018, Member States will only have one year and a half to negotiate, approve and ratify the new system.

[30] To be precise, revenue can only be increase until the level stated in the Own Resources Decision, which is currently 1.23% of EU GNI. In 2016, revenue from Own Resources stood at only 0.89% of GNI (cf. Amending Budget No. 6, 2016, p. 198).

[31] Some could argue that this would in principle reinforce the negotiating position of net recipients vis-a-vis those of net contributors. However, a non-agreement scenario could be also disruptive for net recipients as the stalemate could result in major legal and financial uncertainty and problems with the disbursement of EU spending (see Haas and Rubio, 2017).

[32] Monti, Mario et al (2016), op.cit.

3. THE IMPACT OF BREXIT ON THE CAP BUDGET

KEY FINDINGS

- Whereas the weight of CAP in the EU budget has decreased over time, **CAP spending still represents 37.8% of total EU expenditure.** Most of it is allocated to direct payments, which make up approximately 70% of the CAP budget and more than a quarter of the EU budget.
- **The CAP in its current form has a large distributional impact**. The four largest net recipients of CAP funds in absolute terms are Poland, Greece, Romania and Spain, while Germany and the UK are among the largest net contributors.
- **Brexit will leave a 'CAP gap' worth €3 billion annually**, but CAP spending could face larger reductions if other areas of the EU budget are protected from cuts.
- **Increasing Member State's contributions by €3 billion** predominantly affects today's largest net contributors and especially Austria, Germany, The Netherlands and Sweden. This **adds to imbalances in the CAP**. However, the sums involved are rather small compared to government spending.
- **Reducing CAP spending by €3 billion has mixed effects**. Among the largest losers in absolute terms are CAP net contributors like Germany and The Netherlands, but also net recipients like Spain and Poland.
- **Reducing CAP spending by €10 billion favours large net contributors**. The losses of net recipients are significant not only in absolute terms, but also compared to their government spending in relatively poor countries like Bulgaria, Lithuania and Romania.

3.1. Basic features of the CAP budget

The Common Agricultural Policy (CAP) is one of the EU's oldest policies. Established in 1962, CAP has undergone significant changes through a series of reforms since 1992, but its basic 2-pillar architecture remains unchanged.

Pillar 1 includes direct payments for farmers and market measures, and it is delivered through the European Agricultural Guarantee Fund (EAGF).

Pillar 2 concerns rural development measures under the European Agricultural Fund for Rural Development (EARDF).

CAP spending has shrunk over the last decades but it still represents 37.8% of total EU expenditure. Most of it is allocated to direct payments, which make up approximately 70% of the CAP budget and more than a quarter of the EU budget (see table 1). Pillar 2 spending accounts for 8.8% of total EU spending.

Table 1. Main components and relative size of CAP budget 2014-2020

	EUR million (2011 prices)	As % of MFF spending
CAP budget 2014-2020	362 827	37.8%
Pillar 1	277 851	28.9%
Of which: direct payments	265 153	27.6%
Pillar 2	84 976	8.8%

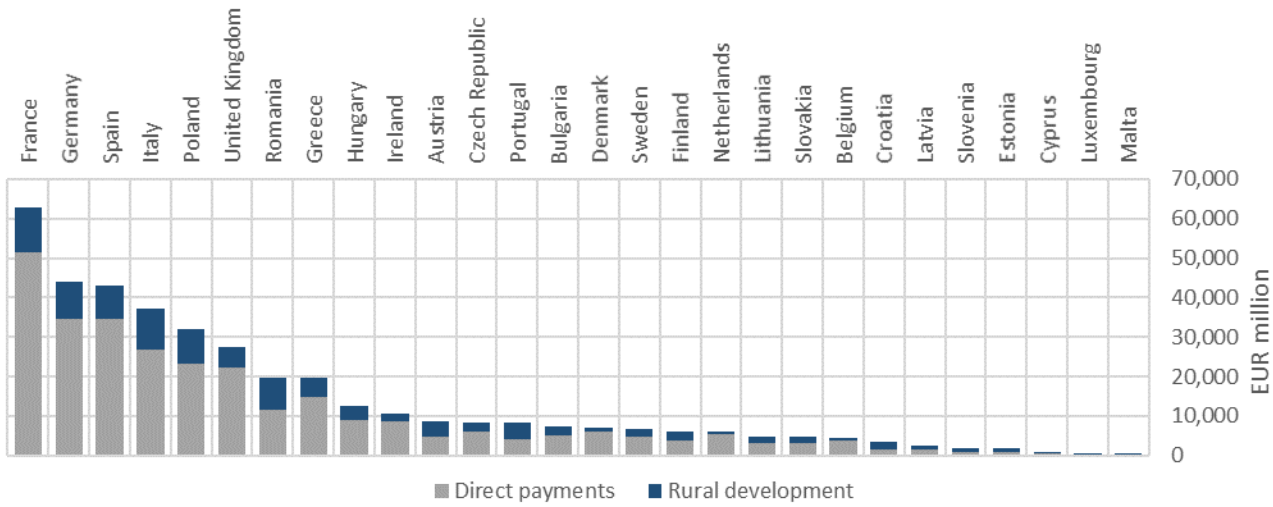
Source: Council Regulation No 1311/2013, EU regulation 73/2009. EU regulation 1307/2013 and EU Regulation 1305/2013

Both direct payments (EAGF) and rural development measures (EARDF) a**re implemented by national authorities**, following the principle of shared management. **Direct payments are 100% financed by the EU whereas rural development measures are subjected to co-financing**, with different co-financing rates applied depending on the type of rural area for which support is intended and the measures co-financing.

CAP commitments under shared management – that is, spending for direct payments (EAGF) and for rural development (EARDF) – are pre-allocated to Member States at the beginning of the MFF. In particular, the European Council's agreement on the MFF set the overall CAP budget and indicative annual break-downs per Member State, which are later on negotiated with the European Parliament and included in the EAGF and EARDF legal acts. The distribution of CAP spending per Member States takes as basis the amounts received by Member States in the last year of the expiring MFF (and therefore is strongly path dependent), but it is also the outcome of a political bargaining which takes into account other criteria as well as budgetary concessions on other policies.

Figure 3 shows CAP pre-allocations per Member State for the period 2014-2020. If we look at the distribution of CAP pillar 1 spending by Member State, we can notice that the biggest beneficiaries are Western European countries (France, Germany Spain, Italy). This is partly explained by historical differences as regards to the level of generosity of direct payments per hectare. As part of the MFF agreement, it was convened that Member States' differences in direct payments would be gradually reduced between 2015 and 2020 via a process known as '**external convergence'**. Through this process, Member States with average direct payments per hectare above the EU average will see their allocation progressively reduced in order to finance the increase in those Member States with an average direct payments below 90 % of the EU average. While the MFF 'external convergence' has entailed a redistribution of EAGF funding, mostly from Eastern to Western European countries, it has not altered the ranking of countries in terms of EAGF allocations.

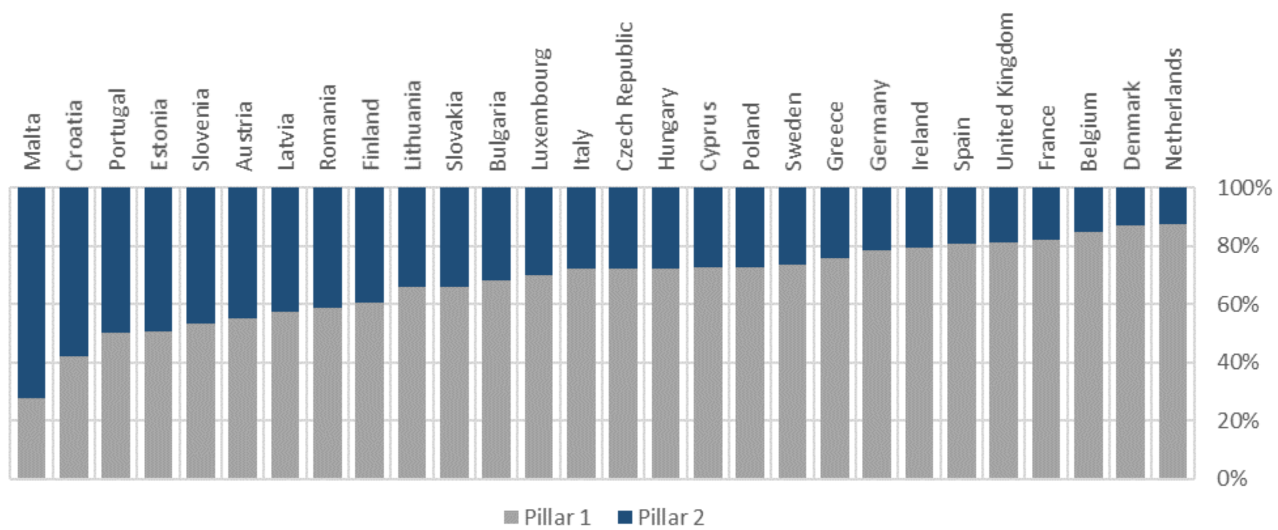
Figure 3: CAP pre-allocations per Member State, 2014-2020 (in € million, at current prices)



Source: European Commission, DG BUDGET website. http://ec.europa.eu/budget/mff/preallocations/index_en.cfm
Note: Allocations before transfers between pillars.

Looking at pillar 2 pre-allocations, the distribution between Member states is more balanced. Following the Commission's proposal, the allocation of rural development funds per Member State was made on the basis of more objective criteria than in the past. There were however a series of discretionary allocations made to 16 different Member States, particularly to compensate some of them for lower pillar 1 allocations due to external convergence. **Figure 4 shows the relative importance of pillar 1 and pillar 2 allocations per Member State.** It is worth noting that pillar 1 spending tends to be more important in Western European countries. Having said this, there are also important exceptions. For example, the EAGF accounts for less than 60% of total CAP spending in Austria and Portugal. As discussed in section 3, this factor is likely to influence Member States' positions with regards to adjusting the CAP to Brexit.

Figure 4: Relative importance of pillar 1 and 2 per Member State



Source: European Commission, DG BUDGET website. http://ec.europa.eu/budget/mff/preallocations/index_en.cfm
Note: Allocations before transfers between pillars.

Finally, it should be taken into account that **the current MFF allows Member States to transfer funds between pillars, up to 15% of the original amounts**. Those Member States with average direct payments per hectare below 90 % of the EU average are allowed to transfer up to 25% of the support they receive for rural development to Pillar I. So far, 11 countries have used this option to move part of their direct payment allocations to the rural development policy and four Member States (Poland, Hungary, Slovakia and Croatia) have increased their direct payments allocations using part of their rural development funds. The net transfer from pillar 1 to pillar 2 over the 2014-2020 period has amounted to around €4 billion[33].

3.2. How Brexit can alter debates on post-2020 CAP spending

CAP spending was already under pressure before the UK decided to leave the EU. During the last MFF negotiations, which took place against the backdrop of budgetary cutbacks, there was a general expectation that the CAP budget would be cut significantly to free up resources for new spending priorities. In the end, there was no dramatic reduction in CAP spending but an agreement to progressively reduce it in real terms[34].

During the next round of MFF negotiations, calls for lower CAP spending could become louder. Depending on the strategy chosen to cover the Brexit gap, **two different political dynamics could threaten the CAP**:

- If EU spending is reduced to balance the EU budget, the largest spending categories will be especially likely to be targeted. Cutting the CAP by a fifth would be enough to fill the Brexit gap, while even deep spending cuts in the small categories would yield considerably less (see figure 2).
- If EU Member States decide to increase contributions in order to make up for the Brexit budget gap, existing imbalances between net contributors and net recipients will become further entrenched. Pressure to shift spending to other areas can grow (see figure 6).

How exactly these dynamics will impact post-2020 CAP spending is unclear at this stage. CAP could suffer large cuts or be largely spared from the adjustment effort. Importantly, profound changes to the CAP architecture, be it in form of co-financing or new instruments and allocation criteria could contribute to reducing costs.

Speculation about **introducing co-financing in pillar 1 direct payments** has grown after the Commission's reflection paper on the future of the EU finance explicitly mentioned this option[35]. According to AGRA Europe estimates, switching to such a system could reduce budgetary expenditure on the CAP by between €7.5 and €13.5 billion a year, depending of the specific design of co-financing rates. Nuñez Ferrer et al even imagine a co-financing system that would save up to €29 billion per year[36]. However, so far, most Member States reject the idea[37].

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[33] Augère-Granier, Marie-Laure and Sgueo, Gianluca (2016), *Common Agricultural Policy – Pillar II*, European Parliamentary Research Service briefing, July 2016.

[34] See Henke, Roberto et.al. (2015) Jonathan Little et al (2013) and Matthews, Alan (2017).

[35] European Commission (2017), *Reflection paper on the future of EU public finances*, COM(2017) 358 of 28 June 2017.

[36] Nuñez Ferrer, Jorge et al., (2016), *Study on the potential and limitations of reforming the financing of the EU budget, Expertise commissioned by the European Commission on behalf of the High Level Group on Own Resources*, Brussels.

[37] Ciaran Moran, "CAP under pressure as most Member States reject co-financing of direct payments", Independent.ie, 13 october 2017.

Regarding the timing of a major reform, it is true that historically there has been a strong link between MFF negotiations and CAP reforms[38]. This link was clear between the last CAP reform in 2013 and the negotiation of the current MFF, and it seems reasonable to expect changes in the CAP design following the adoption of the post-2020 MFF, all the more if the latter decreases the share of CAP spending in the EU budget.

However, it is also true that the uncertainty about the budgetary implications of Brexit and the difficult negotiations about the Brexit bill could delay the next MFF compromise. Furthermore, the election of a new European Parliament will interrupt the EU's legislative activity in 2019. Consequently, some experts consider that a major revision of CAP will not be possible until 2022 or 2023, with implementation starting in 2024 or 2025[39].

3.3. Estimating the Brexit effect on the CAP: data and methodology

In order to estimate possible effect of Brexit on Member States CAP net balances, we rely on data provided by the European Commission in its overview of 'operating budgetary balances (OBB)**[40]**. They record revenue as well as executed expenditure by member state. Since revenue as well as spending has shown considerable variance in the past, **we use the 2014-16 average for our calculations**.

There are no official calculations for Member States' net balances in specific spending areas because all EU revenue goes into a unitary budget. However, balances can be estimated by comparing a country's share in financing the EU budget to the share of EU funds it receives in a specific area. Or approach can be outlined as follows:

- First, we calculate each Member State's national contribution (i.e., revenue raised via the VAT- and the GNI-based resource, including rebates) as a share of all national contributions. By multiplying the contribution share with EU-28 spending on CAP, we arrive at an estimated contribution to the CAP.
- Second, we subtract the funds a Member State receives via the CAP from its estimated contribution. This gives us today's estimated net contribution.

Estimating the impact of Brexit on CAP net balances requires a few additional steps:

- We remove the UK rebate and the so-called 'rebate on the rebate' that mitigates the UK rebate's impact on the contributions of Austria, Germany, the Netherlands and Sweden[41]. In order to do so, we estimate a simplified UK rebate based on CAP expenditure, taking into account that spending in 'new' Member States under pillar 2 is excluded from the calculation of the UK rebate[42]. We then calculate how much each Member State would have to contribute to financing the rebate under the current rules and how the burden would be shared if a GNI key was used instead. The difference between the two gives us the net impact of the discontinued rebates, which can be negative or positive.
- We split up the UK's net contribution among Member States. Again, we use the GNI-based resource because it is the EU budget's marginal revenue source.

[38] The 1999 Agenda 2000 reform was closely linked to the negotiations of the 2000-2006 MFF, just like the last CAP reform in 2013, but this was not the case for the 'Fischler Reform' in 2004 and the CAP the 'Health Check' in 2009.

[39] Matthews, A.(2017), *The budgetary context for the CAP,* blog article, CAPreform.eu, September 4 2017.

[40] OBB are included as annex in EU annual Financial Reports.

[41] How the corrections are calculated is described in great detail in the 2014 Own Resources Decision.

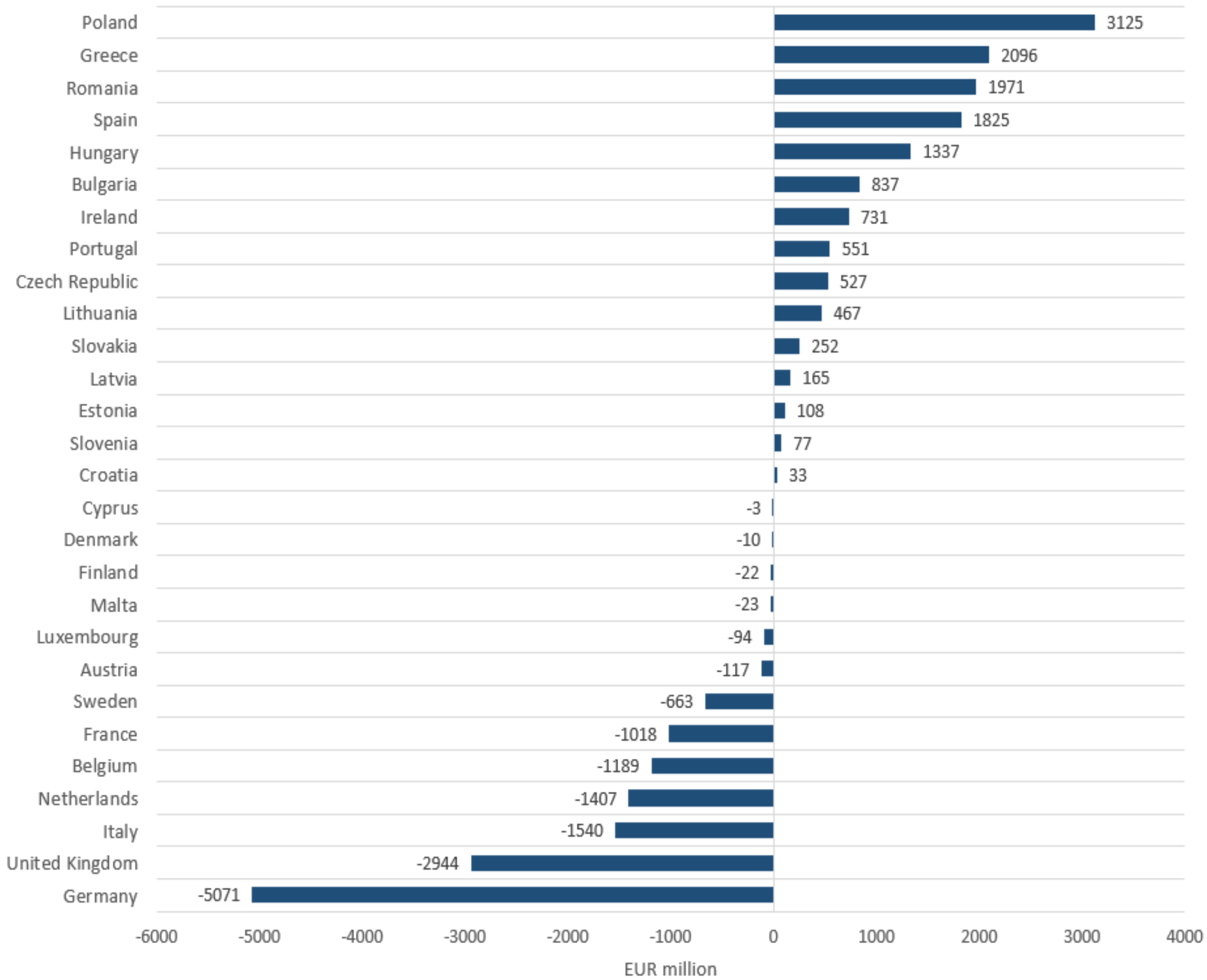
[42] For the sake of simplicity, we leave out smaller items in the calculation, such as the United Kingdom's advantage and TOR windfall gains.

- Finally, we sum up the original CAP contribution, the effect of discontinuing the rebates, and the cost of covering the UK's net contribution. The result is an updated CAP contribution that can be subtracted from the (possibly also updated) CAP spending in a country to arrive at a new net balance.
- The approach outlined above simulates an increase in contributions that balances the budget shortfall after Brexit. To simulate a budget cut instead, we simply lower CAP spending by the desired amount and compare it to the sum of updated contributions. If spending is lower than revenue, contributions are decreased according to the GNI key until the budget is in balance once again.

3.4. Current CAP net balances

Figure 5 shows current CAP net balances. As can be noticed, the CAP has a large distributional impact. The four largest net beneficiaries in absolute terms, namely Poland, Greece, Romania and Spain, together receive transfers worth around €9 billion annually, which translates into positive net balances of between €1.8 and €3.1 billion. On the other side of the spectrum, Germany is by far the largest net contributor, followed by the UK. Their net annual contribution to CAP amounts to €5.1 and €3 billion, respectively. Since 2014, there has been some variance in CAP net balances but no clear trend towards convergence or divergence.

Figure 5: CAP net balances of EU Member States, 2014-2016 average



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

3.5. Adjusting the CAP to Brexit

In analogy to the Brexit gap, it is possible to estimate the size of the budget shortfall left by the British departure from the EU. **The 'CAP gap' is equal to the British net contribution in the field of CAP, worth around €3 billion annually**. However, it does not follow that Brexit will lead to a reduction of CAP spending by this amount. **Expenditure could just as well be reduced by €10 billion, or not at all**. There is no automatism, the decision is up to the EU institutions and the Member States.

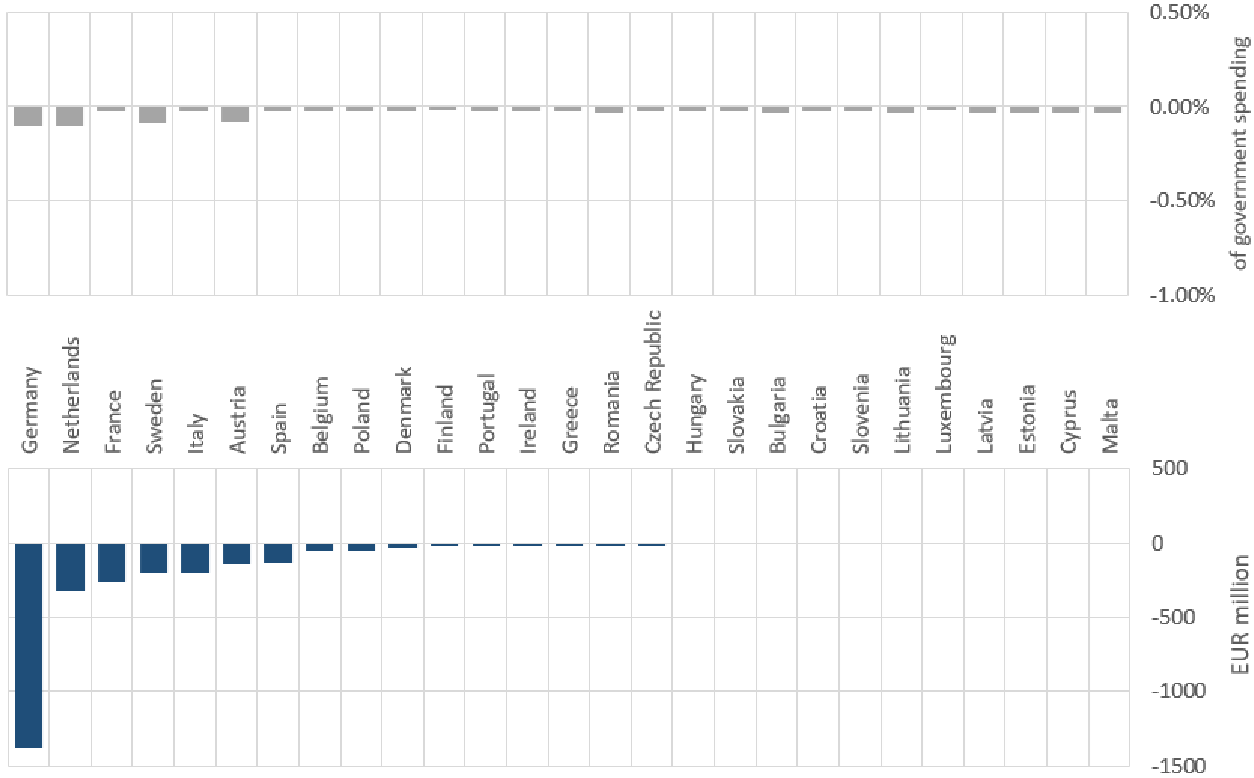
Simulating the impact of different reform options on CAP net balances can give us an idea where Member States' material interests lie. **The scenarios we outline in the following are not reform proposals. Rather, they serve to illustrate the dynamics that follow from the different possible changes to the CAP**.

3.5.1. Scenario 1: the impact of higher contributions

If the current CAP spending levels are maintained after Brexit, additional revenue worth €3 billion must be raised to finance them. Assuming that there is no radical change to the EU financing system before 2020, this happens via the GNI-based own resource (see section 1.2.3). **As figure 6 shows, adjusting to the 'CAP gap' through higher contributions leads to a worsening net balance in all Member States. However, not all are equally affected**. Austria, Germany, The Netherlands and Sweden lose their benefits from the 'rebate on the rebate' (ibid.). Consequently, in this scenario, a country like The Netherlands sees its CAP net balance deteriorate by almost the same absolute amount as Italy, a country whose GNI is three times larger. Whether this represents an unfair additional burden for the former rebate countries or whether today's financing system is unfair to most Member States, is up for debate.

More generally, **higher contributions magnify the already existing imbalance between CAP net contributors and net recipients**. We estimate that Germany's CAP net balance deteriorates to -€6.1 billion in this scenario and even France ends up with a €1.2 billion CAP net deficit. At the same time, the Polish CAP net balance remains almost unchanged at €3 billion. Nevertheless, it is worth noting that the amounts involved represent relatively small shares of government expenditure. Even for the former rebate countries, the change in net balances is limited to around 0.1% of general government spending.

Figure 6: Estimated change in CAP net balances resulting from a €3 billion increase in national contributions



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

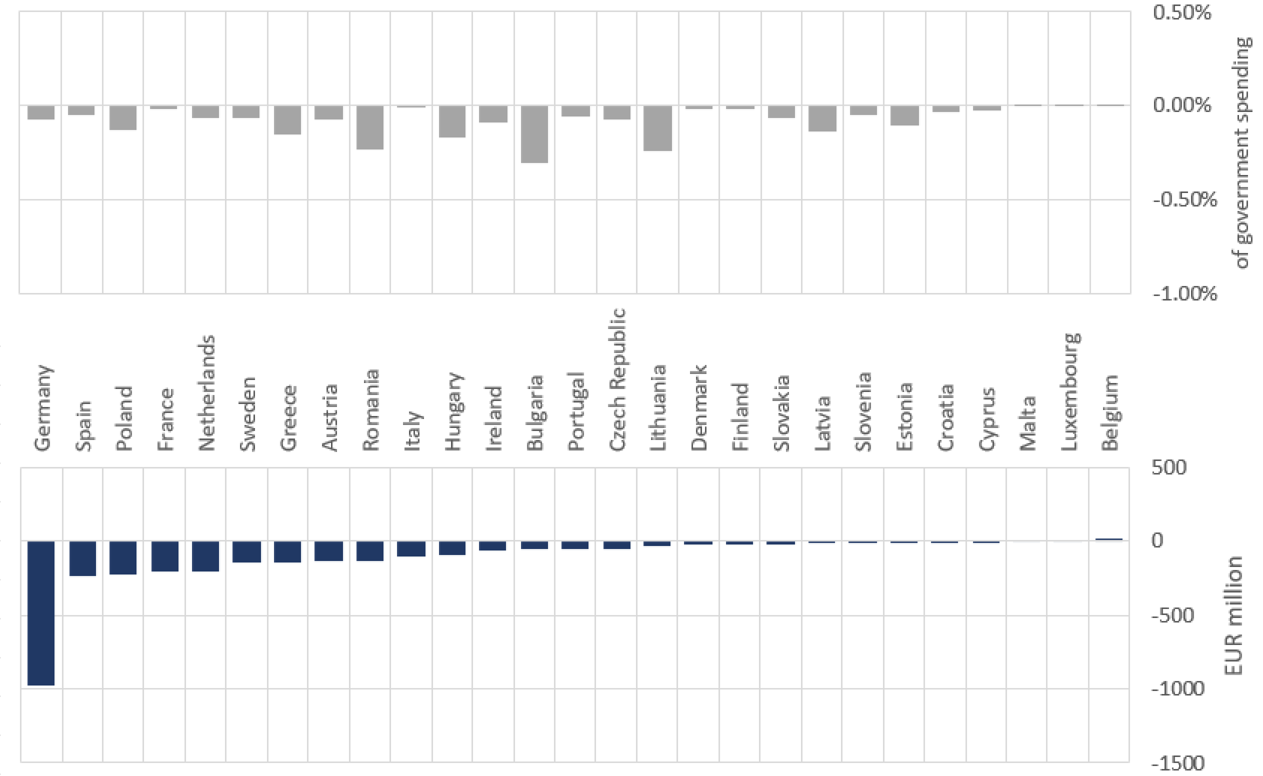
3.5.2. Scenario 2: the impact of CAP spending cuts

Reducing spending puts a higher burden of adjustment on net CAP recipients. **A €3 billion cut, equivalent to the British CAP net contribution, reduces the Polish and Greek net gains from the CAP by €230 million and €140 million respectively. Some net contributors, like Luxembourg and Belgium, see their CAP net balance improve very slightly, but most are still negatively affected (see figure 7).**

The mixed result reflects two conflicting effects of Brexit. On the one hand, the EU's CAP expenditure is reduced in all Member States. The higher the amount a country receives at the moment, the larger the negative effect. On the other hand, money is redistributed from former rebate countries to all other Member States (see previous section). For example, German CAP net contributions increase by more than €600 million. In absolute terms, this is especially beneficial for countries that used to finance the bulk of the UK rebate, such as France and Italy. In some cases, the reduced CAP contribution more than makes up for the loss in EU funding.

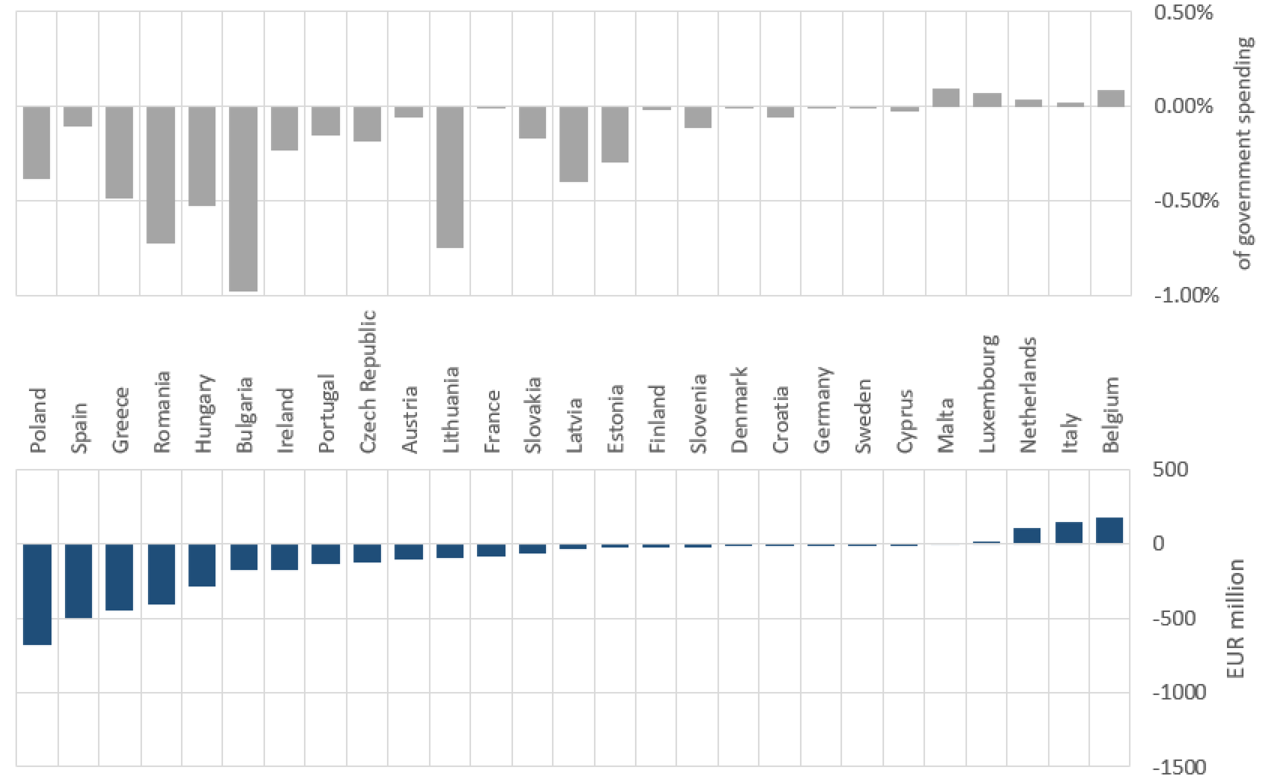
If the entire Brexit gap of €10 billion is financed by cutting CAP expenditure, the roles are almost completely reversed compared to the "higher contributions" scenario (see figure 8). Large net contributors to the CAP benefit from the reform. For most former rebate countries, the savings from reduced contributions outweigh the loss of EU funds. In contrast, most net recipients pay only slightly less than before, but receive substantially reduced payments. The Polish CAP net balance deteriorates by a fifth, or €680 million. Furthermore, some of the poorest Member States are strongly affected by cuts. For example, in Bulgaria, Lithuania and Romania, the negative impact exceeds 0.7% of government spending.

Figure 7: Estimated change in CAP net balances resulting from a €3 billion CAP spending cut



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

Figure 8: Estimated change in CAP net balances resulting from a €10 billion CAP spending cut



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

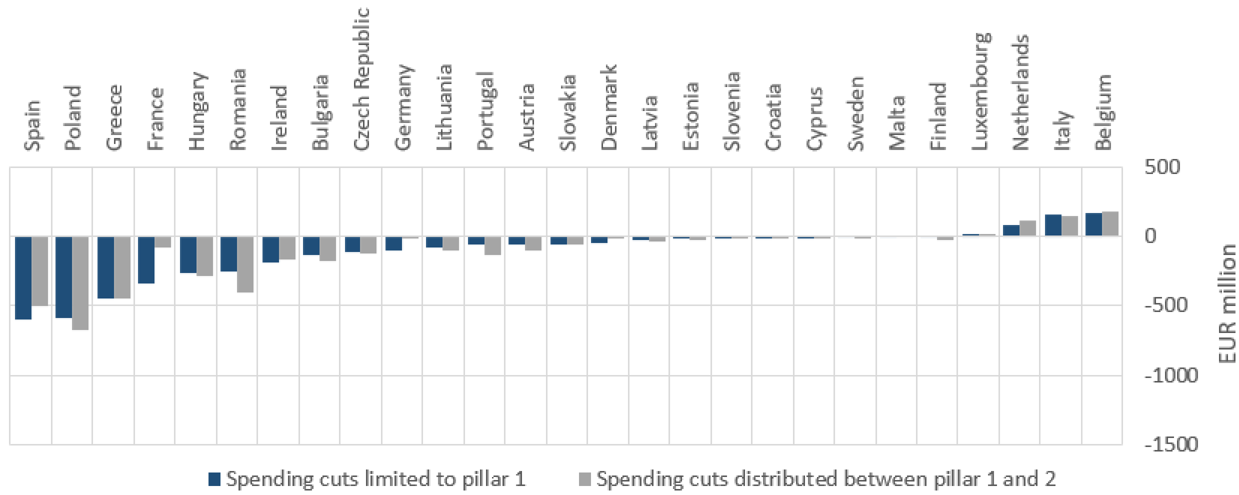
3.5.3. The impact of co-financing and re-balancing the two pillars of the CAP

The decision to cut or to maintain overall CAP expenditure has important distributional consequences. They can be modified via changes within the CAP. Changing eligibility criteria or protecting certain elements from cuts can mitigate or exacerbate the consequences of spending cuts.

One proposal that has much appeal among experts and researchers is to introduce national co-financing for pillar 1 spending. This is seen as a good measure not only to reduce overall CAP spending, but to give Member States a greater incentive to improve the fairness and cost-effectiveness of direct payments[43].

Figure 9 shows the estimated impact of a €10 billion spending cut achieved through the introduction of co-financing rates for direct payments. The results are compared to the 'reference' scenario where the same cut is distributed between pillar 1 and 2. As can be noticed, there is no clear net recipient/net contributor divide. Several net recipients (e.g. Poland, Romania) and some net contributors (e.g. Austria, the Netherlands) are less affected than in the reference scenario. The main losers in this scenario are those countries which are especially dependent on pillar 1 payments (France, Spain). In contrast, countries such as Portugal, Romania or Austria, where pillar 2 represents more than 40% of total CAP allocation (see figure 4) benefit particularly from concentrating cuts on pillar 1.

Figure 9: Estimated change in CAP net balances resulting from a €10 billion reduction in CAP pillar 1 spending



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

More sophisticated adjustments could make large reductions in overall CAP expenditure compatible with protecting economically weaker Member States. One option would be to introduce a cohesion-based system of direct payments, with different co-financing rates for applied to Member States according to their levels of per capita GDP[44]. A more radical option would be the introduction of co-financing for direct payments only in the old Member States (EU-15), as suggested in a recent Agra article[45]. In order to make up for the €10 billion Brexit gap, the EU-15 would have to finance one third of the direct payments out of their own budget. Figure 10 compares the estimated effect of this measure to the reference scenario.

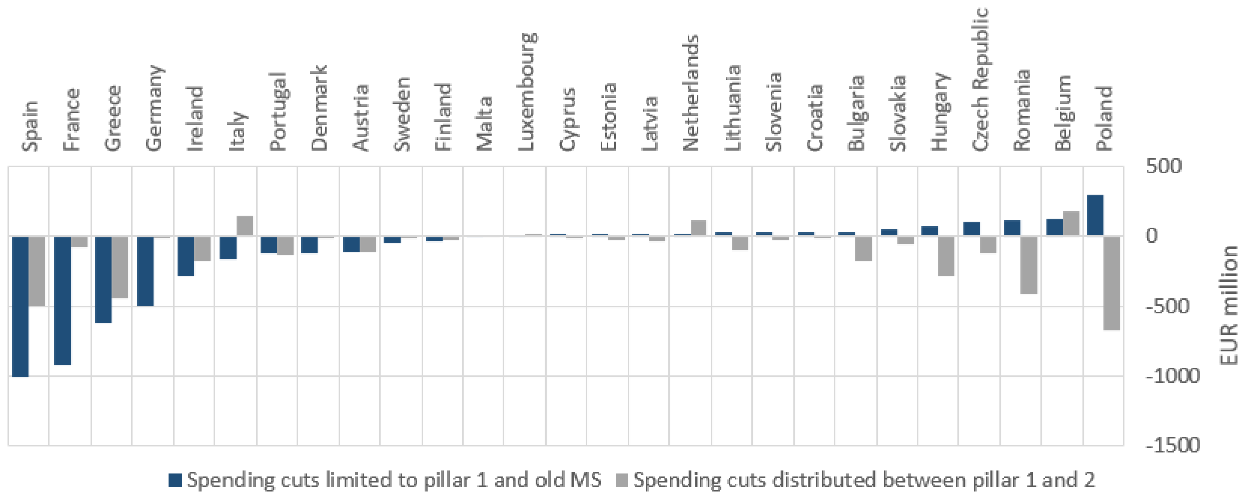
[43] Matthews, Allan (2016); von Cramon-Taubadel, Stephan et. al (2017).

[44] Nuñez Ferrer, Jorge et al. (2016), op.cit

[45] Horseman , Chris, "Analysis: P1 co-financing could save CAP up to €13.5 billion per year", Agra Europe, 29 June 2017.

The main losers in this scenario are big EU-15 CAP gross recipients, particularly Spain, France and Germany but also Greece and Ireland. The main beneficiaries are Poland, Romania and the Czech Republic, which see their net balances improve rather than worsen.

Figure 10: Estimated change in CAP net balances resulting from a €10 billion reduction in CAP pillar 1 spending (only old Member States)



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

4. CONCLUSIONS AND RECOMMENDATIONS

Brexit has far-reaching consequences for the EU's finances. The departure of the UK may alter the dynamics of budgetary negotiations in the European Council. The end of the UK rebate can also open the door to a more profound reform of the system of Own Resources. **The most immediate consequences, however, are those related to the impact of the ongoing 'Brexit bill' negotiations on the current MFF and the expected permanent shortfall that the UK will leave in the EU budget at the moment of withdrawal**.

How exactly these two factors will affect the current and future MFF – and by extension current and future CAP spending – depends to large extent on politics. We do not know what the final outcome of the Brexit bill negotiations will be, but it seems clear that they will depend as much on legal as on political arguments. Likewise, Member States and the European Parliament can take different decisions on how to adjust the EU budget to the Brexit gap. Depending on the decisions taken, Brexit can offer an opportunity to reform the spending and the revenue side of the EU's finances or, on the contrary, entrench and deepen existing divides between Member States and further complicate the EU budget with the establishment of additional corrections.

In this note, we have summarised the possible financial consequences of Brexit for the EU budget and CAP in particular.

- The **size and nature of the 'Brexit bill'** determines whether there will be a gap in the EU's finances before the end of the current MFF and whether the negotiations about the next MFF will be complicated by an unexpectedly large amount of RAL.
- The **loss of the British net contribution to the EU budget** leaves a yearly gap that must be filled by cutting expenditure, increasing contributions or finding new revenue sources. We assume that by 2020, no new revenue will come from the introduction of additional own resources or a Single Market membership fee. Consequently, **we estimate an overall 'Brexit gap' of €10 billion and a 'CAP gap' of €3 billion.**

We have outlined two scenarios to adjust to Brexit at the level of the overall EU budget. Both suggest that CAP spending will be affected.

- **Scenario 1: Filling the Brexit gap by increasing Member States' national contributions.** This especially affects countries that already have a large negative net balance. Some of them, including Germany and The Netherlands, are hit by further contribution increases because rebates related to the British EU membership run out. Consequently, they are likely to push for a restructuring of EU spending.
- **Scenario 2: Reducing expenditure.** The precise consequences of this option depend on the distribution of the budget cuts, but €10 billion in savings cannot be achieved by reducing spending on small EU programmes. Attention is therefore likely to turn to the Structural and Investment Funds and the CAP.

Furthermore, we have estimated what impact the different options to adjust CAP to Brexit might have on Member States' CAP net balances.

- **If the current CAP spending levels are to be maintained after Brexit, an increase of GNI-based contributions worth €3 billion (the equivalent to the British net contribution in the field of CAP) is needed** to finance them. This leads to a deterioration of CAP net balances in all Member States, and widens the already existing imbalance between CAP net contributors and net recipients.

- **Reducing the CAP budget by €3 billion has moderate consequences for Member States' CAP net balances**. However, it seems likely that there will be pressure for deeper cuts if other EU programmes are protected.
- **Adjusting to the Brexit gap only through CAP spending cuts** (that is, cutting CAP by €10 billion) **benefits CAP net contributors and shifts the burden of adjustment to net recipients.** As a result, CAP imbalances shrink, but the cuts are significant, especially for some of the poorer Member States.
- **Concentrating spending cuts on pillar 1 while protecting pillar 2** has been suggested as a way of reducing the costs of the CAP and improving the quality of CAP spending. Our estimates suggest that such a strategy spreads the burden of adjustment between net contributors and net recipients. However, it **requires some large gross recipients of CAP funds (particularly France and Spain) to accept a sizable deterioration in their net balances.**

Our research shows that there is no pain-free path to adjustment. However, it also shows that **the financial impact of the different reform options is in most cases limited when compared to general government spending**. The challenge for governments mainly consists in communicating to their constituents that a slightly higher net contribution or a lower net benefit helps make the EU budget more efficient and ultimately benefits all EU members. Their case might be more convincing if they simultaneously simplify the EU's revenue system and refocus spending instead of devoting energy on creating new rebate mechanisms.

On a more general note, the following recommendations could contribute to mitigating the impact of Brexit on the EU budget and on the CAP:

- **The EU should be careful in linking the agreement on the Brexit bill to an agreement on a future and hypothetical transitional period**, as proposed by the UK. Moving to the second phase without any clear agreement on the Brexit bill can offer to the UK the opportunity to use money as a bargaining chip when negotiating the transition to and future EU/UK relation.
- **The EU's priority in the Brexit bill negotiations should be to minimise the adverse financial impact of Brexit in current and future MFF**. If concessions are needed, they can come from other elements of the deal such as the UK's participation in EU bodies and funds, payment for pensions and other employees' benefits or payment for contingent liabilities.
- **Bargaining about budget cuts and contribution increases should not be limited to one spending area**, but include the entire system of EU finances. For example, net contributors might be more willing to accept further increases in their payments if the overall budget was reformed.
- **It is important to start debating contested key concepts (like 'EU added value') and potential compromises soon**, even if the actual budgetary impact of Brexit could become clear only at a very late stage of the Brexit negotiations. If the preparations for the post-2020 MFF start only in March 2018, there might not be enough time for an ambitious reform and the EU might end up with a system that is barely less complicated than the current one. A unique opportunity to improve the EU's public finances would be wasted.
- **Brexit can provide the narrative for a profound reform in the architecture of CAP**, aimed not only at reducing overall CAP spending but at rendering CAP more effective and sustainable. However, **a major revision of CAP seems unlikely before 2022 or 2023, with implementation starting in 2024 or 2025**.

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