**ICAEW**
BETTER GOVERNMENT SERIES

# ANALYSING THE EU EXIT CHARGE

*A policy insight update*

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## A deal at last

In the last few months the UK and the EU have agreed a method for calculating a financial settlement to be paid by the UK after it ceases to be an EU member state.

Although this is still subject to embedding in a formal written withdrawal treaty, we now have a much clearer idea of what the UK will have to pay to the EU to settle its financial obligations on its departure.

In particular, HM Treasury has estimated that the net financial settlement will be **£37bn**, plus or minus £2bn.

This comprises £21bn to settle financial obligations incurred while the UK is a member of the EU and £16bn for the transition period.

This estimate is higher than the scenarios identified in the ICAEW policy insight on the EU exit charge that was published in June last year. This update provides an analysis of the changes since the original policy insight and what they can tell us about the negotiations.

**Figure 1 – The financial settlement**

| ICAEW high scenario | HM Treasury estimate | |
|---|---|---|
| £20bn | £16bn | Transition period |
| £15bn | £19bn | Authorised spending not yet paid |
| £10bn | £9bn | Pensions |
| (£5bn) | (£4bn) | Recoveries |
| (£10bn) | (£3bn) | European Investment Bank |
| £30bn | £37bn | |
| £82bn | £84bn | Payments to the EU |
| (£52bn) | (£47bn) | Receipts from the EU |
| £30bn | £37bn | **Net exit charge** |

Sources: ICAEW, *Analysing the EU exit charge*; National Audit Office, *Exiting the EU: the financial settlement*.

The ICAEW high scenario has been reformatted and amounts reclassified in order to be comparable with the National Audit Office's analysis of the HM Treasury estimate.

## WHAT HAS CHANGED?

The most significant change since our original policy insight has been the agreement of a transition period of 21 months through to the end of 2020.

This means that the UK will remain a financial contributor through to the end of the EU's current multi-year financial framework on 31 December 2020.

In our original policy insight, we identified three scenarios for the financial settlement: a low scenario of £5bn, a central scenario of £15bn and a high scenario of £30bn.

The low and central scenarios are no longer relevant as neither included a transition period. However, the high scenario did include an assumption that the UK would contribute to the EU budget until the end of 2020.

**INSIGHT**
Although our high scenario included contributing to the EU budget until 2020, it still assumed an exit date of 29 March 2019. The agreement of a transition period means the effective exit date for the financial settlement is 31 December 2020.

**Table 1 – Updating the estimate**

| | £bn | £bn |
|---|---|---|
| **ICAEW high scenario** | | **30** |
| Exchange rate movement[1] | 2 | |
| Approved spending | 1 | |
| Cost of transition period | (3) | |
| Rebates, receipts and recoveries | (1) | |
| **Changes to estimates** | | **(1)** |
| **Timing of 2019 payments** | | **(3)** |
| European Investment Bank | 7 | |
| Change of exit date to 2020 | 3 | |
| Assets and liabilities | 1 | |
| **Outcome of the negotiations** | | **11** |
| **HM Treasury estimate** | | **37** |

[1]Change from €1.20 to £1 to €1.13 to £1.
Sources: National Audit Office, Office for Budget Responsibility, ICAEW calculations.

## CHANGES TO ESTIMATES

The HM Treasury estimate uses more up to date numbers from the European Commission, together with a different exchange rate. Overall the resulting changes mostly offset each other.

There is also a difference arising from the timing of payments to the EU, with HM Treasury assuming that the first quarter contribution in 2019 will include £3bn paid in advance. The National Audit Office highlight this £3bn as a risk to the estimate of the financial settlement amount, albeit in terms of its classification between payments before or after 29 March 2019.

## OUTCOME OF THE NEGOTIATIONS

The most significant difference between our original estimate and the HM Treasury estimate concerns the UK's 16% shareholding in the European Investment Bank (EIB).

We assumed that the UK would be entitled to recover its full share of net assets, estimated at £10bn, but instead the EIB will only return the UK's original capital investment of £3bn, with no accompanying share of profits.

Another difference arises from the agreement of a transition period. This means that the UK will contribute an extra £2bn for spending approvals between April 2019 and December 2020, together with approximately £1bn for pension entitlements earned in that time.

The EU and the UK have also agreed to exclude 'operational assets' from the financial settlement. We estimate that this concession is worth £1bn to the EU.

**INSIGHT**
The return of the UK's original investment in the EIB, with no accompanying share of profits, is the most puzzling outcome from the negotiations.

## THE EXIT CHARGE

Table 2 summarises the amounts expected to be paid by the UK to the EU after the end of the transition period.

**INSIGHT**
The largest element of the financial settlement is for approved expenditure not yet paid. This is described as budgetary commitments by HM Treasury and as 'amounts yet to be paid' or 'reste á liquider' (RAL) by the EU.

**Table 2 – Net exit charge**

| | **£bn** |
|---|---|
| Approved expenditure not yet paid | 19 |
| Pension obligations | 9 |
| European Investment Bank | (3) |
| Recoveries | (4) |
| **Exit charge excluding transition period** | **21** |

Sources: National Audit Office, Office for Budget Responsibility, ICAEW calculations.

The largest element relates to approved expenditure not yet paid. This arises from the EU's approach of approving in advance certain spending requests for multiple years. For example, at the end of 2020 there would still be three years yet to be paid on a five-year grant approved in 2019.

According to the withdrawal agreement, the UK will still be able to participate in the specific programmes that it is contributing to until the final payments concerned are made, even if it may no longer able to participate in new or ongoing programmes.

## PENSIONS

It was not a surprise that the UK accepted that it had an obligation to contribute to pension and health costs of EU employees, given the guarantees provided by member states over these liabilities. These guarantees are one of the reasons why the EU has not needed to establish a pension fund to cover future payments as they fall due.

The UK has agreed to contribute an estimated £9bn for pension and health care entitlements earned up until the end of 2020. This is a significant amount, albeit it is relatively small compared with the £1.8tn owed to members of the UK's public sector pension schemes.

These payments are expected to continue up until at least 2064, unless the UK decides to exercise an option to make a one-off payment before then.

Exercising this option is likely to be a sensible financial decision: the interest rate on government debt should be much lower than the discount rate on this liability. Whether the government of the day will actually choose to exchange a not very visible balance sheet liability for an increase in the headline measure of public debt is another matter.

## RECOVERIES

In our original policy insight, ICAEW noted that, with the exception of pensions, most of the EU's liabilities were offset by assets and the UK's net share would be relatively small.

In the event, the UK and the EU have agreed to exclude most assets and liabilities from the financial settlement, with the exception of recoveries of advance payments, fines and capital investments in EU institutions.

One item that was left open relates to the UK's share of space-related assets, in particular the Galileo global positioning system. What happens to that share will depend on the nature of co-operation between the UK and the EU on space programmes in the future.

**INSIGHT**
The withdrawal agreement means that the UK has no claim to the EU's wine or art collections, a possibility that received extensive press comment even though the amounts involved are extremely small compared with the billions at stake in the wider negotiation.

## CONTINGENT LIABILITIES

The financial settlement requires the UK to continue to guarantee around £5bn of commercial loans made by the EIB and £6bn in loans to member states and partner countries.

The UK is exposed to around £1bn relating to legal cases, in particular the risk that the European Commission might have to repay fines following an appeal to the European Court of Justice.

These amounts have not been included in the financial settlement as they are not expected to crystallise, with the UK's exposure reducing over time as the loans are repaid or legal cases are resolved.

The UK could also be called on to provide additional capital to the EIB of up to £30bn in certain circumstances, although this too will reduce gradually over time.

## RELOCATING EU AGENCIES

During the negotiations, the EU suggested that the UK should contribute to the cost of relocating EU agencies to other European countries.

In the event no amounts were included in the financial settlement, but the withdrawal agreement does indicate that the UK will 'support' the two agencies concerned with their moves.

This support is likely to be in the form of taking over the leases of the buildings occupied by the EU agencies, in particular avoiding a potential break cost of £0.5bn that might otherwise be payable by the European Medicines Agency to its landlord in Canary Wharf.

**INSIGHT**
No announcements have yet been made as to which government departments will be moving to the European Medicines Agency and European Banking Agency offices in Canary Wharf.

## EU SPENDING IN THE UK

In calculating their estimate, HM Treasury adopted the same approach as we did in our original policy insight and deducted amounts coming back from the EU to the UK private sector. This is a change from the way HM Treasury and the Office for Budget Responsibility have traditionally reported EU contributions.

Without these amounts, the net financial settlement would be reported as being £7bn higher. However, it is important to realise that a significant proportion of these payments are to university and research institutions covered by the government's promise to replace any funding that might be lost if there were to be no deal with the EU.

A much more important question is how new grants will be funded from 2021 onwards and whether these will still be through joint arrangements with the EU or through separate UK programmes.

## GROSS VERSUS NET

During the negotiations, press and political comment focused on the gross amounts of the financial settlement, before taking into account the UK's rebate, amounts coming back to the UK, and the recovery of assets.

Table 3 provides an analysis of the gross amounts implied by the withdrawal agreement, although neither the UK nor the EU have published a definitive pre-rebate equivalent number themselves. At €95bn, our analysis is not far short of the €100bn that has appeared in many headlines over the last two years.

**INSIGHT**
In reality, the UK was never going to have to pay €100bn to the EU, even though it did make for an exciting headline. The rebate, receipts and recoveries have always meant that the net settlement was likely to be less than half of the gross amount.

**Table 3 – Gross versus net**

| | £bn |
|---|---|
| Approved expenditure not yet paid | 38 |
| Transition period | 35 |
| Pension obligations | 11 |
| **Gross payments before rebate (€95bn)** | **84** |
| **Rebates, receipts and recoveries** | **(47)** |
| Approved expenditure not yet paid | 19 |
| Transition period | 16 |
| Pension obligations | 9 |
| Recoveries, including EIB | (7) |
| **Net financial settlement (€42bn)** | **37** |

Sources: National Audit Office, Office for Budget Responsibility, ICAEW calculations.

**INSIGHT**
The net financial settlement (excluding transition) of £21bn is just over £300 per person, or nine days of government spending.

Although during the transition period the EU will follow the normal (extremely complicated) process for calculating the UK's rebate, the withdrawal agreement establishes a fixed percentage for calculating the UK's share of post-exit payments, net of the associated rebate. This will be based on the average of five years contributions from 2016 and 2020.

## DEVELOPMENT AID

The National Audit Office highlighted how the estimate excludes £3bn in commitments made by the UK to contribute to the European Development Fund outside of the EU budget.

As this is part of the legally required 0.7% Overseas Development Aid target, it is money that would be spent anyway even if it wasn't going via the EU.

As such it appears reasonable to treat this funding commitment separately from the financial settlement arising from the withdrawal from the EU Treaties.

## RISKS TO THE ESTIMATE

As with all forecasts, the likelihood is that the final amounts to be paid will differ from these latest Treasury estimates.

Exchange rates will change, the calculated share for post-2020 payments will be determined by numbers that will not be known until 2021, the EU could attempt to take advantage of the UK's loss of voting rights after 2019, and there may be inaccuracies in the data used.

Although the risks in each case are relatively small, and may well offset each other in practice, the final cost of the financial settlement could end up outside the rather narrow range of £35bn to £39bn put on the estimate by Treasury.

**INSIGHT**
Agreement of the financial settlement is only the first step. The nature of the future financial relationship with the EU has yet to be negotiated.

## NOTHING IS AGREED UNTIL EVERYTHING IS AGREED

The plan is to incorporate the financial settlement into a formal withdrawal treaty between the UK and the EU, to be ratified prior to 29 March 2019.

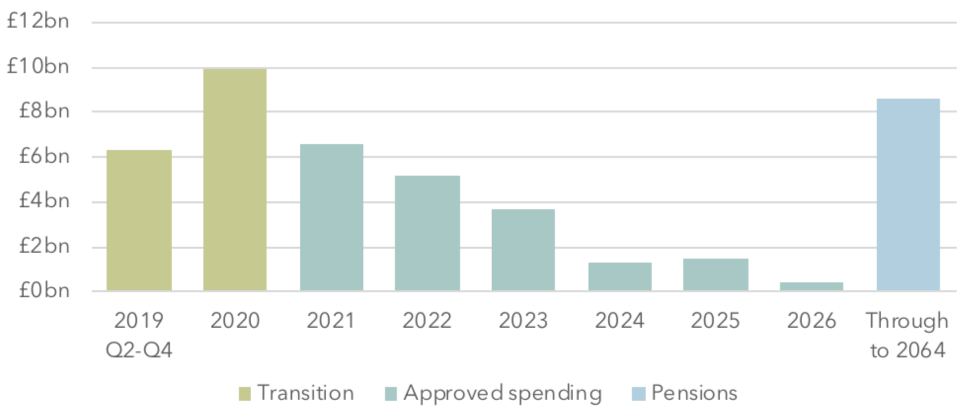
The withdrawal treaty will provide a legal basis for these payments. This will be irrespective of the nature of the future relationship between the UK and the EU, which may not be fully agreed until at least 2020, and perhaps not even then.

However, if the withdrawal treaty is not ratified then the UK is still likely to pay the EU money after ceasing to be a member state. This is because the government has confirmed, in the words of the Prime Minister, that 'the UK will honour commitments we have made during the period of our membership'.

**INSIGHT**
Although 'nothing is agreed until everything is agreed', the UK is still likely to pay a financial settlement even if there is no deal.

### Forecast payment profile

**Figure 2 – Forecast payment profile (net)**




Sources: National Audit Office; ICAEW calculations. Excludes recoveries of £3bn EIB capital over 12 years, and other recoveries of £4bn over 20 years.

## Insights

- Although our high scenario included contributing to the EU budget until 2020, it still assumed an exit date of 29 March 2019. The agreement of a transition period means the effective exit date for the financial settlement is 31 December 2020.
- The return of the UK's original investment in the EIB, with no accompanying share of profits, is the most puzzling outcome from the negotiations.
- The largest element of the financial settlement is for approved expenditure not yet paid. This is described as budgetary commitments by HM Treasury and as amounts yet to be paid or 'reste á liquider' (RAL) by the EU.
- The withdrawal agreement means that the UK has no claim to the EU's wine or art collections, a possibility that received extensive press comment even though the amounts involved are extremely small compared with the billions at stake in the wider negotiation.
- No announcements have yet been made as to which government departments will be moving to the European Medicines Agency and European Banking Agency offices in Canary Wharf.
- In reality, the UK was never going to have to pay €100bn to the EU, even though it did make for an exciting headline. The rebate, receipts and recoveries have always meant that the net settlement was likely to be less than half of the gross amount.
- The net financial settlement (excluding transition) of £21bn is just over £300 per person, or nine days of government spending.
- Agreement of the financial settlement is only the first step. The nature of the future financial relationship with the EU has yet to be negotiated.
- Although 'nothing is agreed until everything is agreed', the UK is still likely to pay a financial settlement even if there is no deal.

## More about the authors

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## Further information

**Our original policy insight**

Analysing the EU exit charge (June 2017)

**Latest estimate for the financial settlement**

National Audit Office

Office for Budget Responsibility

**Latest information on the negotiations**

Department for Exiting the EU

European Commission

European Parliament

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