University of Glasgow | Adam Smith Business School

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The Big Divorce Bill and the implications for Scotland’s spending

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1: The €60 billion EU Divorce Bill

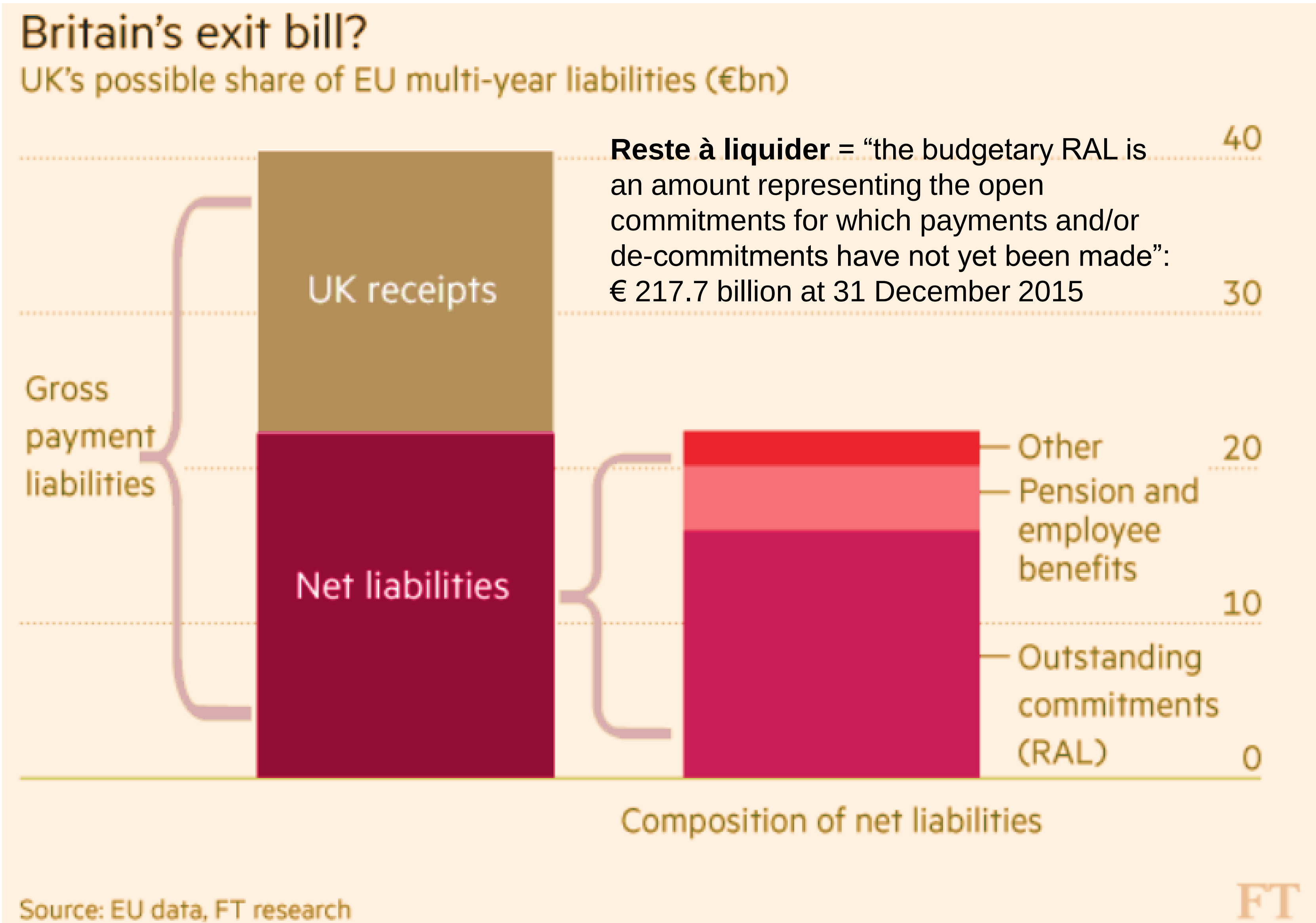
- The first public mention of €20 billion found in the public domain was on 13 October 2016, in a report written by Alex Barker (*Financial Times* Brussels correspondent). This indicates that the EU had been making preparations in the period after the Brexit Referendum on 23 June 2016
- Providing a much bigger number and more detail in a Centre for European Reform Policy Brief (06/02/17), Alex Barker stated that “The European Commission calculates that the UK has €60 billion of charges to settle.”
- Sir Ivan Rogers (former UK Ambassador to the EU) stated on 1 February 2017 that the €60 billion figure had been doing the rounds in Brussels, for months before he wrote his letter that was leaked
- Reasonable to conclude that the emergence of the €60 billion figure from the Commission was politically motivated and not an ‘unauthorised’ leak. The Treasury frequently plant numbers in the *Financial Times*, something the Commission will have noticed. Clearly the Divorce Bill is bundled into a wider political negotiation, so neither legal entitlements nor accounting principles will determine what the UK does pay

2: Background to the Divorce Bill

- The European Commission has confirmed that:
    - There is still no information published by the internal Commission Task Force which has been working on a need-to-know basis
    - EU entities have made calculations that seem to be based on the 2015 accounts
- The 2014-20 Multiannual Financial Framework (MFF) could be adjusted to reflect Brexit on 29 March 2019. With the Commission operating on a calendar-year basis, that means almost two years of the present MFF will be after Brexit. Moreover, there is a ‘N+3’ rule for spending before the commitments expire at the end of 2023
- Treaties are the higher authority. The 1969 Vienna Convention on the Law of Treaties provides a framework where Treaties are sparse on detail, but Article 70 (Vienna Convention) does not directly apply when Article 50 (Treaty of the European Union) sets out procedures for withdrawal. Relevance comes if there is no deal
- House of Lords European Union Committee (2016, para 196) concluded: “Even though we consider that the UK will not be legally obliged to contribute to the current MFF after Brexit, we expect the issue of continuing payments to be a factor in withdrawal negotiations. The Government will have to set the financial and political costs of such payments against potential gains from other elements of the negotiations.”
- Competing analogies include (a) leaving a golf club (entitlements and obligations end immediately membership ceases – all members might leave); and (b) leaving a professional partnership (bought out in the same way that originally bought in). EU accession countries did not pay an entry fee

Graphic from *Financial Times*, 13 October 2016

Alex Barker ‘UK faces Brexit divorce bill of up to €20bn’



Reste à liquider = “the budgetary RAL is an amount representing the open commitments for which payments and/or de-commitments have not yet been made”: € 217.7 billion at 31 December 2015

Calculations of Liabilities behind the EU Claim

Alex Barker, *The €60 billion Brexit bill, Centre for European Reform, February 2017, p.10*

	EU end 2018 € billions	UK share (12%) € billions	UK share (15%) € billions
LIABILITIES			
Pension liabilities	63.8	7.7	9.6
Reste à liquider (RAL) end 2018	241.0	29.2	36.2
ESI Funds Cohesion: Outstanding allocation 2019-20	113.0	13.7	17.0
ESI Funds Rural/Fish: Outstanding allocations 2019-20	30.4	3.7	4.6
Copernicus	2.9	0.4	0.4
Connecting Europe Facility	10.1	1.2	1.5
EFSI Capital	16.0	1.9	2.4
European Development Fund and Trust Funds	-	1.7	1.7
TOTAL	**€477.2**	**€59.6**	**€73.3**
CONTINGENT LIABILITIES			
Guarantees/Provisions	23.1	2.8	3.5
EU loans	56.1	6.8	8.4
TOTAL	**€559.7**	**€69.1**	**€85.2**
OFFSET PAYMENTS: UK RECEIPTS			
Assets	22.5	2.7	3.4
UK rebate for 2018 (approx)	-	6.0	6.0
Receipts for UK projects (approx)	9.0	9.0	9.0

Alternative Methods of Calculating the UK's Divorce Bill

Alex Barker, *The €60 billion Brexit bill, Centre for European Reform, February 2017, p.10*

METHOD 1: Maximum liabilities, includes contingent liabilities paid upfront, excludes rebate			
UK share of liabilities	-	59.6	73.3
Contingent liabilities (UK share upfront)	-	9.6	11.9
UK receipts	-	11.7	12.4
NET TOTAL		**€57.4**	**€72.8**

METHOD 2: Maximum liabilities, excludes contingent liabilities and rebate			
UK share of liabilities	-	59.6	73.3
UK receipts	-	11.7	12.4
NET TOTAL		**€47.9**	**€60.9**

METHOD 3: Excludes 2019-20 allocations, maximum receipts			
UK share of liabilities	-	42.2	51.8
UK receipts including rebate	-	17.7	18.4
NET TOTAL		**€24.5**	**€33.4**

3: The Basis for the Split (1)

- This exposition concentrates on technical issues, but media and political reaction will dominate. For comparison, Total Managed Expenditure was £753 billion in 2016-17
- The divorce metaphor has acquired so much tailwind that there is no point disputing the terminology. But certain points should be remembered:
  - In a human divorce, there are two parties: here it is 27 versus 1
  - In a human divorce, the focus is on the net assets of the marriage; the only assets number on Slide 5 is trivial in relation to total EU assets. Only property assets and assets available for disposal are included in the Barker calculations, valuations being at historical cost. The EU27 have no intention of putting total assets into play, or viewing Brexit as a partnership dissolution
  - The EU thinks in terms of budgeting on a commitment accounting basis, rather than in terms of International Financial Reporting Standards (IFRS) or International Public Sector Accounting Standards (IPSAS). Hence, the proposed liability bill covers 2017 to circa 2023, in relation to projects and items not yet determined [NB The momentum of Brexit and concerns about being able to afford matched funding may result in UK receipts being less than forecast]
  - In a human divorce, there is the crucial decision about (a) clean break from the past after sharing net assets, versus (b) continuing financial relationship. Option (b) means that decisions by one party may have continuing effects on the other party (eg increasing/decreasing pensions generosity or writing off loans to Member States or countries in the EU Accession queue)

3: The Basis for the Split (2)

- Two obstacles to a UK-EU trade agreement are likely to be (a) reciprocal populations, and (b) the Divorce Bill. Settling (b) early as a lump sum will be diplomatically attractive, as it draws down a financial curtain on UK membership. This is then separated from possible post-Brexit co-operation on programmes between the UK and the EU (eg student exchange and research funding; crime, security and immigration)
- 'Clean Break' has obvious attractions, but:
  - The remarkably low interest rates since the 2008 Global Financial Recession mean that discount rates used to present-value future liabilities are very low positive and may turn negative [NB discounting at negative nominal discount rates means that liabilities are valued at more than will ever be paid out in cash]. There are strong economic arguments for using positive discount rates but accounting standards are influential on this matter. The counter-argument to early payment is that interest rates are not expected to stay at current levels over the relevant period that for some liabilities might run for 60 or more years [NB issues of legal jurisdiction may arise if EU27 decisions increase future UK payments]
  - Paying €60 billion or thereabouts would significantly add to the UK fiscal deficit in the year when it is paid and add to the debt/GDP ratio. Whereas this would be one-off and could be financed, political vulnerability arises from the fact that (a) the architects of Brexit wish to stop sending money to Brussels, and (b) politicians, if not parties, may make "Can't Pay, Won't Pay" election commitments. The transparency of up-front amounts contrasts with the potential opacity of annual payments

4: How to Fill the Hole in the EU Budget

- Notwithstanding the 1984 Fontainebleau Agreement, the UK is a net contributor to the EU budget. Average over 2010-15 is £7 billion (including UK private sector receipts) and £9 billion (excluding them). UK per capita net contribution at £79 per capita is lower than Germany (£131) and Norway (£115). Brexit ends these, though the UK might buy in to some EU programmes
- This will concern the northern European EU members (who might have to pay more) and the eastern and southern members (whose net receipt position will be under threat). These issues seem likely to affect country positions, well beyond their numerical importance, in part because they are reminders of potential power shifts within the EU resulting from Brexit
- An upfront lump sum from the UK might therefore be attractive to several Member States fearful of the EU budget consequences of Brexit and of continuing arguments with the UK about what should be paid. The capital sum could be parked in such a way as to phase in more gently the loss of the annual UK net budget contribution
- This discussion has related to the core EU Budget, but there is a complex web of payments to EU institutions that are outside the core Budget and also institutions that are connected to the EU without being part of the Treaty architecture. The most important is the European Investment Bank (in which the UK has 16.1% of the subscribed capital but only EU Member States can be shareholders)
- Substantial relocation costs will be incurred when the European Banking Authority and the European Medicines Agency leave London (NB private sector locational decisions will be affected)

5: Impact on the Scottish Budget

- The 2016 Scottish Fiscal Framework maintains the Barnett formula, though the total budget will now depend also on the revenue performance of Scottish taxes relative to performance of the rest of the UK
- Weak recovery from 2008 and Brexit may lead to reductions in public spending in England on services that are devolved in Scotland, thereby generating negative Barnett formula consequentials. The uncertainties attached to Brexit suggest that the post-2010 austerity will continue through the 2020s. The UK may choose to compete with the EU by near-zero Corporation Tax and low regulation
- Underperformance of the Scottish economy relative to that of the rest of the UK (dependence on oil and financial sectors; Foreign Direct Investment motivated by EU membership) will lead to a Block Grant Adjustment (ie deduction) which is larger than the revenues from devolved taxes and assigned tax revenues
- Certain areas of spending, such as agriculture and fisheries, have been tightly regulated by the EU but execution has been at the devolved level in Scotland. The UK Government wants to take over the policy role hitherto exercised by the European Commission. Whatever the future role in agriculture and fisheries of the Scottish Government, the critical point is where the funding of that spending (£499.7 million in 2016-17) will come from