B The EU financial settlement

Introduction

B.1 The effects of Brexit on the public finances are likely to be dominated by the indirect effects of changes in trade, migration and other policy regimes on the economy and its capacity to generate tax receipts. Such effects are impossible to quantify now, since there is no meaningful basis upon which to predict the precise end-point of the negotiations that are underway. And even in hindsight, they will be very difficult to enumerate with any confidence, since it will not be clear what would have happened in the absence of Brexit.

B.2 One of the more direct and readily quantifiable ways that Brexit will affect the public finances is by reducing or stopping the UK's contributions to the EU budget. But, soon after the referendum, the Chancellor guaranteed funding for certain EU projects after the UK leaves the EU (e.g. in agriculture, science and structural fund projects), subject to various conditions.[1] And the Prime Minister has subsequently stated that the UK may continue to make contributions where it wishes to participate in some European programmes.[2]

B.3 The Government has not yet fully articulated its intentions in this area and, even if it had, the precise post-Brexit outcome remains subject to negotiation. Since the referendum vote, we have therefore adopted the fiscally neutral assumption that, after leaving the EU, the 'net expenditure transfers to the EU' line in our fiscal forecast would be fully recycled into other spending lines. This approach underpinned our forecasts in November 2016 and in March and November 2017. It was detailed in Annex B of our November 2017 *Economic and fiscal outlook (EFO)*, which also showed how the measure that affects public sector net borrowing relates to other, more familiar, gross and net measures of the UK's EU contributions. In that annex, we discussed the many forms that alternative spending could take, including ongoing contributions to the EU budget, the 'divorce bill', substitute spending where EU programmes cease, replacement overseas aid in order to meet the legislated 0.7 per cent of national income requirement, and other Brexit-related costs.

B.4 On 8 December 2017, the EU and the UK Government published a joint report on phase one of negotiations under Article 50.[3] This included the caveat that "*nothing is agreed until everything is agreed*" and that it was "*also agreed by the UK on the condition of an overall agreement under Article 50 on the UK's withdrawal*". One of the three areas the report discussed was the financial settlement – the 'divorce bill'. This provides sufficient information for us to estimate the prospective cost of a financial settlement on those terms and incorporate it into our central forecast.

[1] See '*Chancellor Philip Hammond guarantees EU funding beyond date UK leaves the EU*', HM Treasury, 13 August 2016.
[2] See '*PM speech on our future economic partnership with the European Union*', 2 March 2018.
[3] *Joint report on progress during phase 1 of negotiations under Article 50 TEU on the UK's orderly withdrawal from the EU*, Department for Exiting the European Union, 8 December 2017.

B.5 The Treasury estimated that the total cost of the settlement would be between €40 billion and €45 billion, equivalent to £35 billion and £39 billion at the then prevailing exchange rate of €1.13 per pound.[4] On the basis of assumptions consistent with our central economy and fiscal forecasts in this *EFO*, we estimate that the total cost of the settlement would be €41.4 billion or £37.1 billion), with £28.0 billion falling due between 2019-20 and 2022-23 – i.e. within our forecast horizon.

B.6 A key feature of the joint report is that "*the UK will not be required to incur expenditures earlier than would be the case had it remained a Member State unless agreed by both sides*". In effect, this means that, if the settlement is calculated using the same assumptions as used in our forecast, it cannot exceed the amount we have included in our post-referendum forecasts as unspecified spending in lieu of EU transfers as per our fiscally neutral assumption.

B.7 The rest of this annex discusses:

- how we have estimated **the size of the financial settlement** in total;
- the assumptions needed to generate a **year-by-year payment profile**;
- how those payments **compare with our public finances forecast**; and
- **future developments and uncertainties**.

B.8 We are grateful to staff at the National Audit Office for their help in producing this annex and scrutinising the material provided by the Treasury. All assumptions and judgements are the responsibility of the OBR's Budget Responsibility Committee.

Estimating the size of the financial settlement

B.9 The joint report lays out three main components of the settlement:

- the period up to 2020;
- outstanding commitments at the end of 2020; and
- other actual and contingent liabilities and corresponding assets.

B.10 The settlement will follow the EU budget in being denominated in euros and operating on a calendar year basis, so all the estimates in this section are presented on that same basis.

[4] See '*Chancellor's letter to the Treasury select committee regarding the financial settlement in relation to UK withdrawal from the European Union*', 24 January 2018.

UK participation in EU annual budgets to 2020

B.11 The current EU Multiannual Financial Framework (MFF) was agreed by EU Member States in 2013 and runs from 2014 to 2020. The joint report states that "*The UK will continue to contribute to, and participate in, the implementation of the Union annual budgets for the years 2019 and 2020 as if it had remained in the Union*".

B.12 As we routinely forecast the UK's net expenditure transfers to EU institutions and the wider measures of EU contributions, this element of the settlement can be drawn directly from our central forecast. Table B.1 shows our latest forecasts for the relevant public and private sector flows. Gross contributions after the UK's rebate and the amount retained to notionally meet the cost of collecting customs duties are set to total €38.4 billion across 2019 and 2020. After subtracting public sector receipts from the EU – for example, funding under the Common Agricultural Policy – net contributions from the public sector sum to €25.5 billion in those two years. And once private sector receipts – for example, EU-funded research at UK universities – have been subtracted, the overall net flow from the UK to the EU sums to €21.5 billion. The Treasury's estimate of the total cost of the financial settlement also used an estimate of this overall UK net contribution as its starting point.

Table B.1: Total UK contributions to the EU if we remained a member

	€ billion							
	Outturn	Estimate	Forecast					
	2016	2017	2018	2019	2020	2021	2022	2023
GNI based contribution (a)	17.5	12.6	14.9	17.7	17.9	17.5	17.1	16.9
VAT payments to the EU (b)	3.6	3.3	3.4	3.4	3.4	3.5	3.6	3.7
Traditional own resources (c)	3.8	4.0	3.9	3.8	3.8	3.8	3.8	3.8
Notional contribution (d)=(a+b+c)	**24.9**	**19.8**	**22.1**	**24.9**	**25.1**	**24.8**	**24.5**	**24.3**
TOR collection costs (e)	-0.4	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8
UK abatement (f)	-6.7	-5.1	-4.8	-4.7	-5.4	-5.3	-5.2	-5.2
Gross contribution (g)=(d+e+f)	**17.8**	**13.8**	**16.5**	**19.4**	**19.0**	**18.8**	**18.5**	**18.4**
Public sector receipts from the EU (h)	-4.3	-5.6	-5.6	-6.3	-6.6	-6.6	-6.6	-6.7
Public sector net contribution (i)=(g+h)	**13.5**	**8.3**	**10.9**	**13.0**	**12.4**	**12.2**	**11.9**	**11.7**
Private sector receipts from the EU (j)	-2.8	-1.7	-1.7	-2.0	-2.0	-2.0	-2.0	-2.0
UK total net contribution (k)=(i+j)	**10.7**	**6.5**	**9.2**	**11.1**	**10.4**	**10.1**	**9.8**	**9.7**

B.13 Since the UK is currently set to leave the EU on 29 March 2019, in calendar year 2019 there will be one quarter in which we make contributions as a Member State and three quarters when those contributions are made under the terms of the financial settlement. This does not affect the total amount paid in 2019, but it does affect the estimated cost of the financial settlement.

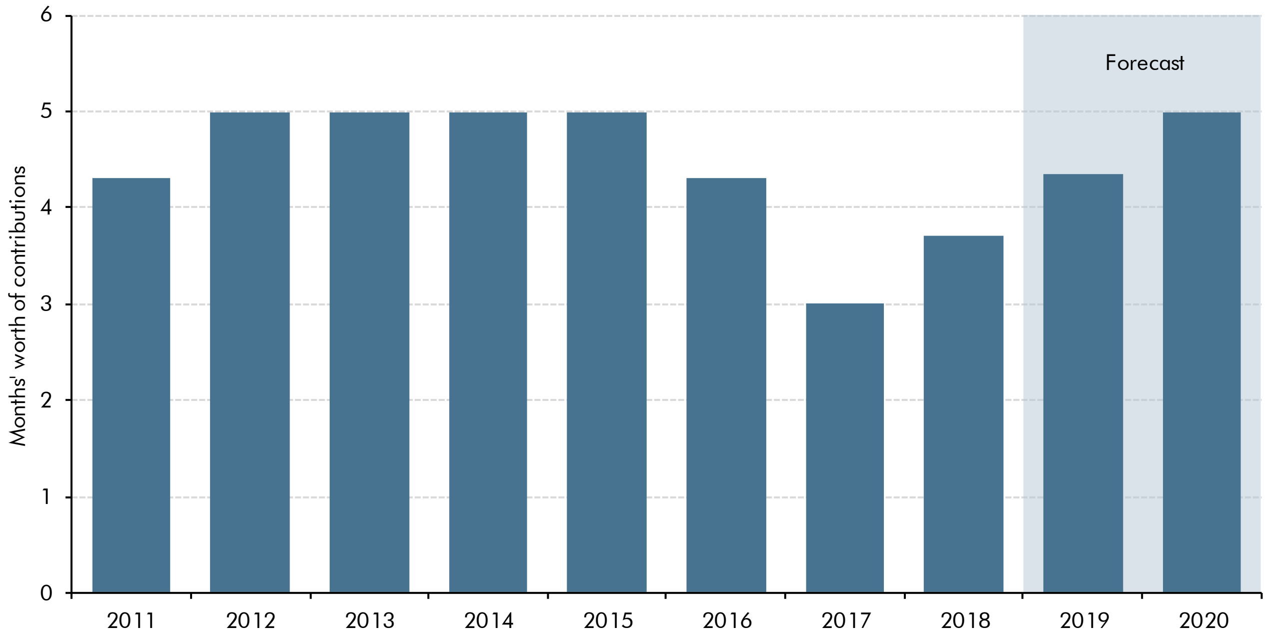
B.14 Splitting the 2019 payments between contributions and settlement is not simply a matter of pro-rating the payments as one quarter and three quarters. The Commission can request up to five months' worth of total GNI and VAT contributions less the UK rebate in the first quarter of the year, to take account of frontloaded CAP payments. In the four years up to 2015, it requested the maximum amount, but since then it has requested less as the EU budget has underspent (see Chart B.1). The request increased from 3.0 months in 2017 to

3.7 months in 2018, so we have assumed that it will rise again to 4.35 months in 2019 (half-way back to 5) and return to the maximum in 2020.

B.15 Assuming less than the maximum draw-forward in 2019 (and that private sector receipts are received evenly throughout the year) means that €3.0 billion of net contributions to the EU that year are treated as normal Member State contributions and €8.1 billion as part of the financial settlement. Our 4.35 months draw-forward assumption equates to roughly 30 per cent of the net contribution being paid in the first quarter of 2019. If the Commission were to request the minimum possible three months' contributions in the first quarter, an extra €1.8 billion of payments would be treated as part of the settlement. If it requested the maximum five months' contributions, €0.9 billion less would be part of the settlement.

B.16 On our central forecast, this element of the financial settlement therefore amounts to €8.1 billion in 2019 and €10.4 billion in 2020, giving a total of €18.5 billion (£16.4 billion).

Chart B.1: Contributions requested in the first quarter of the calendar year



Source: HM Treasury, OBR

Outstanding commitments at the end of 2020

B.17 The current MFF will close at the end of December 2020, but payments associated with commitments made during this MFF will continue for some time after that. The joint report states that *"The UK will contribute its share of the financing of the budgetary commitments outstanding at 31 December 2020."* To estimate the size and timing of this element of the settlement, we first need to estimate the EU-wide stock of outstanding commitments at the end of 2020, then the pace at which they will be either paid or 'decommitted', and finally the proportion that will fall due to the UK.

Outstanding commitments

B.18 The largest component of the settlement, the *reste à liquider* (RAL), is the sum of outstanding commitments at the end of the MFF. These are commitments that have been agreed, but not yet paid. Until now we have not needed to produce an explicit forecast for the RAL, but we factored it in when making assumptions about the EU budget beyond 2020.

B.19 To estimate the RAL at the end of 2020, we have:

- **started with the estimate of €254.2 billion published by the European Commission** in its 2016 mid-term review of the current MFF;
- **added €14.3 billion to reflect the recent under-implementation of EU budgets**, as reported in the 2014-2016 EU annual accounts and the final amending budget of 2017 (AB6/2017), and differences between our latest forecast for EU budget implementation and the Commission's mid-term review 2016 forecast;
- **added €6.6 billion in respect of lower forecast decommitments and slightly higher commitments across 2014-20**, derived from recent Commission forecasts; and
- **assumed that 6.8 per cent of the RAL at end-2020 will be decommitted** (€18.7 billion) from 2021 onwards, based on RAL decommitments from the end of the previous MFF.[5]

B.20 These assumptions give an estimate of the RAL of €256.4 billion. We then need to make further assumptions to estimate how much of this cost will fall to the UK and when.

Table B.2: Post-2020 RAL after decommitments

	€ billion
2016 Commission estimate	**254.2**
Under-implementation adjustment	+14.3
Increases in commitments pre-2020	+0.5
Lower expected commitments	+6.1
Decommitment rate adjustment	-18.7
Post-2020 RAL	**256.4**

The UK's financing share

B.21 The joint report states that "*Except for the UK payments relating to UK participation to Union annual budgets to 2020… the UK share in relation with the Union budget will be a percentage calculated as the ratio between the own resources made available by the UK from the year 2014 to 2020 and the own resources made available by all Member States, including the UK, in the same period.*"

[5] Decommitments associated with the 2007-13 MFF are still ongoing, so this is partly an estimate rather than being entirely outturn.

B.22 To calculate a UK financing share consistent with the rest of our central forecast, we have:

- **for 2014 to 2016**: used outturn figures published in the European Commission's *Financial Report 2016*;
- **for 2017**: used estimates set out in the EU's AB6/2017 amending budget; and
- **for 2018 onwards**: used our own forecasts for UK and total Member State contributions, drawing on IMF and Commission estimates to forecast the latter.

B.23 On this basis, we estimate that the UK's financing share over the full MFF will be 12.4 per cent. This is marginally lower than the 12.7 per cent used by the Treasury in its estimate of the financial settlement. The difference relates to the period from 2018 onwards, where the Treasury estimate used the UK share of contributions in the Commission's 2018 draft budget. The Commission forecast assumes higher UK shares of EU GNI and EU uncapped VAT bases than we have for 2018 to 2020. If we were to use the Treasury's higher figure, but retain all other assumptions, our estimate of the financial settlement would be €0.8 billion higher.

Table B.3: UK financing share over the 2014-20 MFF

	€ billion, unless otherwise stated							
	Outturn[1]				Forecast			Total
	2014	2015	2016	2017	2018	2019	2020	
UK own resources	14.1	21.4	16.6	13.6	16.5	19.4	19.0	**120.7**
EU own resources	133.0	137.3	132.2	115.5	139.9	157.3	162.2	**977.4**
Financing share (per cent)	10.6	15.6	12.6	11.8	11.8	12.3	11.7	**12.4**

[1] 2014-2016 figures are taken from 2016 Commission financial report, 2017 contributions are taken from 'Amending Budget 6\2017'.

B.24 We have applied the UK financing share to our estimate of the RAL at end 2020, which results in a €31.7 billion gross payment from the UK. We also need to estimate the amount that the UK will receive as receipts, so we have assumed that the split of the RAL between budgetary headings will be in the same proportions as the previous MFF. We then assume that the UK's share of receipts from each heading will be the same percentage as that received over 2015 and 2016. This gives us an estimate of UK receipts of €11.5 billion, resulting in a net RAL payment of €20.2 billion (£18.2 billion).

B.25 The timing of payments related to the RAL is yet to be agreed. We have assumed that the RAL is paid out on a declining path over an 8-year period from 2021 to 2028, in line with past RAL payment profiles (as derived from EU annual accounts). We have also assumed that UK receipts will follow the same profile as UK payments towards the RAL.

Table B.4: Assumed net RAL payment profile in the financial settlement

	€ billion							
	2021	2022	2023	2024	2025	2026	2027	2028
Net reste à liquider (RAL)	**7.6**	**5.8**	**3.1**	**1.7**	**0.9**	**0.5**	**0.3**	**0.2**
of which:								
UK RAL contributions	11.9	9.2	4.9	2.7	1.4	0.8	0.4	0.4
UK RAL receipts	-4.3	-3.3	-1.8	-1.0	-0.5	-0.3	-0.2	-0.1

Other assets and liabilities, including contingent liabilities

B.26 The joint report states that "*The UK will contribute its share of the financing of the Union's liabilities incurred before 31 December 2020 except for liabilities with corresponding assets and any assets and liabilities which are related to the operation of the budget and the Own Resources Decision.*" We have estimated the size of these other liabilities by drawing on various sources – in particular the EU's latest published accounts.

Actual liabilities and corresponding assets

B.27 The UK's share of the EU's assets and liabilities, where not specified, has been calculated by applying the 12.4 per cent financing share set out above to relevant assets and liabilities recorded in previous annual accounts and recent valuations. The date at which some of these assets will be returned is uncertain, so for these we have assumed a common approach whereby they are redeemed at a uniform rate over 20 years, starting in 2021.

- **Pension liabilities**: we have based our estimate on a study by Eurostat of the profile of pension payments. This puts the liability at €76.7 billion extending up to 2064.[6] Applying the UK financing share to this means that pension liabilities add €9.5 billion to the total settlement cost. These liabilities will fall due over a very long period, so there is clearly uncertainty over how and when this or future Governments would decide to meet the estimated cost. There are also elements which we have not included in this figure, such as liabilities associated with the 'Joint Sickness and Insurance Scheme' (which is still a subject for the negotiations) and some smaller pension schemes. There are a number of differences between our estimate and the figure stated in the EU's annual accounts (€67.2 billion, of which €6.7 billion is JSIS, implying a UK share of €8.3 billion), for example because we have not applied any discount rate to this figure. In conjunction with the NAO, we expect to refine this estimate in our future work.

- **Fines and 'recoverables'**: these assets include fines levied by the Commission and corrections on EU funding (much of which relates to agricultural expenditure). They reduce the total cost of the settlement by €0.7 billion and €0.4 billion respectively. These figures are estimated by averaging total fines and recoverables across the 2014 to 2016 annual accounts.

[6] *Eurostat study on the long-term budgetary implications of pension costs*, Eurostat, July 2016.

- **European Investment Bank** (EIB): the UK's paid-in capital at the EIB totals just under €3.5 billion, which will be reimbursed in twelve annual instalments starting at the end of 2019. The first eleven instalments will be €300 million each, followed by a final balancing instalment of €195.9 million.

- **European Fund for Strategic Investments** (EFSI): this fund is managed by the EIB, on behalf of the EU, and provides a liquidity cushion against potential losses incurred by the EIB.[7] Based on planned provisioning over the current MFF, and assuming no further profit or loss, €1.0 billion will be returned to the UK.

- **Guarantee Fund for External Actions** (GFEA): this fund is intended to cover any defaulting loans guaranteed by the EU budget. The fund is maintained at 9 per cent of the guaranteed loans outstanding at year-end. Payments from the EU budget to top up the GFEA are made with a two-year lag. Based on the value of the fund at end-2016, €0.3 billion will be returned to the UK.

- **Financial instruments financed by the EU budget**: these include instruments created to enhance access to finance for research innovation and infrastructure projects. Based on the 2016 annual accounts estimate, €0.7 billion will be returned to the UK.

- **European Central Bank** (ECB): the UK's paid-in capital at the ECB will be reimbursed to the Bank of England after withdrawal. The precise payment modality will be established by the ECB's governing council and the Bank of England. Overall, around €55 million is expected to be returned to the UK. We have assumed that it is returned in a single payment in 2021.

- **2020 cash surplus**: the joint report states that *"the UK will also participate in the surplus exercise with respect to 2020."* As this will represent the return of some European Commission cash assets to the UK, we have included it alongside other assets and liabilities. We expect this figure to be around €0.2 billion. We have assumed that is repaid in a single payment in 2021, when we would have benefitted from it if the UK had remained a Member State.

B.28 Combining the UK's share of liabilities and assets gives a net liability of €2.7 billion (£2.5 billion). This estimate is subject to several sources of uncertainty. The cost to the UK will reflect the amounts actually paid out, rather than estimates in the accounts. The exact profile of payments – and any simplifications, such as agreeing to pay or receive lump sums rather than small recurring sums over many years – are yet to be agreed with the Commission.

[7] The terms on which this role is carried out are stipulated in '*Regulation (EU) 2015/1017 of the European Parliament and of the Council of 25 June 2015 on the European Fund for Strategic Investments, the European Investment Advisory Hub and the European Investment Project Portal and amending Regulations (EU) No 1291/2013 and (EU) No 1316/2013 — the European Fund for Strategic Investments*'.

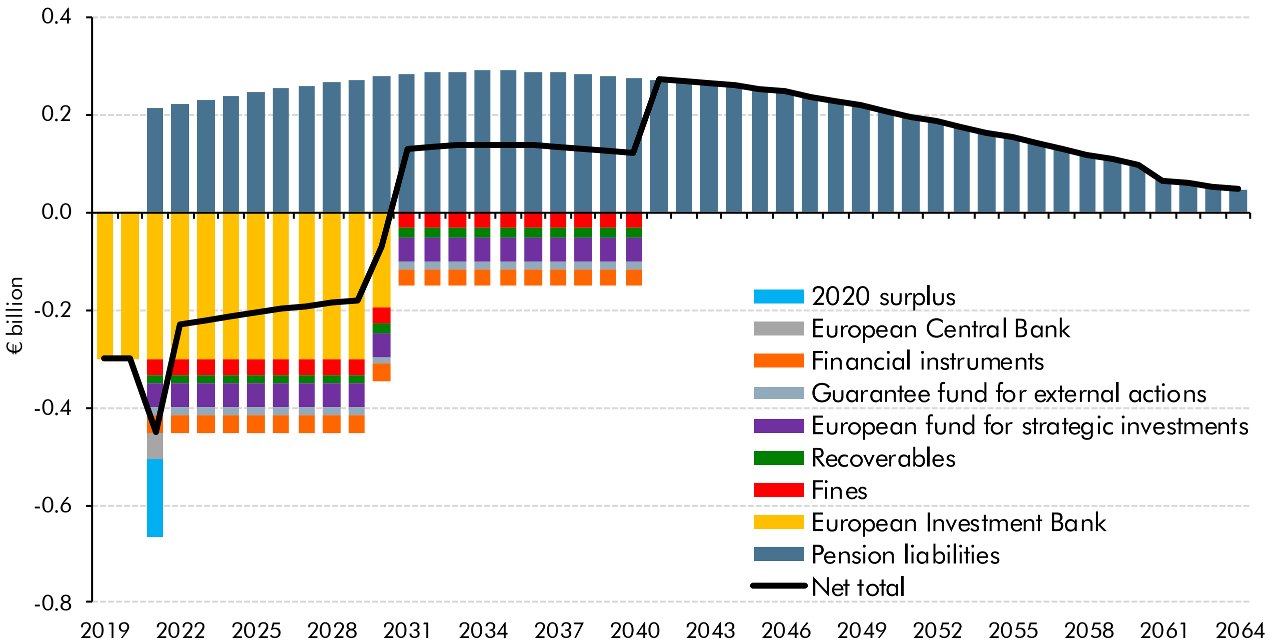
Table B.5: The UK's share of liabilities and corresponding assets

	Payment period	€ billion	
		Total[1]	UK share[1]
Pension liabilities	2021-2064	76.7	9.5
Fines	2021-2040	-5.3	-0.7
Recoverables	2021-2040	-3.1	-0.4
European Investment Bank (EIB)	2019-2030	-21.7	-3.5
European fund for strategic investments (EFSI)	2021-2040	-8.0	-1.0
Guarantee fund for external actions (GFEA)	2021-2040	-2.3	-0.3
Financial instruments	2021-2040	-5.9	-0.7
European Central Bank (ECB)	2021	-0.1	-0.1
2020 cash surplus	2021	-1.3	-0.2
Total	**2021-2064**	**29.0**	**2.7**

[1] Assets are presented as negative values.

B.29 Chart B.2 illustrates the long-term payment profile consistent with the asset and liability assumptions set out above. This moves from a net flow to the UK over the decade after Brexit to a net flow from the UK thereafter. It is worth noting that the overall net payment from the UK, even excluding the specific sums for paid-in capital at the EIB and ECB, is €6.3 billion – equivalent to around half a year's worth of contributions the UK makes as a Member State.

Chart B.2: Liabilities and assets payment profile



Source: HM Treasury, OBR

Contingent liabilities

B.30 The bulk of the EU's contingent liabilities relate to guarantees in respect of borrowing to finance financial assistance loans to Member States and third countries, as well as guarantees to the EIB and other financial institutions where they undertake investments on behalf of the EU. These would only be called upon in the case of borrower default. For those in respect of Member State loans, such costs would be met outside the MFF expenditure ceilings if necessary. For those in respect of third countries and EU programmes, pre-paid guarantee funds are in place to prevent the crystallisation of contingent liabilities from affecting EU spending plans.

B.31 The UK records most of these guarantees in the accounts of the Consolidated Fund, which would be called upon to make any payments to the EU above and beyond our normal contributions. They are recorded as remote contingent liabilities, reflecting the Treasury's judgement that the possibility of them being called is remote. This seems reasonable.

B.32 The EU's other contingent liabilities primarily relate to legal cases. Of these, most involve challenges against fines and budgetary corrections that have been levied on firms and Member States. Costs arising from these fines and corrections are met through the return of any fine provisionally paid, so do not generate an additional cost to Member States.

B.33 We have assumed that all contingent liabilities have been appropriately categorised as having a less than 50/50 chance of being called. Given that there are relatively few contingent liabilities of significant size, we have not included any costs associated with them in our central estimate of the financial settlement.

Other components of the settlement

B.34 Other items referred to in the joint report include the facility for refugees in Turkey, the European Union Trust fund and the European Development Fund (EDF). The UK will continue to honour its commitments to these programmes, maintaining existing modalities for payments. For the EDF, the UK has committed to remain part of it until the eleventh EDF closes in 2020 and will honour its share of total commitments made under the current and previous EDFs. The EDF is financed by direct contributions from participating countries and is not included in the MFF – i.e. it is not paid for via contributions to the overall EU budget. Future contributions to the EDF are therefore not included in the total size of the settlement. We estimate there is €2.2 billion of contributions to be made after 2020.

The total cost of the financial settlement

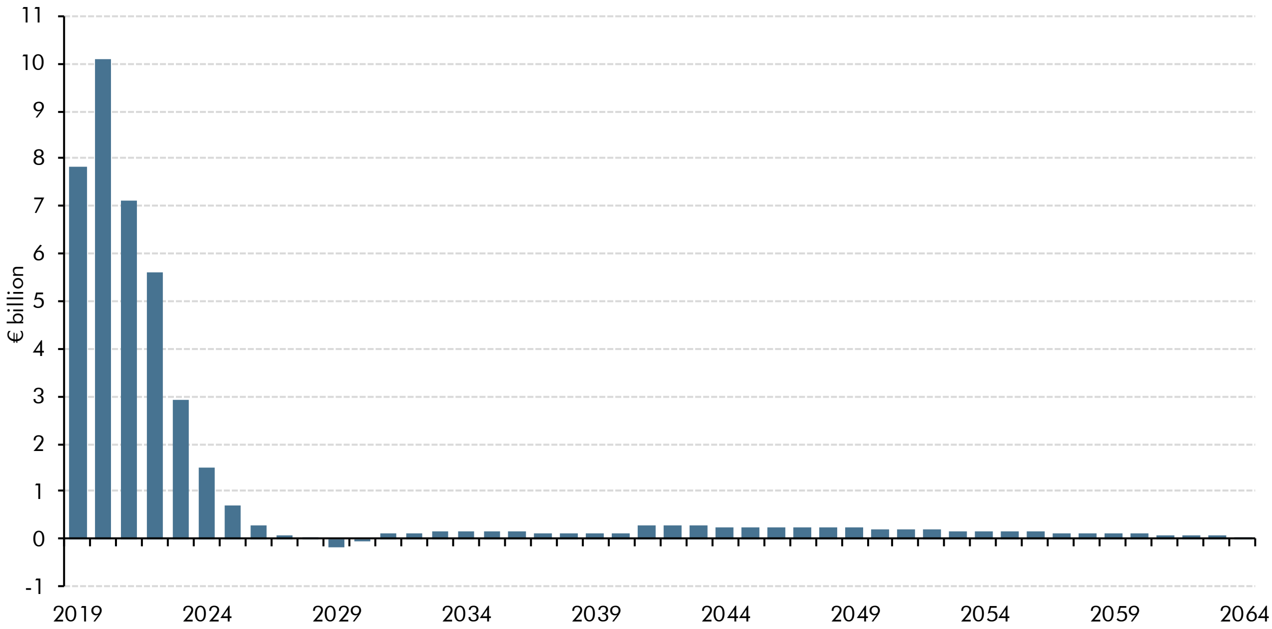
B.35 Based on the assumptions set out above, we estimate the total size of the financial settlement to be €41.4 billion, with just under half due to continuing in the current MFF, around half due to RAL payments and only a fraction due to other liabilities. The total cost is within the range presented by the Treasury following the joint report's publication. We have used our forecast for the sterling-euro exchange rate to convert these payments into pounds for use in our central forecast. This gives a total cost of £37.1 billion.

Table B.6: Settlement components and time periods

	Payment period	Amount	
		€ billion	£ billion
Total	**2019-2064**	**41.4**	**37.1**
of which:			
UK participation in EU annual budgets to 2020	2019-2020	18.5	16.4
Reste à liquider	2021-2028	20.2	18.2
Other net liabilities	2019-2064	2.7	2.5

B.36 We forecast, as shown in Chart B.3, the majority – around 75 per cent – will be incurred by 2022, as we conclude our participation in the MFF and pay the majority of the RAL. The path of payments after the final RAL-related payments averages around €150 million a year, with a small number of years seeing receipts from returning assets exceed payments linked to pensions. This would be equivalent to 0.004 per cent of GDP a year.

Chart B.3: Annual path of financial settlement payments



Source: OBR

B.37 Our estimate of the settlement is almost exactly in the middle of the £35 to 39 billion range presented by the Treasury in December. We have noted throughout this Annex where we have deviated from the Treasury's estimate and how that has changed our figure. We reduced our estimate relative to the Treasury's through: a lower financing share; a stronger pound-euro exchange rate; the incorporation of the 2018 adopted budget; and our profile of EU expenditure from 2019 onwards. While we have increased our estimate relative to the Treasury's through: our lower Commission draw-forward in 2019; and using our own forecast for the future pound-euro exchange rate rather than employing a spot rate.

Uncertainties and future developments

B.38 There are numerous uncertainties around each component of our estimate of the settlement. These are for the most part economic factors, which influence most elements of the settlement, and timings, which for the most part are yet to be agreed upon. Specifically:

- our forecast for the **pound-euro exchange rate**, given that the financial settlement will be paid in euros;
- our forecasts for **UK and EU growth rates**, as this affects our estimate for the UK financing share;
- the assumptions underlying the size of the **RAL**, such as planned MFF programme decommitments and the composition of the UK's share, both in terms of receipts and contributions; and
- the assumptions for the overall **timing of these payments**, as this will affect the size of the overall settlement if the exchange rate changes.

B.39 We have also assumed that any transition period that is agreed upon will not run beyond the end of 2020. If the transition does extend beyond that point, the UK may be required to continue contributions to the EU.

B.40 Finally, there are several practical aspects that will need to be resolved. For example:

- the modalities for **implementing this methodology** and any potential simplification of the payment schedule for some items and for any revenue adjustment exercises, such as making lump-sum payments in lieu of a stream of a continuing flow;
- the **administration of any UK participation** in EU programmes; and
- the potential **future relationship** between the UK and organisations such as the EIB.

Impact of the settlement on the public finances

B.41 The joint report states that "*payments arising from the financial settlement will become due as if the UK had remained a Member State. In particular, the UK will not be required to incur expenditures earlier than would be the case had it remained a Member State unless agreed by both sides*". In the absence of any such agreement, we assume that cash payments continue to take place as if the UK were a member and also that the ONS continues to accrue these payments in the public finance statistics as now.

B.42 As noted in the introduction to this annex, we have adopted a fiscally neutral post-Brexit approach, namely assuming that any reductions in the UK's net expenditure transfers to the EU will be fully recycled into extra spending. Hitherto, we have labelled this 'assumed domestic spending in lieu of EU transfers', while noting that in practice some of it might be used to make ongoing contributions to the EU or to pay a 'divorce bill'. For this forecast, we have subtracted the financial settlement estimates in this annex from the total 'in lieu of' amounts in our forecast to derive a new line: 'assumed spending in lieu of EU transfers'.

B.43 Until 2020, the UK will continue to pay to, and receive money from, the EU as if it were a member, so all the post-Brexit amounts will go to the EU, leaving zeros in the 'assumed spending' line. From 2021 onwards, the cost of the financial settlement falls progressively and increasing amounts are shown in the 'assumed spending' line.

B.44 Ending the analysis here would give a misleading picture of the cash freed up by ceasing full contributions to the EU. This is because the Government has made several commitments – some firm, some less so – to continue support for specific activities at the levels that would have been received from the EU, to recycle the savings into similar activities, or to continue to make payments to retain access to specific schemes. And, as noted at the start of this annex, the largest effects of Brexit on the public finances are likely to be indirect ones via the wider economic impact rather than this direct effect.

B.45 We asked the Treasury to confirm Government policy in respect of EU contributions and/or post-Brexit spending priorities that would have a bearing on this element of our public spending forecast. In response, the Treasury highlighted several post-Brexit spending priorities that we list below. But it also stated that decisions about any post-Brexit spending, including the priorities highlighted, will only be made at the next Spending Review in 2019. So we have not included them in our forecast or attempted to estimate how costly they would be, instead merely noting the sums that have been spent in the recent past. Since the Treasury's response, the Prime Minister has also made some further statements in her Mansion House speech that we have also listed here on the same basis:

- **Farm support**: the Treasury's response stated that "*The Government has confirmed that the UK will maintain the same cash total in funds for farm support until the end of the parliament. This commitment will reflect the average annual funding for farm support under both Pillar 1 and Pillar 2 of the EU's 2014-20 MFF.*" European Commission figures suggest that this farm support was around £3 billion in 2016.

- **Shared prosperity fund (SPF)**: the Treasury's response pointed us to the recent *Industrial strategy white paper*, which set out that "*following the UK's departure from the European Union, we will launch the UK Shared Prosperity Fund. We intend to consult next year on the precise design and priorities for the fund.*"[8] The 2017 Conservative manifesto stated that "*we will use the structural funds that come back to the UK following Brexit to create a UK shared prosperity fund*". On the definition of structural funds used in the Treasury's *European Union finances 2016* document, the 2016 figure was around £1 billion.

[8] *Industrial strategy: building a Britain fit for the future*, Department for Business, Energy and Industrial Strategy, 27 November 2017.

- **Replacement of Official Development Assistance (ODA) funds**: the Treasury noted that the Government has legislated to maintain ODA spending of at least 0.7 per cent of gross national income (GNI).[9] At present, some EU ODA (broadly the proportion funded by UK contributions) counts towards meeting this commitment. As we reported in our November 2017 *EFO*, attributing some EU ODA spending to the UK accounted for around £1 billion of the UK's total ODA spending in 2016.

- **Science and education**: the Prime Minister stated in her Mansion House speech that *"The UK is also committed to establishing a far-reaching science and innovation pact with the EU, facilitating the exchange of ideas and researchers. This would enable the UK to participate in key programmes alongside our EU partners. And we want to take a similar approach to educational and cultural programmes, to promote our shared values and enhance our intellectual strength in the world - again making an ongoing contribution to cover our fair share of the costs involved."* It is unclear what precisely this would apply to, but if it were taken to relate to programmes like Erasmus, Creative Europe and Horizon 2020, the cost of participation in 2016 was around £2 billion.

- **Regulatory agencies**: the Prime Minister also noted in her Mansion House speech that *"We will also want to explore with the EU, the terms on which the UK could remain part of EU agencies such as those that are critical for the chemicals, medicines and aerospace industries: the European Medicines Agency, the European Chemicals Agency, and the European Aviation Safety Agency. We would, of course, accept that this would mean abiding by the rules of those agencies and making an appropriate financial contribution."* Again, it is unclear as to the precise list of agencies that the UK will seek to remain part of (there are over 30 EU regulatory agencies). The EU decentralised agencies budget in 2016 was around €350 million, implying a UK financing share of around €40 million for the full list.

B.46 Among the uncertainties if and when spending in any of these areas is adopted in the Spending Review is the implications of the RAL and as to how much these commitments would, at least in the first years of the RAL, be covered by the UK's receipts (see Table B.4). The RAL is primarily composed of structural funds, but could potentially cover aspects of science and education and ODA.

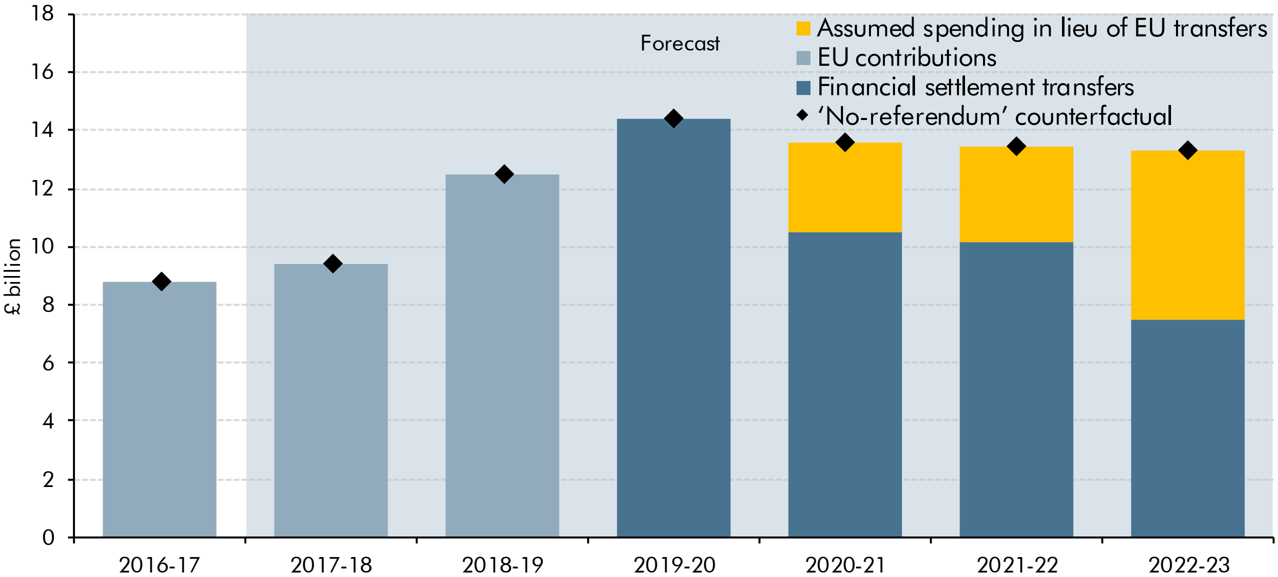
B.47 Table B.7 and Chart B.4 show the transfers associated with the financial settlement that affect the National Accounts definitions of expenditure and public sector net borrowing against our no-referendum counterfactual and our fiscally neutral assumption that any difference is recycled as other spending. Before factoring in any spending commitments of the type discussed above, the Government would have £3.0 billion to allocate to those or other purposes in 2020-21, rising to £5.8 billion in 2022-23 at the end of the forecast period. This amount would increase further as the rest of the RAL is paid off.

[9] *The International Development (Official Development Assistance Target) Act 2015*, 26 March 2015.

Table B.7: Expenditure transfer to EU institutions and other assumed spending

	£ billion						
	Outturn	Forecast					
	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
'No-referendum' counterfactual	8.8	9.4	12.5	14.4	13.6	13.4	13.3
Financial settlement transfers	-	-	-	14.4	10.5	10.1	7.5
Assumed spending in lieu of EU transfers	-	-	-	-	3.0	3.3	5.8

Chart B.4: EU transfers, financial settlement and other assumed spending



Source: ONS, OBR

B.48 It is important not to view these figures in isolation. While this is one of the more direct ways in which leaving the EU impacts upon the public finances, it is unlikely to be the largest one. In our November 2016 *EFO*, we made several changes to our forecast as a result of the referendum result: in particular, we assumed lower migration, lower productivity growth and a cyclical slowdown, alongside higher inflation due to the fall in the pound and lower interest rates as the Bank of England eased monetary policy. The net effect was to increase our forecast for borrowing by around £15 billion a year by the end of our forecast.

B.49 In our November 2017 *EFO*, we set out how the UK's financial relationship with the EU affected our forecast and the judgements underpinning it. We highlighted the many uncertainties surrounding our Brexit-related fiscal assumptions, of which several go beyond the financial settlement, such as continuing contributions and substitute spending that are touched upon in this annex, but also areas such as the wider costs of implementing Brexit, including departmental funding and staff resources, and uncertainties around the UK's custom duties regime.

B.50 The impact of Brexit on the public finances is complex and uncertain and ultimately will depend on both the outcome of the current negotiations and how it affects our future relationship with the rest of the world. Moreover, even with hindsight, it is likely to be difficult to quantify the impact of Brexit on both the economy and the public finances with any degree of confidence, since that requires a presumption as to what would have happened in the absence of a vote to leave the EU.