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Post-Brexit EU budget – the next hot button issue

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2018-2019 will be crucial for the future of EU finances. In May, the European Commission will present a proposal on how to "modernise" the Union's Multiannual Financial Framework, including a broad range of reform proposals both on the spending and revenue side. As last week's EU27 summit already indicated, heated debates can be expected throughout this period as the Commission aims for the post-Brexit financial perspective to be adopted by the Council and Parliament already in spring 2019. However, if previous budget negotiations are of any guidance – the EUR 1 trillion 2014-2020 MFF took almost two years to be completed – it would be no surprise, if "last minute" agreement could only be found by end-2020, when Germany holds the EU Presidency.

Compared to previous MFF negotiations, this time the challenges ahead are disproportionally larger, including a large annual budget gap of above EUR 10 bn to be left by the UK's exit from the Union. The need for additional spending on migration, security and defence, proposals for new EU/Eurozone budgetary lines as well as considerations to link budget receipts to compliance with the Union's judicial standards, fiscal rules and acceptance of refugees will contribute to tough negotiations.

Our scenario analysis illustrates that Western and Northern European members would see their net contributions deteriorate most in case of a substantial budget expansion in order to cover the UK shortfall as well as additional spending needs. Among them, many will therefore heavily resist considerations within the EC to increase the budget towards the 1.2% of GNI spending ceiling from currently 1%, notwithstanding signals from Germany's prospective government to spend "more" on Europe.

Eastern European members would be hurt most by the alternative of harsh spending cuts to close the Brexit gap in the budget, in particular if "richer" EU members continue to reject calls to carry the main burden of potential cuts to structural and investment funds.

To complicate matters further, the abolishment of the UK rebate and probably all "rebates on the rebate" will lead to a redistribution of costs among members, some of which already see themselves overproportionally affected by the economic impact of Brexit.

Profound discussions will therefore be necessary regarding the prioritization, efficiency, subsidiarity and cost sharing of future common finances as well as the question of truly "European added value" vs. narrow national interests.

EU budget hardball – get ready for tough post-Brexit MFF Negotiations

The EU's Multiannual Financial Framework (MFF) 1

- § Sets the limits for the EU's annual budget for a period of at least 5 years (currently 7)
- § Determines annual spending on commitments and payments
- § Needs to be balanced, i.e. cannot go into deficit
- § Transformed into a legally binding act through the Lisbon Treaty (2009)
- § MFF proposal by the European Commission, requires unanimous vote in the European Council and consent from the European Parliament (majority vote)

Sources: Deutsche Bank, European Commission, European Parliament

MFF 2014-2020 2

	EUR bn, current prices
Commitment appropriations	
Competitiveness for growth and jobs	142
Economic, social and territorial cohesion	371
Sustainable Growth: Natural Resources	420
Security and citizenship	18
Global Europe	66
Administration	70
Total commitment appropriations	1087
as % of GNI	1.03 %
Total payment appropriations	1026
as % of GNI	0.98 %
Own resources ceiling, % of GNI	1.22 %

Sources: Deutsche Bank, European Commission

2018-2019 will be a crucial period for the future of EU finances. In May, the European Commission will present a proposal on how to "modernise" the Union's post-Brexit Multiannual Financial Framework (MFF). The MFF, currently adopted every seven years, regulates how much can be spent on average each year in the EU budget's different spending categories and how expenditures will be funded. At around 1% of the EU28's Gross National Income (GNI), the EU's joint finances are small compared to the bloc's total public expenditures accounting for almost half of its GNI. Still, with payments of around EUR 147 bn and commitments of EUR 155 bn annually under the 2014-2020 MFF to be allocated between programs and member states, from a national perspective there is much at stake.

While the current framework is still running until 2020, heated debates can already be expected throughout the years as the Commission aims for the financial perspective to be adopted by the European Council and Parliament already in spring 2019. On February 20, the EU's ECOFIN Council of finance ministers addressed the upcoming MFF, followed by an informal meeting of EU27 heads of state in Brussels three days later dedicated to the same topic.

Following its reflection paper on the future of EU last June[1], the Commission came out in February with more detailed ideas and options for future allocation of funds as well as sources of revenues[2]. By early May at the latest, the Commission will present its proposals for the next multiannual framework, leaving member states just one year if they want to avoid budget negotiations to overlap with elections for the European Parliament set for May/June 2019 followed by the appointment of the next Commission.

But this time the challenges ahead are disproportionally larger, in particular regarding the question of what to do about the large gap left in the EU's budget when the UK leaves the union. Sticking to the Commission's timeline might therefore proof rather unrealistic, as also indicated in a note published by European Council President Donald Tusk ahead of last week's EU27 meeting.[3] It would be no surprise, if "last minute" agreement could only be found by the end of 2020. Germany, at this time set to hold the rotating Presidency will then find itself in the peculiar role of mediating compromise on the future budget – to which Germany itself contributes the most.

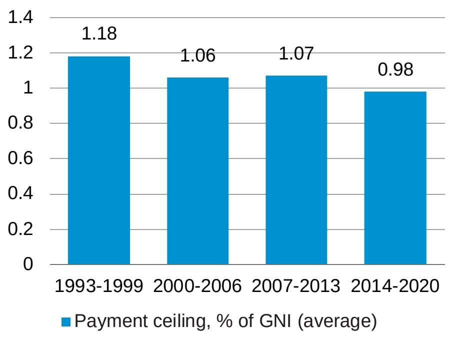
Compared to previous budget negotiations, this time around, the challenges ahead are disproportionally larger

— Brexit. The UK is set to leave the European Union next year in March after 47 years of membership. This will be followed by a transitional period foreseen until the end of 2020 during which the EU's second largest economy can be expected to fully comply with its financial obligations to the EU budget. But after that it will leave a sizable gap in the EU's budget estimated at above EUR 10 bn annually, based on the current MFF. This gap needs to be addressed either through additional funds to be stemmed by the 27 remaining members, budget cuts or a combination of the two, as proposed by the Commission.

1 See EC (June 2017): Reflection paper on the future of EU finances.
2 See EC (February 2018): EU long-term budget after 2020.
3 See European Council (February 2018): February MFF debate.

Post-Brexit EU budget – the next hot button issue

EU budget limits over time 3



Sources: Deutsche Bank, European Commission

— A dramatically changed geopolitical environment, calling for additional resources (of around EUR 10 bn annually according to EU Commissioner Oettinger) on migration, security and defence. This comes on top of strengthened investment needs identified to maintain the bloc's competitiveness and innovative potential, linked to its ability to deal with long-term developments such as technological change, globalization and climate change.

— Proposals for new EU/Eurozone budgetary lines. As part of a broader range of proposals on the EU's agenda to reform and further integrate the European Monetary Union, these include ideas to create additional budget lines for a propped up program for reform support, an investment protection function to deal with asymmetric shocks and/or a euro area convergence facility (see EU Monitor (December 8, 2017)). Many of these ideas will be highly controversial in the upcoming debates. Particularly Northern European member states are concerned regarding the risks of hidden transfers and moral hazard of such instruments while they doubt their positive contribution to fiscal and economic stability. Non-Eurozone members are concerned that funds will be shifted to the euro area needs.

— Calls for conditionality in the EU budget. Increasing tensions between the EU and some of its member countries, most prominently Poland and Hungary, about lacking compliance with the EU's judicial standards have also found their way into the budget debate. This is reflected in considerations within the Commission to make future access to EU funds conditional on compliance with rule or law (or reward compliance through an incentive system), supported e.g. by Germany, Sweden and the Netherlands. These countries also favour the idea of linking payments from the EU budget to the implementation of structural reforms and follow the EU's recommendations for economic policy. Angela Merkel's proposal last week to link budget payments to migration policy has been met by strong opposition among EU's eastern members but also by criticism from Austria and Luxembourg. This illustrates how calls for conditionality could contribute to a poisoned and prolonged procedure while also bearing the risk of (further) fragmentation within the EU, particularly along a North-South, East-West divide.

Taken together, these aspects raise some fundamental questions regarding the future of the EU's budget

— It's size – should the post-Brexit budget framework be cut from the current roughly EUR 1 trillion from 2014-2020 (1% of EU28 GNI) to account for the shortfall of UK contributions, remain unchanged or be expanded e.g. to 1.2% of EU27 GNI – as recently raised by the Commission, or even 1.3% – as called for by the European Parliament and European Committee of the Regions?[4]

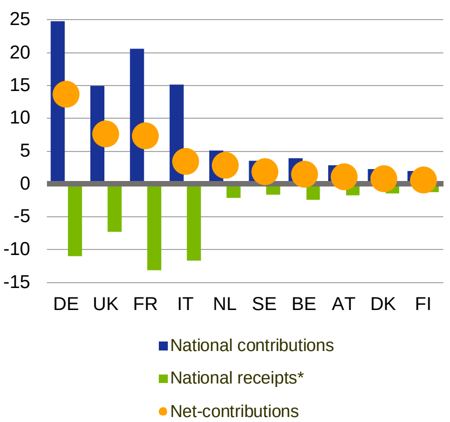
— How to spend it – should the budget continue to largely focus on agricultural and cohesion policy (73% in the current MFF) – often mainly seen as a reallocation of funds between member states that partly lacks the much summoned "European added value"? Or should budget priorities be newly set? This is closely linked to the question of subsidiarity – which policy fields are best addressed on the European or rather on the national level, as well as the question of efficiency, i.e. whether the budget requires more and/or rather better use of resources.

— How to fund it – should the budget continue to mainly rely on national GNI/VAT based resources (accounting for around 80% of total revenues) or

[4] See European Parliament (2018), and European Committee of the Regions (2018).

Net contributors to the 2014-2020 EU budget 4

EUR bn, annual av. (est.)



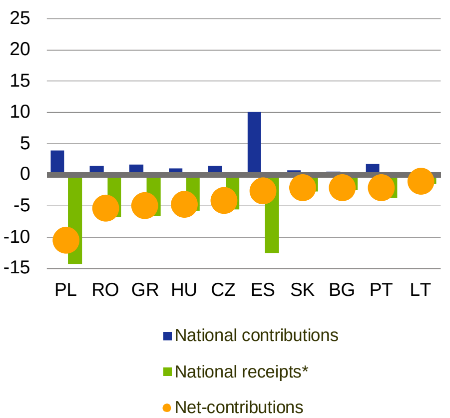
* excluding expenditures for administration

Note: Budget receipts/contributions are extrapolated to the 2014-2020 MFF, based on 2014-2016 budget numbers

Sources: Deutsche Bank, European Commission

Largest net recipients from 2014-2020 EU budget 5

EUR bn, annual av. (est.)



* excluding expenditures for administration

Note: Budget receipts/contributions are extrapolated to the 2014-2020 MFF, based on 2014-2016 budget numbers

Sources: Deutsche Bank, European Commission

should the EU be endowed with additional real own resources (e.g. stemming from a tax related to a common corporate tax base, seignorage or income from emission trading)? This idea is not popular among all EU members as some fear reduced control over their contribution to the EU budget and/or loss of own revenues.

— Its duration – should the duration of the framework be reduced to 5 from currently 7 years to align it with the term of the EP and the EC and increase its flexibility to react to unexpected events, be kept unchanged, or even be extended to 10 years (5+5 with a mid-term review) to increase stability of financial planning?

— Who will pay for it – for the upcoming debates maybe most important – how will contributions to and receipts from the EU budget be distributed among members in the post-2020 budgetary framework? How will the abolishment of the UK rebate and all "rebates on the rebate" affect EU27 countries' share in budget contributions? How will cost cuts, merger of programs and reprioritisation change member states' (relative) net position in the EU's financial framework? Should cost cuts on existing programs be evenly distributed or mainly be borne by the bloc's most wealthy countries?

— Zero-sum game or added value for all – will the perception in European capitals on EU budget negotiations broadly remain one of a "zero-sum game" – where one member's gain is another one's loss? Or will the Commission succeed in promoting its priorities of a "modernized" EU budget that focuses on maximizing "European added value" that goes beyond each member's net contribution?

Estimating the post-Brexit gap in EU finances

The exit of the United Kingdom from the European Union will leave a sizeable revenue gap of up to EUR 10 to 11 bn per year in the EU's post-2020 budget that needs to be filled either through spending cuts, additional contributions from the remaining 27 member states and/or new own resources.

The 2014-2020 Multiannual Framework foresees total payment appropriations of EUR 1026 over seven years or EUR 147 bn annually. Around 80% of the budget is financed through national contributions – mainly based on each member state's GNI as well as on VAT. Around 14% are EU "real own resources", the bulk of which stems from the bloc's customs duties, while the remainder are other revenues such as corporate fines and EU staff salary taxes[5].

The UK is expected to fully meet its obligations within the current 2014-2020 MFF, including a post-Brexit transitory period foreseen between March 2019 and end-2020. After that, there are pending long-term commitments still to be settled as part of the "divorce bill" and the UK might even continue to pay into the EU budget under a new agreement (e.g. as a non-EU EEA-member like Norway or through a bilateral agreement such as between the EU and Switzerland).

However, these payment can be expected to be much smaller than the UK's current contribution to the EU's budget of around EUR 15 bn annually.

This makes the UK the EU's second largest net contributor at around EUR 7.5 bn per year (national contributions minus total expenditures) after Germany at around EUR 14 bn. If one adds to this bill the EU's own resources (mainly

[5] Estimated based on 2014-2016 budget figures.

customs duties) channelled through the UK, the potential budget gap to be addressed post-Brexit sums up to between EUR 10 and 11 bn per year[6].

The UK rebate and "rebates on the rebate" explained 6

- § The "correction mechanism" in the EU budget aims at correcting contributions by some EU members that these consider excessive
- § UK rebate: a reimbursement of 66% of the UK's net-contribution to the EU budget
- § Cost of UK rebate is divided among other EU members based on their share in EU GNI; Germany, the Netherlands, Austria and Sweden only pay 25% of their normal share
- § One-off gross reductions in the 2014-2020 MFF on GNI contributions for Denmark, the Netherlands, Sweden and Austria; one-off reduced VAT call rates for Germany, the Netherlands and Sweden
- § With the post-Brexit reform of the EU budget, the Commission aims at abolishing all corrections in the EU's revenues

Sources: Deutsche Bank, European Commission

Abolishment of the UK rebate

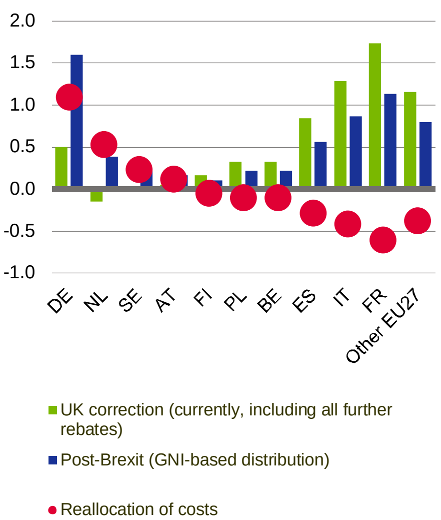
But the shortfall of the UK's contribution will not only leave a substantial gap in EU revenues – it could also have a significant distributional effect regarding the cost sharing among the remaining EU27 members.

With the UK leaving, the payment share of all remaining members in the EU budget will go up automatically. At the same time, the UK correction – a 66% reduction on its net contributions to the EU budget currently amounting to around EUR 6 bn annually will fall away. This discount for the UK is currently financed through additional payments by the remaining EU countries based on their GNI-share. But due to the complex framework of historically developed further payment corrections or “rebates on the rebate” in the current framework, member countries will be affected differently.

Under the current framework, Germany, the Netherlands, Sweden and Austria – considering their share in the EU budget payments already as too high – only pay 25% of their normal share of the UK rebate. Additionally, there are one-off GNI/VAT-based payment reductions for Denmark, Sweden, the Netherlands, Austria and Germany within the 2014-2020 MFF. If the Commission gets its will, all these "rebates on the rebate" will be scrapped in the next budget framework. Accordingly, countries which currently benefit from a reduction will have to carry a higher share of the financial burden post-2020.

Abolishment of UK rebate - cost allocation 7

EUR bn, annual av. (est.)



Note: Based on 2014-2016 budget numbers, extrapolated to 2014-2020 MFF, including all rebates and one-off reduction

Sources: Deutsche Bank, European Commission

Through the abolishment of the UK rebate and "the rebates on the rebate" alone (without considering any extra payments to close the budget gap left behind by the UK), the contributions of Germany, the Netherlands, Sweden and Austria to the EU budget could together increase by around EUR 2 bn annually. Germany, which currently draws the largest reduction (in absolute terms), would bear more than half of this adjustment, seeing its contribution to the budget go up by EUR 1 bn. On the other side, for EU27 members without any rebates on the rebate, contributions would be reduced accordingly. This redistribution would mainly go to France, Italy, Spain, Belgium, Poland and Finland, which together could see their payments cut by EUR 1.6 bn annually. While the percentage share in post-Brexit budget contributions will go up for all members, the abolishment of the corrections and rebates will change the relative shares. For Germany its share in national contribution would go up from currently 21% to almost 25% while for France it would rise from 17% to 19% and for Italy from 13% to only 14%.

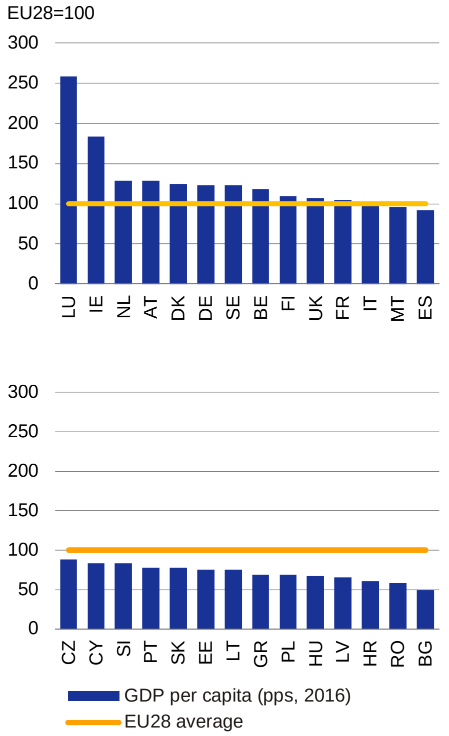
What to do about the gap

How to address the post-Brexit budget shortfall will be on top of the agenda in upcoming EU budget negotiations. It will be closely linked to the discussion about distribution of costs and receipts within the budget, both between member states and policies. Without further adjustments, compensating for the UK shortfall based on the 2014-2020 MFF would lift the ratio of total own resources – national contributions and EU own resources – to 1.1% of GNI from previously below 1.0%. This increase is explained by the fact that the UK's contribution to EU28's GNI (16% in 2014-16) is much larger than its 7% net contribution to the EU28 budget. While the binding upper limit for the EU budget (total own resources) is set at 1.2% of GNI, net contributors have been eager to keep it at

[6] This is a simplification as not all EU own resources gathered through the UK can be expected to fall away after Brexit. Additional tariffs between EU27 and the UK are likely to increase custom duties of other members, the net impact accordingly is rather unclear.

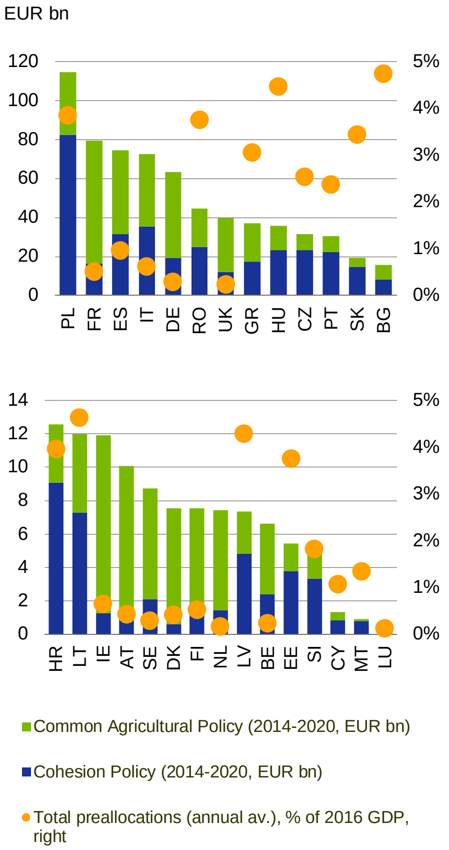
Post-Brexit EU budget – the next hot button issue

Still strong divergence in EU member's GDP per capita 8



Sources: Deutsche Bank, Eurostat

Spending preallocations 2014-2020 9



Sources: Deutsche Bank, European Commission, Eurostat

1% over the previous multiannual frameworks. Any post-Brexit increase towards that ceiling, as recently also raised by the Commission, would therefore certainly be subject to heated debates and calls for more efficient spending.

The EU's Commissioner responsible for the budget, Günther Oettinger, recently made a proposal on how to deal with the revenue hole left by the UK's departure in the EU budget. According to him, 50% of the Brexit gap (which he estimates at up to EUR 13 bn) could be closed by cutting on all existing programmes – while making exemptions for budget headings that are considered essential for Europe's future such as the Horizon 2020 research and Erasmus/educational programmes. The other 50% would be covered with "fresh money"[7]. Additionally, Oettinger identifies spending needs of EUR 10 bn stemming from new or propped up tasks such as border control, migration, internal and external security and defence. According to him these could be finances by 80% through new resources and 20% through cuts on existing items. His proposals would sum up to around EUR 15 bn of financing needs to be covered either through additional national contributions or new EU own resources. He suggested to raise the budget to 1.1x% of GNI in order to address the spending gap, with the x still to be decided in upcoming negotiations.

However, some members with sizeable net contributions already expressed their opposition to an increase in the budget: the Netherlands, Denmark, Sweden and Austria, which is going to hold the EU Presidency in the second half of 2018. The Austrian Minister for European Affairs, Gernot Blümel, recently argued that it “cannot be that in a smaller European Union it means that you have to pay a lot more” (Politico, 10.01.2018). The Dutch Finance Minister, Wopke Hoekstra, claimed that countries such as Ireland, the Netherlands, Denmark and Spain would already have to cope with economic pain from Brexit and should therefore not have to "pay the bill" (Bloomberg, 16.01.2018).

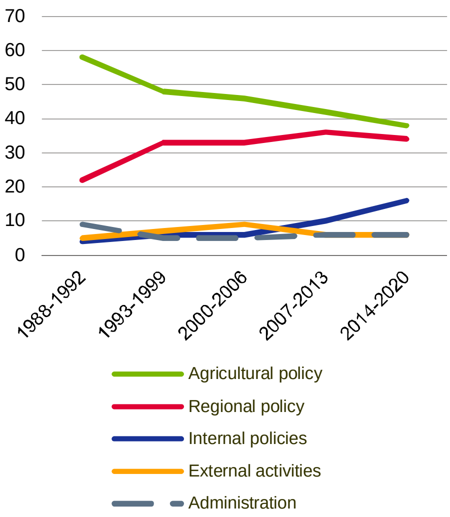
But critics of expansionary budget plans also receive backup from within European institutions. At a Brussels EIB conference titled "Doing more with less", Klaus-Heiner Lehne, the president of the European Court of Auditors together with EIB Vice-President Alexander Stubb called for making the budget more flexible and cut on programs with the lowest impact (Politico, 01.02.2018).

Others have presented themselves more open to larger contributions. The German coalition agreement struck in early February between CDU/CSU and SPD after a four months deadlock following the September elections emphasizes the parties' willingness to spent more money on Europe (see Germany Monitor, 8 February 2018). The agreement leaves open whether this commitment goes beyond the looming Brexit gap but coming from the EU's largest economy and contributor to the budget still gives some assurance that no substantial cuts to the EU budget should be expected. At the same time, the prospective government committed itself to maintain current spending under the agricultural and structural policy, reflecting the interest of the German state Bavaria and eastern German states. This is a clear signal against cutting the Common Agricultural Policy (CAP) and against limiting the eligibility to cohesion policy to the EU's "cohesion countries" (e.g. the blocs poorest members), as for example considered in the communication on the EU budget published by the Commission in mid-February. At a meeting with EU Commissioner Oettinger eight Eastern European members (Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Slovenia and Slovakia) gave their support to an increase of the EU budget to 1.1% of GNI from currently 1%. This is not a real surprise, though, given that all of them rank among the budget's net recipients. While an increase in budget contributions based on members' GNI share would lower their net receipts, cuts to the budget would most likely affect them more.

[7] See European Commission (2018): A Budget Matching our Ambitions.

The evolution of EU budget spending 10

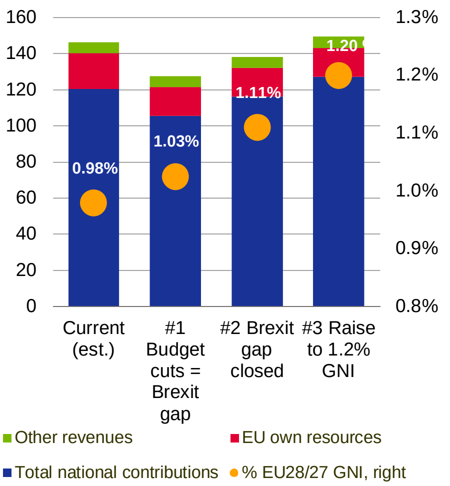
Budget expenditures, % of total



Sources: Deutsche Bank, European Parliament (2017): "The next Multiannual Financial Framework (MFF) and its Duration"

Post-Brexit budget scenarios 11

Annual revenues, EUR bn (est.)



Note: Estimates based on 2014-2020 MFF in current prices, revenue breakdown derived from 2014-2016 budget; total national contributions VAT/GNI-based, rebates only included in current budget; EU28 GNI for the current budget, EU27 GNI for the post-Brexit budget; all increases in revenues through national contributions/GNI-based resources.

Sources: Deutsche Bank, estimates based on European Commission data

How to spend it

As in previous budget frameworks, the bulk of the EUR 1026 bn 2014-2020 MFF is dedicated to spending for agriculture and regional policy (73%). Accordingly, if cuts to existing budget items are necessary, sizeable adjustments should be expected in these areas as well. However, Commission President Juncker already excluded "drastic" cuts in both spending categories, being aware of the high sensitivity of the issue among member states. After all, the next MFF needs to be agreed unanimously by all EU27 members. While describing cuts to agricultural and cohesion spending as necessary, Commissioner Oettinger expects them to be rather moderate between 5 and 10%. Still, one can expect that the distribution of cost cuts will trigger hot debates.

The EU budget always had a strong "status quo bias" and proved itself resilient to past reform attempts. In particular efforts to reduce spending for the Common Agricultural Policy have met strong resistance over the last decades. The share of subsidies to farmers and agricultural development programs has gradually given way to regional policy spending, in particular with the accession of 12 new member countries in the early 2000s, which required substantial spending in order to address increased regional economic and social discrepancies.

But agricultural policy still remains the largest spending area, accounting for 39% of total commitments under the 2014-2020 framework, followed by regional policy with at around 34%.

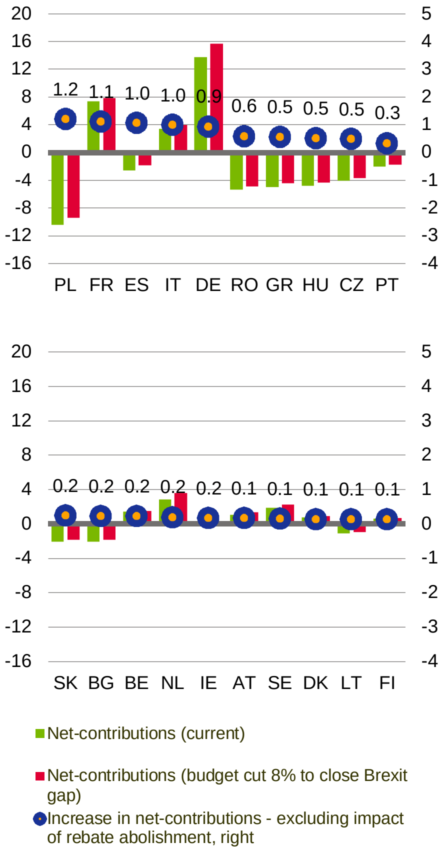
EU member states' benefits from the different budget headings can diverge quite substantially. Accordingly, they will also be asymmetrically affected by looming budget cuts. Poland is by far the largest recipient of preallocated funds under 2014-2020 MFF, with around EUR 115 bn (or 15% of EUR 767 bn total preallocations).

It mainly draws funds through the different facilities for regional policy, with EUR 82 bn (22% of total) but also is the fifth largest destination for agricultural funds (EUR 32 bn). After Poland, absolute spending from structural and investment funds is highest in the EU's largest Western European countries – France, Spain, Italy and Germany. However, the importance of EU funding relative to the size of members' economies is substantially higher in Central-Eastern Europe. As a share of 2016 GDP, annual EU preallocated gross funds are highest in Bulgaria (4.7%), Lithuania (4.6%) and Hungary (4.5%), while in Western Europe they go as low as 0.1% in Luxembourg and 0.2% in the UK, Belgium and the Netherlands.

France has traditionally been the strongest recipient under the headings of agricultural policy, with EUR 63 bn (or 16% of all agricultural spending) preallocated in the 2014-2020 financial framework. It is therefore also quite remarkable that French President Macron over the last months repeatedly presented himself open to reforms of the common agricultural policy (CAP) that could confront him with strong headwinds domestically.

Scenario 1 - EU budget cut to close Brexit gap 12

EUR bn p.a. (est.)



Note: budget cuts assumed to be symmetrically applied to EU27 members (but might be shifted between spending areas); administration costs excluded from expenditures; abolishment of all member rebates/corrections in post-Brexit scenario.

Sources: Deutsche Bank, estimates based on European Commission data

The EU budget has repeatedly been criticized for largely serving "redistribution purposes" of the EU member states[8] rather than really focusing on maximizing added value on the European level. Additionally, the effectiveness and efficiency of EU spending through agricultural and regional policy, which consume a lion's share of the common funds, often has been questioned, also with a view to the principle of subsidiarity, prudent allocation of resources from a centralized budget, spending errors, as well as cases of fraud and corruption related to EU-funded projects, investigated by the EU's anti-fraud watchdog OLAF[9].

The Commission's aim to "modernize" the budget and reset the focus in joint spending on tasks where "European added value" can be maximized, such as in border management and European defence is understandable. However, hopes in Brussels to use the Brexit dynamics to overhaul EU finances and spending priorities might rather be disappointed. Risks appear high that also this time, distributional forces will dominate budget negotiations, as has been illustrated by rather "protectionist" statements from member states regarding their stakes in regional and agricultural policies.

Post-Brexit budget scenarios

As with previous budget negotiations, the struggle between EU members about distribution and payments of common funds will broadly be along the net recipient/net contributor divide. This time, however, negotiations will be overshadowed by the hole to EU finances left by the UK. The following three scenarios try to give some rough guidance on the scope of adjustments and how EU members would be affected.

Scenario 1: no extra funding for UK budget shortfall, harsh spending cuts

In this scenario, resistance among net contributors against higher contributions (on top of the rebate reshuffling) would lead to harsh cuts of the EU budget amounting to the UK's net contribution (including customs duties and sugar levies) of around EUR 10 to 11 bn. Post-Brexit spending would have to be reduced by around 8% to EUR 129 bn. However, the size of the budget relative to EU27 GNI would still increase to slightly above 1% from below 1% in the current framework, given the UK's larger contribution to the bloc's GNI than budget. If it were decided to keep the GNI-ratio of the budget unchanged, spending would have to be cut even further by almost 12% to EUR 123 bn.

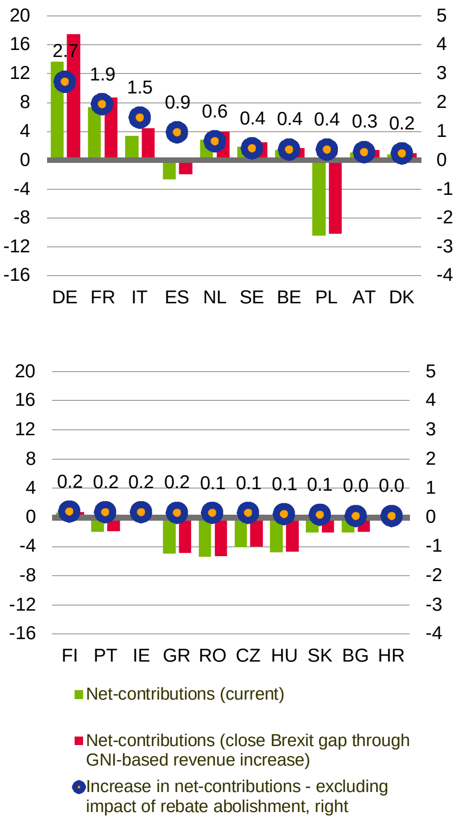
In both cases, sizeable savings regarding existing programs and budget headings would be necessary, despite the Commission's opposite call for higher spending e.g. on migration and security-related issues. As pointed out in recent paper prepared for the European parliament, a EUR 10 to 11 bn spending cut is more than the entire annual budget spend for example on the Horizon 2020 program or equal to 20% of the total regional policy spending.[10]

To what extent individual countries would be affected very much depends on the allocation of cuts between different spending categories as well as between wealthier and poorer member states. If net contributors remain unwilling to forgo their receipts from the programs one could assume that budget cuts would be equally applied to all budget headings and countries. In case of an 8% cut to the budget, this would translate into an 8% cut to all spending categories and all members states.

[8] See also European Parliament (2017): The next Multiannual Financial Framework (MFF) and its Duration.
[9] See also OLAF (2017) and European Court of Auditors (2017).
[10] Haas, J. and Rubio, E. (2017): Possible impact of Brexit on the EU budget and, in particular, CAP funding.

Scenario 2 - close Brexit gap through increased national contributions 13

EUR bn p.a. (est.)



Note: Net contributions estimated on the assumption that increased revenues to close Brexit gap raised through GNI-based resources only, i.e no additional EU own resources generated; assumes that any shift of funds between budget headings does not change the total amount of country level receipts; administration costs excluded from expenditures; abolishment of all member rebates/corrections in post-Brexit scenario.

Sources: Deutsche Bank, estimates based on European Commission data

However, the national impact can still differ substantially. For many net recipients from the EU budget, structural and investment funds account for a substantial share of public investment (e.g. around 70% in Portugal and around 50% in Poland from 2015-2017). For these countries, an 8% or EUR 4 bn cut on regional policy would be non-negligible. EUR 5 bn cuts on agricultural policy would – in absolute terms – mainly affect Western and Southern European countries (France, Spain, Germany, Italy, Greece and Ireland).

Relative to the size of their economies, also here the impact would be much larger in Eastern European members as well as Greece. Net contributions to the budget would go up most for France, Germany and Italy at around EUR 1 bn annually while Poland and Spain would lose around EUR 1 bn in net receipts. As a share of GNI, the impact would be strongest in Bulgaria and Hungary at 0.4%, compared to only a fraction in Germany (0.03%) and France (0.05%).

Scenario 2: full compensation of UK budget shortfall, no spending cuts

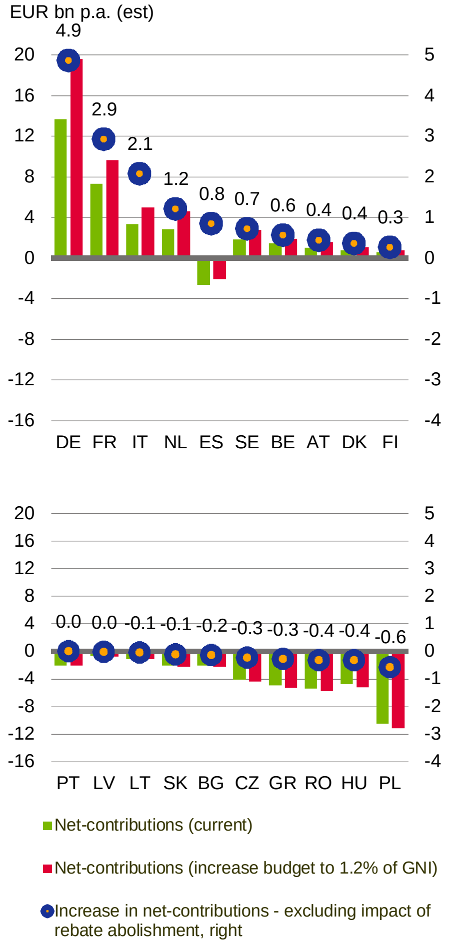
In a second scenario, member states can be convinced that EUR 10-11 bn additional spending needs to be provided in order to compensate for the budget gap left by Brexit, an increase of around 10% compared to their current contributions. If one assumes that no additional EU own resources can be activated, this spending would entirely come from the EU's GNI based own resources as the budget's residual resource. The total budget would still decrease – but only by the UK's current budget receipts of EUR 7.5 bn to EUR 139 bn. Thus former EU27 expenditures as well as the EU's joint expenses could be maintained. However, this would require to accept that in terms of GNI, the budget would increase to around 1.1% from currently below 1%.

As in the previous scenario, one might find it prudent not to open the Pandora's box of reallocating budget receipts between countries. For example, in order to account for the new spending needs identified by Commissioner Oettinger, one might decide to shift funds between and within budget headings while keeping the impact on members' total receipts neutral. In reality this might be rather difficult. Countries with higher GNI-based contributions and/or which already see their spending share increased due to abolishment of their rebates might call for limiting the impact rather on net contributions than gross receipts. In this scenario, the net contributions for Germany, France and Italy would go up by EUR 2.7 bn, EUR 1.9 bn and EUR 1.5 bn, respectively (excluding the post-Brexit impact of rebate(s) abolishment). Compared to the previous scenario, large net recipients among the new member states, in particular Poland (EUR 0.4 bn), would see a much smaller decline in their net receipts. This is because their net position is less sensitive to GNI-based increases of payments than cuts in expenditures.

Scenario 3: increase of budget to 1.2% of GNI to account for Brexit gap and additional spending needs

Maybe for testing the water, the Commission's already announced ahead of its May budget reform program that its proposals for reforming the EU budget might exhaust the current 1.2% of (EU27) GNI budget ceiling. Compared to the current budget of EUR 147 bn this would not appear to be a dramatic expansion to around EUR 150 bn. However, given that this increase needs to be financed without the UK this would translate into additional payments by the remaining members of around EUR 23 bn. It would be enough to cover the budget gap caused by Brexit as well as EUR 10 bn additional spending needs identified by the Commission. By increasing the budget, one might be able to avoid a deadlock in upcoming negotiations about shifting of funds between and within budget headings as outlined for scenario 2. But if – as in scenario 2 – additional

Scenario 3 - raise EU budget to 1.2% of GNI through national contributions 14



Note: Net contributions estimated on the assumption that increased revenues raised through GNI-based resources only, i.e no additional EU own resources generated; assumes that any additional spending and shift of funds between budget headings does not change the EU27 share of country level receipts; administration costs excluded from expenditures; abolishment of all member rebates/corrections in post-Brexit scenario.

Sources: Deutsche Bank. estimates based on European Commission data

spending would come from GNI-based resources, strong resistance from net contributors can be expected. Assuming again that spending shares between countries would not be altered, they would have to accept a substantial deterioration of their net balances. Again, Germany, France and Italy would have to bear the bulk of adjustments, with annual net contributions going up by almost EUR 5 bn, EUR 3 bn and EUR 2 bn, respectively. On the side of net recipients, for most members (with the main exception of Spain) the net position would improve compared to the current budget.

Risk of deadlocks – and no timely agreement – ahead

The three scenarios illustrate the national sensitivities related to budget adjustment in the next Multiannual Financial Framework, either through cuts on the spending or increases on the cost side. They are anything but exhaustive. The assumption of symmetric cost cuts or payment increases among members is certainly an oversimplification but might not be such an unrealistic outcome as countries on both the contributing and receiving end of the budget can be expected to defend their stakes fiercely. But other combinations of cost cuts and payment increases are equally possible as well. Revenues would not necessarily have to come from national contributions alone – the Commission has a strong interest in strengthening the EU's own resources in the budget. However, in many cases this might just result in a transfer of existing national resources to the EU level (e.g. in case of emission trading revenues or from a consolidated corporate tax base) and can therefore be expected to meet resistance among several members.

Given the budget constraints left by Brexit, conflicts between net contributors and net recipients are almost inevitable and the risk of prolonged deadlocks in upcoming negotiations is considerably high. Matters could become even more complex if considerations within the Commission to link budget payments to compliance with EU legal standards find their way onto the bargaining table. For all these reasons, the Commission's hope to finalise the budget before next year's elections for the European Parliament seems overly ambitious. We deem it more likely that "last minute" agreement can only be found close to the end of the current framework, i.e. in the second half of 2020 when Germany holds the rotating EU Presidency.

But there is a fourth scenario that has not been addressed so far – no timely agreement at all. As pointed out by a report prepared for European Parliament, the current MFF does not provide guidance on how to adjust the budget to the unanticipated event of a member leaving the union (it does address the issue of EU enlargement and Treaty changes though[11]). And any modifications to the current MFF need to be agreed on unanimously by all EU27 members in the European Council. So if members fail to find compromise, there is a non-negligible risk that no new framework will be in place when the current ones ends by December 2020. In that case, EU treaties foresee that the budget ceilings and provisions from the last year of the previous MFF (thus in our case 2020) would be extended until a new MFF is adopted. This would coincide with the end of the expected post-Brexit two-year transition period and accordingly to the shortfall in financial resources from the UK. And given that the EU budget cannot go into deficit, this could lead to increased uncertainty regarding the budget's commitment and payment appropriations. In order to avoid

[11] Haas, J. and Rubio, E. (2017): Possible impact of Brexit on the EU budget and, in particular, CAP funding.

unprecedented chaos in the EU's finances, both net recipients and contributors should have strong interest to avoid this scenario. This does not necessarily make it less likely to materialize, though.

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