The United Kingdom's Exit Charge from the European Union: Insights from Modes of Accounting

David Heald[*] and Iain Wright[†]

Abstract

Whatever the final charge on the United Kingdom for leaving the European Union, the money itself may seem relatively marginal to the United Kingdom's public finances. However, this exit charge is politically toxic and financially aggravating during one of the longest periods of fiscal austerity in the United Kingdom's history. The ways in which Brexit is conceptualized have political implications as legitimizing devices for obligations that must be managed within fiscal austerity and political uncertainty. Analysis of alternative conceptualizations reveals that the exit from the European Union is a unique transaction: it is not analogous to a divorce settlement, the leaving of a club, the termination of a commercial contract, the leaving of a treaty-based international organization, or secession from a state. Analysing the formulation of the exit charge through four modes of accounting – budgeting, financial reporting, statistical accounting, and fiscal sustainability projections – brings fiscal transparency to the exit charge calculation. Now forecast to be €41.4 billion, the negotiations evidenced not only the weakness of the United Kingdom position but also the dominance in European Union 27 thinking of short-term budgetary calculations regarding the 2014-20 Multiannual Financial Framework over its long-term sustainability without a large net contributor. The final amount paid by the United Kingdom will depend on the future crystallization of liabilities and contingent liabilities associated with the increasingly complex European Union financial architecture. This complexity derives from political competition between the European Council and the European Commission and from the political difficulty of securing Treaty revisions.

Keywords: Modes of accounting; Brexit; Off-balance sheet finance; Consolidation; Exit charge; European Union; Public sector accounting; Austerity.

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* Professor of Public Sector Accounting, Adam Smith Business School, University of Glasgow.
† Research Fellow, Adam Smith Business School, University of Glasgow.

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INTRODUCTION

Commentators compete rhetorically about the portentous nature of the decision by the United Kingdom (UK) referendum on 23 June 2016 to leave the European Union (EU). This paper does not discuss the merits of what has become known as 'Brexit' but focuses on the charge that the UK must pay the EU for its leaving.

The exit process provided for in the Treaty of Lisbon (2007) was designed by the UK diplomat Sir John Kerr in the aftermath of the failed attempt to create a European constitution. His recollection of the negotiations is:

> Nor do I remember any serious opposition to the idea, enshrined in the Lisbon Treaty in what became Article 50, that nation-states were entitled to change their minds, and leave if they so choose. Equally I'm certain no-one dreamed that in 2017 a member state would trigger the procedure, as Mrs. May did on 29 March (Kerr, 2017).

However, the UK did trigger Article 50 and immediately Article 218(3) took over. This made the UK a third party and kept certain UK citizens working in EU institutions away from documentation and decisions on the basis of their allegedly conflicted loyalties. Control of the exit process passed to the European Commission (EC), acting on behalf of the Council of Ministers (i.e. the governments of the Member States), now the 'EU27'. Pre-conditions were set that the Commission would not discuss the UK's future trading relationship with the EU until three issues were settled: the treatment of non-UK EU citizens resident in the UK and of UK citizens resident in the EU27; the arrangements for the border between Northern Ireland and the Republic of Ireland; and the exit charge that the UK would pay.

Remarkably, the eventuality of such a charge had not featured in the Brexit referendum campaign. It quickly became known as the 'divorce bill' (Keep, 2017) although, as we shall see, other analogies also gained currency. Brexit added another element to the crises already faced by the EU (Laffan, 2016), notably the 2009 eurozone crisis, instability on its Eastern border, and migration flows from failed states in the Middle East and North Africa. One segment of 'Brexiter' opinion considers this an opportunity to complete those parts of the state-shrinking Thatcher revolution that had been frustrated by EU membership (Lawson, 2016).

The exit charge generated acrimony, despite its relatively marginal economic impact. The UK net contribution to the EU is £8-10 billion per annum (ICAEW, 2017), approximately 1% of annual UK public expenditure. A much-cited early figure was €60 billion if leaving on 29 March 2019, which if added to the UK public sector net debt would increase the net debt/GDP ratio from 87% to 90%. Before the global financial recession, the 2008 ratio was 48% (ONS, 2017). The draft Withdrawal Agreement (European Commission, 2018) has been interpreted by the Office for Budget Responsibility (OBR) as involving an undiscounted payment of €41.4 billion (OBR, 2018, para. B.35).

Such a charge is small compared to the potential short-term effects of Brexit on GDP growth and on the public finances, for example due to sterling depreciation and trade disruption The Institute for Fiscal Studies (IFS) estimated the annual budgetary cost as £70 billion (Emmerson et al., 2016).

[1] However, damage to UK public finances through lower economic growth is less politically salient than handing over 'huge sums' to Brussels (May, 2017a). Current politicians are trapped by rhetoric dating back to the Fontainebleau rebate secured by Prime Minister Margaret Thatcher in 1984, and vigorously defended since then by all UK Governments. Moreover, the EU27 took advantage of UK political sensitivities by insisting on an early financial settlement before negotiations could move on to trade issues vital to the UK (European Council, 2017).

The flavour of controversies about the UK's financial relationship with the EU is illustrated by the following quotations:

> The principle is clear: the days of Britain making vast contributions to the European Union every year will end (Theresa May MP, UK Prime Minister, 2017a).
>
> If you were sitting in a bar and if you are ordering 28 beers and then suddenly some of your colleagues is leaving and is not paying, that is not feasible. They have to pay - they have to pay. Not in an impossible way, I am not in a revenge mood. I am not hating British. The Europeans have to be grateful for so many things Britain has brought to Europe during war

[1] The Institute for Fiscal Studies (Emmerson et al., 2016, p. 2) disputed the extra £350 million a week claimed by the Brexit Leave campaign to be available for spending on the NHS after Brexit. This figure was before the UK's receipts from the EU and before the Fontainebleau rebate: the correct figure was £150 million a week, calculated on the assumption that Brexit would have no other effect on UK public finances. Yet the number was widely believed and has since been repeated by Boris Johnson, the UK Foreign Secretary, leading to a rebuke from the Chairman of the Statistics Authority (Norgrove, 2017).

> after war, before and everywhere and every time. But now they have to pay (Jean-Claude Juncker, President of the EC, 2017).
>
> The sums that I have seen that [the EU27] propose to demand from this country seem to me to be extortionate. I think that to 'go whistle' is an entirely appropriate expression (Boris Johnson MP, UK Foreign Secretary, 2017).
>
> I am not hearing any whistling, just a clock ticking (Michel Barnier, EU Brexit Negotiator, 2017).

Our aim is to analyse the accounting formulation of the exit charge within such a political context. We elaborate that context by exploring competing conceptualizations of the UK's break from the EU, noting that adherence to different conceptualizations contributes to Brexit negotiation turmoil. We draw on the academic literature on modes of government accounting: budgeting, financial reporting, statistical accounting, and fiscal sustainability projections (Authors, 2015). While we also draw on our prior involvement in UK and EU public sector accounting developments, we have enjoyed no insider access and have relied on documents in the public domain. This has been less of a disadvantage than it might seem, because both the EU and UK sides have extensively leaked to the media their version of the rights and wrongs of the exit charge. We have tracked events, with the *Financial Times* being particularly useful; drawn on the analysis by the OBR (2018) of the January 2018 draft Withdrawal Agreement (European Commission, 2018); and have participated in seminars held on the Chatham House Rule which facilitated contextualization and interpretation. All have contributed to our understanding of why Brexit has become so conflicted and added to the sense of crisis in both the UK and EU.

CONFLICTING CONCEPTUALIZATIONS OF BREXIT

As in marital divorces, both the UK and the EU secured legal advice confirming their own position in the financial dispute. A report by the House of Lords European Union Committee (2017) concluded that, in the absence of a withdrawal agreement, the UK has no legal obligation to pay to exit, but that the 'political and economic consequences … are likely to be profound'.

Though evocative shorthand, the divorce conceptualization of Brexit is only one of those articulated. Others include quitting a golf club, terminating a contractual relationship under private law, leaving a Treaty-based international organization, and seceding from a state. Of central importance underlying them is the UK's traditional transactional approach to EU membership, always assessing costs and benefits. This has applied across the UK political spectrum and has characterized all UK Governments since entry into (what became) the EU in 1973. The late-arriving UK never embraced the existential ‘peace and prosperity’ vision of the EU that was shared by founder members. Rogers (2017) traced the origins of Brexit to the 1992 Maastricht opt-outs on the single currency and Schengen border control, and particularly to the 2011 UK veto of Treaty changes desired by the eurozone countries at the height of the fiscal crisis. It is not that, for example, France and Germany do not themselves pursue self-interest in economic and fiscal matters, but they do share a European vision to which the UK has never subscribed.

There is irony in that successive UK Governments pressed early membership for the former communist states in Eastern Europe, with the purpose of diluting ambitions for political integration on the lines of the ‘ever closer union’ expressed as a political goal in EU Treaties (Miller, 2015). Although these countries can behave as transactionally as the UK and therefore should be natural allies, resentment about Eastern European immigration into the UK was a powerful factor in the Leave campaign, in turn alienating Member States in Eastern Europe.

Brexit as Marital Divorce

Marital divorces are complicated and how they are constructed has undergone significant legal change, particularly affecting financial settlements. Venue shopping has made London and the English courts the favoured location in high-worth divorces because of the courts’ willingness to specify 50:50 splits of net assets, irrespective of wealth taken into a marriage, relative earnings during the marriage, and projected future earning power after the divorce. If Brexit were a marital divorce then, on this basis, the UK would receive back its share of net assets or pay over its share of net liabilities at the settlement date. There would be an economic calculation of the net assets (or net liabilities) of the EU, with the UK ‘taking its share’, whether positive or negative. There would be several subsidiary complications to argue about: would the UK share be determined with reference to its present GDP share, its present population share, or its cumulative financial contribution over its membership years (or some subset thereof)?

The notion that the exit charge would be calculated on net assets or net liabilities was rendered implausible by the sequencing imposed on the UK by the EU27, once Article 50 had been activated. Although Barker (2017) did calculations based upon the EC's financial accounts, the EU27 has no intention of letting the UK take away a share of the EU's net assets. Disruption having been caused by the UK's decision to leave, it must pay its share of financial liabilities but would in general have no claim on EU assets. Certainly, this will not be a divorce of the kind obtainable from the English courts at the dissolution of a marriage.

Brexit as Quitting a Golf Club

The intense UK political and media rhetoric about extortion and ‘let the EU go whistle' included indications that leading Brexiters likened Brexit to leaving a golf club. Joining a golf club usually involves paying a joining fee (which might loosely be interpreted as relating to existing assets such as valuable land) and then an annual membership fee. Eventually the member exits the golf club, perhaps because they become too infirm to play. That would involve giving a period of notice, paying the final year's fees, and settling any outstanding bar bills and green fees. Golf clubs have large memberships and each member will eventually leave. The departing member does not receive a share of net assets at the date of departure nor has to fund a share of net liabilities, which might relate to employee pension liabilities and negligence claims.

An extreme scenario would be when all members exit and leave behind either net assets or net liabilities for which membership of an unincorporated golf club had previously made them jointly and severally liable. The UK was perhaps never serious in claiming a share of net assets, but it would like the clean break of the golf club scenario. However, the major figures of the EU27 do not see the EU as analogous to a golf club. As for a golf club, the departing Member State does not receive a share of net assets, but, unlike a golf club, it is held responsible for its share of liabilities and contingent liabilities.

Brexit as Terminating a Commercial Contract

In a contractual relationship between two private entities, the relationship will only survive long-term if both see future gain to themselves. Market logic legitimately applies to such terminations, both sides calculating what they can get. This sense of continuous calculation is alien to the European vision, but closer to the transactional approach of the UK.

When disposing of a shareholding in a quoted company, a shareholder sells those shares for their current market value, not returning them to the company at par or issue value. In the days when the large auditing firms were partnerships, one bought into the partnership at entry and was bought out at exit. Because of unlimited liability one was jointly and severally liable during the partnership but free from liability after departure. Accession countries to the EU do not pay an entrance fee, though substantial economic and political costs are implicit in conforming to the European *acquis*.

Brexit as Leaving a Treaty-based International Organization

Countries can walk out of international organizations because of policy disagreements: a recent example is the United States' decision to leave UNESCO in 2018, having suspended its subscriptions since 2011 (UNESCO, 2017). The degree of enforcement of financial obligations depends on the financial firepower and political weight of the particular state. In contrast, the EU is a supranational organization on a track towards political and economic integration, which had assumed that accessions would not be reversed.

Article 70 of the *Vienna Convention on the Law of Treaties* (1969) provides a fall-back position if the treaty in question does not have a termination procedure under its provisions or if the parties do not otherwise agree. As from the termination date, Article 70(1a) removes future obligations to conform to the Treaty, but Article 70(1b) confirms rights and obligations as at termination date. This underpins the EU contention that the UK cannot simply walk away. Because Article 50 includes an exit provision, the Vienna Convention only becomes directly relevant if there is no agreement on the draft Withdrawal Agreement currently being negotiated by the EU and the UK.

Brexit as Secession from a State

The EU is not yet a state, so the analogy is stretched. However, two EU Member States face threats of secession: Catalonia from Spain and Scotland from the UK. At the time of the Scottish independence referendum in 2014, the UK Government position was that a departing Scotland would have no claim on UK assets but would have to assume its share of UK liabilities, such as the national debt (Treasury, 2014).

The EC's chief spokesman captured the EU27 view of the UK Brexit financial liability in a letter to the *Financial Times* (Schinas, 2017):

> all commitments undertaken by the 28 member states should be honoured by the 28 member states. No member should pay more and no member should receive less because of the UK's decision to leave the EU.

This characterizes the UK as the disrupter of EU finances and contends that no other Member State should be worse off because of Brexit. There are fears that the receiving Eastern European Member States would receive less subsidy and/or that Germany and others would have to pay more. Another example would be charging the UK the costs of re-locating the European Banking Authority and the European Medicines from the UK: this is 'the disrupter should pay' principle.

Unless the UK were to pay the present value of all foregone future net contributions, Brexit will damage EU fiscal sustainability because it removes a large net contributor. However, the application of the 'no damage' principle is narrowed in the above quotation by the reference to honouring 'commitments'. The Schinas letter indicates that the 'no worse off' condition would apply to the liabilities and contingent liabilities of the EU on Brexit day, and to the working through of the 2014-20 Multiannual Financial Framework (MFF).

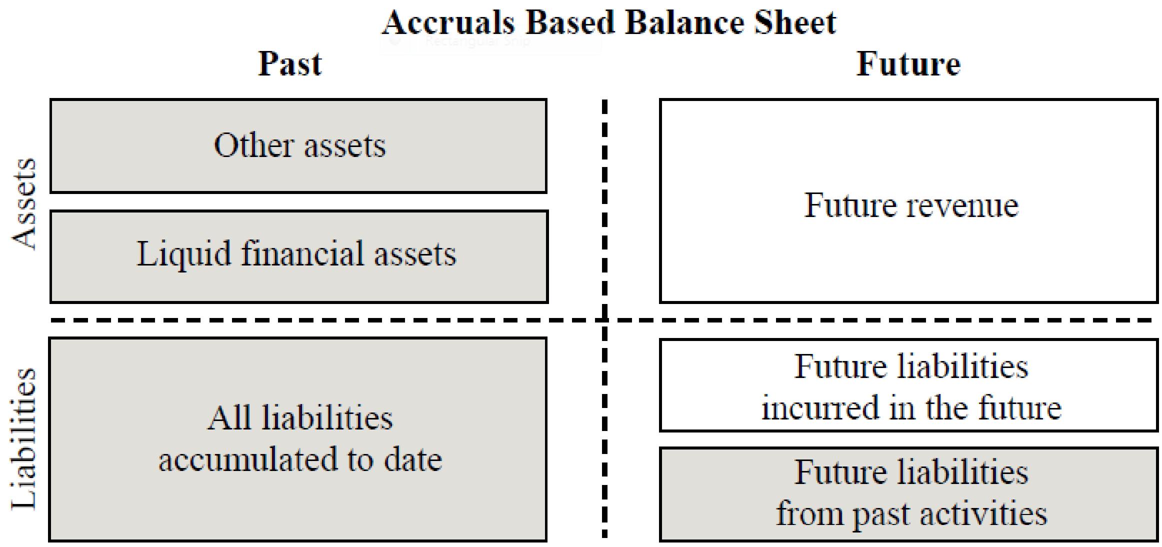
Two conclusions deserve emphasis. First, much argument is opportunistic, with actors calling on principles to support their desired outcome. This is no surprise but it makes satisfactory resolution more difficult when public positions harden and the negotiators expect allegations of betrayal and sabotage from behind them. Second, conflicting understandings of the UK-EU relationship coalesce with deliberate misinterpretations of accounting and statistical data.

FOUR MODES OF GOVERNMENT ACCOUNTING

Power politics dominated the fraught exit charge negotiations between the UK and the EU. On 12 June 2017, the EU27 published a statement of principles governing the calculation (European Commission, 2017a) whereas the UK consistently refused to state publicly its position, while engaging in political rhetoric. A conditional offer of circa €20 billion was made in the UK Prime Minister's Florence speech on 22 September 2017 (May, 2017b), designed to tone down the toxicity.

Pioneering work in the 2000s by Frank Eich, who was then responsible for the UK Treasury's long-term fiscal projections, is conveniently summarized in Eich (2008). Figure 1 reproduces his conceptualization of the public sector balance sheet. This facilitates an exposition of the four modes of government accounting: financial reporting, statistical accounting, fiscal sustainability projections, and budgeting.

Figure 1: Conceptualization of the Public Sector Balance Sheet



Source: Eich (2008, Chart 3.3).

In countries that have led public sector accounting reform, accrual accounting has replaced variants of cash accounting and modified accruals. Figure 1 has four quadrants, the vertical dimension distinguishing between assets and liabilities and the horizontal dimension between events in the past and in the future. It illuminates the gains from having a public sector balance sheet, but also the gaps that affect – to varying degrees – both financial reporting and statistical accounting. The shaded rectangles are those included in a financial reporting balance sheet. The unshaded 'Future liabilities incurred in the future' is an important omission.

Whereas financial reporting provides comprehensive coverage of liabilities accumulated to date (the bottom left quadrant), statistical accounting generally does not include provisions that arise from past events. Both modes of accounting attach central importance to recognition criteria. For example, certain items are not recognized in balance sheets because they are executory contracts: no accounting recognition until delivery. Therefore, though organizations have contractual obligations to employees, future employment costs are not put in the balance sheet as liabilities. Until relatively recently, public sector organizations did not report accrued employee pensions liabilities.

Public sector balance sheets do not include future taxation revenue (top right quadrant). Of most relevance in the present context is what lies in the bottom right quadrant:

a) future liabilities from past activities (which financial reporting seeks to cover comprehensively, unlike statistical accounting)
b) future liabilities incurred in the future.

The innovation of fiscal sustainability projections is to place attention on (b), which fail accounting recognition criteria but which hang over future public finances. An example is the to-be-accrued pension liabilities arising from the future employment of existing and new public employees. Unlike (a), these fail accounting recognition criteria, being treated as executory contracts.

With regard to the top left quadrant, financial reports are prepared on the going-concern convention: the default assumption is that the organization will continue in broadly the same shape, irrespective of whether the measurement basis is historic cost or some form of current cost or fair value accounting. Herein lies one difficulty for exit charge calculations that seek a basis in annual financial reports. For example, the reported net assets of the European Investment Bank (EIB) are irrelevant to a calculation that includes an offset for assets. The relevant number would be the UK's share of the hypothetical flotation value of the EIB.

Fiscal sustainability analysis, taken over from the Treasury on the establishment of the OBR in 2010, is relevant to the exit charge. This involves forecasting cash flows over 50-year and infinite time horizons, on the basis of 'existing policies'. The calculation of fiscal gaps indicates the extent of fiscal unsustainability to be resolved by increases in taxation or reductions in expenditure. Even at the national level, there are serious difficulties in establishing in operational terms what constitutes existing government policies. The economic and demographic uncertainties are profound. What happens over time, in terms of the crystallization of the contingent liabilities relating to the increasingly complex EU financial architecture, should be of profound importance to the exit charge calculation. If assumptions are made now, a lump-sum exit charge can be calculated, whether that is handed over as a single payment or in stages. Alternatively, the final amount of the exit charge will be influenced by future economic conditions and EU decision-making on how to handle such contingent liabilities (e.g. generosity to EU pensioners and willingness to write-off loans to outside organizations and countries).

There is plenty of evidence that it is budgeting that decision makers care about, much more than about the later financial reports (Public Administration and Constitutional Affairs Committee, 2017). Unlike statistical accounting (on Eurostat standards) and financial reporting (more harmonization broadly on IFRS/IPSAS standards), budgeting processes remain largely the responsibility of nation states. There are wide differences, especially on the breadth of coverage of public institutions and in the accounting basis (cash, accruals, or variants). The common features are that Executive decision-making (Diamond, 2013) and the acquisition of legitimacy through legislative endorsement (Lienert, 2013) use the budgeting numbers, however those are constructed.

Of critical importance is the way in which the EU conducts its financial programming within the framework of the 2014-20 MFF. This is not a seven-year budget but facilitates the implementation of common policies and informs beneficiaries and finance ministries. The MFF follows a special acceptance procedure: proposed by the EC, voted on by the European Parliament (EP) on a Yes/No non-amendable basis, after which the European Council can make changes without going back to the Parliament. The MFF has been regarded as binding by recipient and contributing countries, though actual payments can be frustrated by restricting the annual budget. Unspent funds in the MFF accumulate, being known as ‘Reste à liquider’ (RAL). De Wilde (2012) found that the MFF process was characterized by intergovernmental polarization (each Member State calculating its contributions or receipts) rather than transnational polarization (interest groups coalescing across Member States).

The point to be stressed is the different ways in which the UK and EU undertake their budgeting. The UK has Spending Reviews, their periodicity, years covered and content being under Treasury control. Spending Reviews are conducted on an accruals basis and tend to cover three years ahead; they are never voted by Parliament. Formal authorization, again on an accruals basis, takes place after the financial year has started, through what is known as the Supply procedure. Unspent amounts in voted Estimates expire at financial year end, and have to be voted again, even when the Treasury has operated a carry-over system. In 2010, the incoming Coalition Government cancelled all accumulated End-Year Flexibility that had built up during the 1997-2010 Labour Government.

In contrast, the EU operates on a dual commitments (seven-year MFF) and payments (annual budget) basis, in which unspent commitments carry forward and do not automatically expire, though they can be decommitted. Hawkish Member State attitudes to authorizing payments in the annual budget, often with the UK in the forefront, have prevented commitments in the MFF being fully funded for individual years, leading to a build-up of unexpired commitments (i.e. RAL).[2] Working from its own practices, the UK thinks of unspent commitments on 30 March 2019 as not being its responsibility. In contrast, net recipient EU27 countries are programming that expenditure into the 2020s, considering the MFF amounts to be a binding obligation on all the EU28.

THE SUBSTANCE OF THE BREXIT CHARGE DISPUTE

In terms of headline numbers, the EC asked for circa €60 billion and the UK, after initially denying that it had anything to pay, made what was interpreted as an offer of €20 billion in the Prime Minister’s Florence speech (May, 2017b). It did not seem coincidental that €20 billion is about two years’ UK net contribution, thereby filling the budgetary hole in the final two years of the 2014-20 MFF. Sterling depreciation of 14% against the euro since the Brexit referendum increased the sterling cost of the exit charge payable in euros (European Commission, 2017a).

Much discussion about the exit charge has centred around the EU budget and the EC consolidated financial report. However, there is a much broader context, as is shown in Figure 2, which is a schematic representation of an official diagram (European Commission, 2017b, p. 9). Figure 2 demonstrates the increasingly complex EU architecture. The shaded circle represents the EU budget, which might be thought of as the

[2] There was a large build-up of unspent MFF allocations during the 2007-13 period, due in part to the global financial recession leading to austerity measures in most countries which inhibited co-financing.

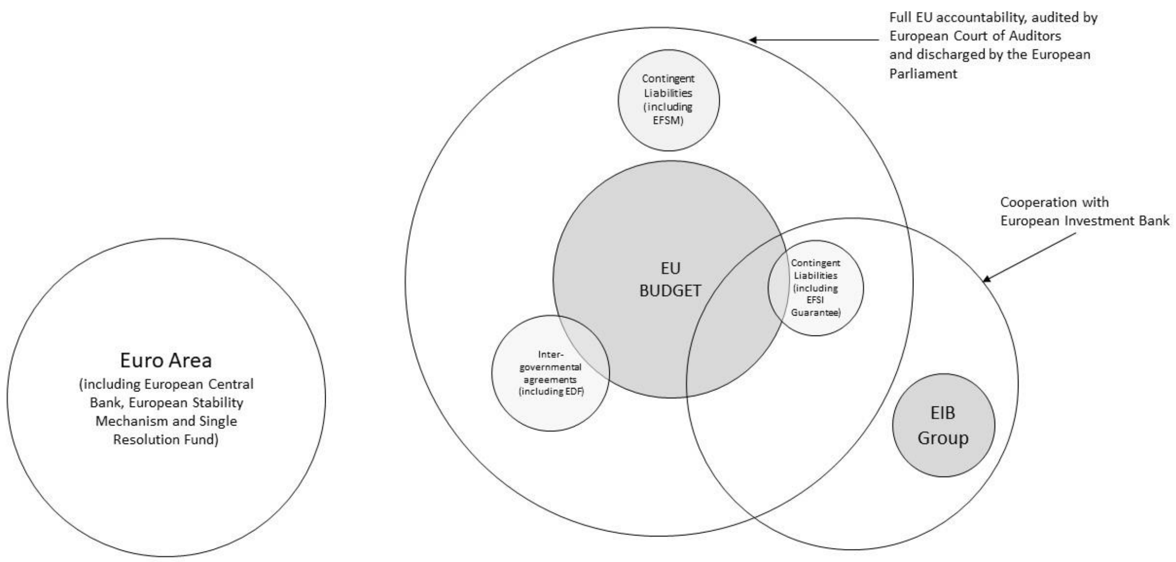
planet. There are many moons, some intersecting with the EU budget and falling within what is known as 'full EU accountability' (represented by the outer circle). This term means that the organizations and/or funds are audited by the European Court of Auditors (ECA) and subject to discharge by the European Parliament.

On the right of Figure 2 and intersecting with the EU budget and full EU accountability is a circle representing the EIB, which is an EU institution not consolidated in the accounts of the EC. The area of intersection contains, for example: financial instruments and EIB shares (within the EU budget); European Fund for Strategic Investments guarantees (partly inside the EU budget and wholly within the outer circle of full EU accountability); and the European Financial Stability Mechanism and Euratom loans (outside the EU budget but inside the outer circle). Contingent liabilities sometimes overlap the budget, and sometimes do not.

On the left of Figure 2, outside both the EU budget and full EU accountability, are the institutions connected to the eurozone, notably the European Central Bank (ECB) and the European Stability Mechanism. The UK's multiple opt-outs mean that it has limited involvement in this area. Moreover, the difficulty of making Treaty revisions, to which the UK has contributed, has increased the use of intergovernmental agreements between subsets of EU Member States. This is also a mechanism by which Member States, acting through the European Council, bypass the EC (Laffan and Schlosser, 2016).

In summary, this architecture reflects not only the growing complexity arising from the co-existence of the eurozone 19 and the non-eurozone 9, but also off-balance sheet activity on behalf of the EU28 and political competition between Member States and the EC. Sinn (2015) has criticized these developments as constituting a 'shadow budget' which – if not checked – will grow non-transparently alongside tight control of the EU budget.

Figure 2: The Whole Picture of EU finances



Notes: The size of the circle does not correspond to actual values. EDF stands for European Development Fund, EFSI is European Fund for Strategic Investments and EFSM stands for European Financial Stabilisation Mechanism.
Source: This schematic diagram is based on European Commission (2017b).

If Brexit were analogous to a divorce on the basis of a *pro rata* split of net assets, there would be a valuation on Brexit day of everything in Figure 2 relating to the UK. Barker (2017) attached a total EU assets valuation of €22.5 billion, providing the UK with an offset of €2.7 billion (12% share) or €3.4 billion (15% share).[3] Alongside France, Germany and Italy, the UK is the equal largest shareholder in the EIB, with 16.11%. Ceasing to be an EU Member State renders it legally unable to continue as a shareholder. The EU27 have no intention of the UK taking core assets with it; Brexit is seen as analogous to secession, not to divorce, and discouraging imitation is a high priority.

Several complications for the financial settlement have arisen since the activation of Article 50. First, the EU view of the likely UK exit liability was first promulgated by well-briefed articles in the *Financial Times* (summarized in Barker, 2017), providing indicative numbers for total EU liabilities and alternative methodologies for calculating the UK share. One of Barker's calculations is summarized in Table 1. On a UK share of 15%, Barker

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[3] The 12% share relates to the average of UK net contributions after the rebate, 15% to before the rebate (Barker, 2017, p. 9).

shows Total Liabilities (€73.3 billion), and Contingent Liabilities (€11.9 billion), against which are €18.4 billion of possible offsets. That gives a total of €66.8 billion. The comparable figure on a 12% share is €51.4 billion.

Table 1: Alex Barker's Brexit Bill Specimen Calculation

	EU end 2018 € billion	UK share 12% € billion	UK share 15% € billion
Pensions	63.80	7.70	9.60
Reste à Liquider (at end 2018)	241.00	29.20	36.20
Other	172.40	22.60	27.60
Total Liabilities	**477.20**	**59.60**	**73.30**
Guarantees/provisions	23.10	2.80	3.50
EU Loans	56.10	6.80	8.40
Total Contingent Liabilities	**79.20**	**9.60**	**11.90**
Total of Liabilities and Contingent Liabilities	**559.70**	**69.10**	**85.20**
Assets	22.50	2.70	3.40
UK rebate for 2018 (approx)	-	6.00	6.00
Receipts for UK projects (approx)	9.00	9.00	9.00
Possible Offsets	**31.50**	**17.70**	**18.40**

Note: There are some rounding errors in the original source.
Source: Barker (2017, p. 10).

In June 2017 came the official publication of the EU's principles for calculating the exit charge, though without numbers (European Commission, 2017a). The numbers reported by Barker (2017) were interpreted in the UK as an opening gambit: however, Jean-Claude Juncker, President of the EC, noted that the financial calculations were more complex than expected, but that the British would 'have to pay' (Juncker, 2017). In contrast, the UK Government has never published its own analysis of the UK liability, though Ministers rubbished the EU figures as extortion, punishment and ransom. It became clear that UK Prime Minister David Cameron's pre-Referendum instruction that the civil service would make no preparations for Brexit had been obeyed. The UK argument that it would accept pension liability only for those EU pensioners who are UK nationals was clumsy (if it were a tactical ploy to have something to concede later on) or inflammatory (if serious).

Second, the UK's liability is affected by the appearance on the UK agenda of a 'transition period' after 29 March 2019, possibly of two years. During this period, the UK would be in the departure lounge: not a Member State, so having no representation, but subject to the usual budgetary contributions, all EU law (included that newly coming into force), and subject to the jurisdiction of the European Court of Justice (ECJ). Although seeming implausible in the aftermath of the Brexit referendum, this ‘transition period’ (EU terminology) or ‘implementation period’ (UK terminology) is included in the draft Withdrawal Agreement (European Commission, 2018). Significantly, the EU restricted duration to 21 months whereas the UK had asked for 24 months: this means that the UK effectively leaves on 31 December 2020, the final day of the 2014-20 MFF.

Such an arrangement solves the short-term budgetary gap which worries both net recipient and net contributing Member States, as two more years of the 2014-20 MFF will have expired. However, the issue of unspent commitments remains: on past experience, significant amounts of RAL will continue until at least 2023, and some for much longer (European Commission, 2015). Further involvement of the ECJ and the ECA crosses ‘red lines’ set by the UK Government for internal party management purposes. Another issue is that impending Brexit may reduce the amount of EU receipts (e.g. from competitively tendered programmes such as Horizon 2020) and thus increase the exit charge beyond estimated amounts.

Third, threats to fiscal transparency have become evident. Having elevated the exit charge to such prominence, the pressures to conceal the amounts payable mounted. Rather than a clean break (pay the agreed financial liability as a lump sum as total discharge, then pay for participation in particular programmes), there will be staged payments. Payments that arise from Treaty obligations generally fall within the accepted areas where UK payments can be classified as Consolidated Fund Standing Service, which leads to an automatic charge on the Consolidated Fund without requiring parliamentary approval. Under the *European Union (Withdrawal) Bill 2017-19*, this requirement could be inserted by secondary legislation. Because of RAL from successive MFFs and the gradual crystallization of contingent liabilities, this situation could exist for a very long time.

Inadequate attention has been paid to the build-up of EU contingent liabilities, an unsurprising development after long periods of tight control over EU expenditure. There could be EU27 demands for further payments for several decades as contingent liabilities crystallize (NAO, 2018). This crystallization process will be managed by the EU27, with the UK having no role in decisions that influence those amounts, for example, debt write-offs from the EU budget to EU institutions and third parties.

RESOLUTION OF THE DISPUTE

The draft Withdrawal Agreement (European Commission, 2018) specifies calculation principles, without attaching numbers. Fortunately, these numbers fall within the remit of the OBR which has published estimated payments (OBR, 2018, Annex B) subsequent to an explanatory letter from the Chancellor of the Exchequer to the Chair of the Treasury Committee (Hammond, 2018). The total exit charge is estimated as €41.4 billion, roughly midway between Barker (2017) and May (2017b).

The upper part of Table 2 shows UK payments if the UK were to remain in the EU. The lower part shows UK payments with the UK leaving the EU on 29 March 2019. Whereas the UK operates on financial years ending 31 March, the EU has a year end of 31 December. The Brexit date means that, in calendar year 2019, the UK will be a Member State from 1 January to 29 March, but thereafter a 'third country'. Moreover, the EU does not call for money on an even basis: the OBR (2018) has estimated the seasonal profile in its calculations. The membership calculations cease part way through 2019, with exit charge payments taking over. The bottom line of Table 2 shows the annual path of payments from 2019.

Although no longer a Member State from 30 March, the UK will be financially treated as such until 31 December 2020. In 2023, the Leave payments will be €2.9 billion in comparison with Remain payments of €9.7 billion. The layout of Table 2 shows how the total UK contribution depends significantly on public sector net receipts and private sector receipts. In the latest outturn year (2018), these offset 40% of the gross contribution and – without Brexit – would have been forecast to offset 47% in 2023. A fiscal risk is that a combination of continued austerity (affecting the capacity to meet co-funding requirements) and of unwillingness to engage in the context of Brexit (or being frozen out by EU27 partners) will lead to a shortfall in UK receipts.

The size of the exit charge depends on the base date from which it is calculated. If calculated from the day after Brexit day (30 March 2019), the OBR (2018, para. B.35) states it to be €41.4 billion. Using its forecast of exchange rates, this converts to £37.1 billion. If calculated from the date (1 January 2021) when the EU financial regime ceases to apply to the UK, the exit charge would be €22.9 billion.

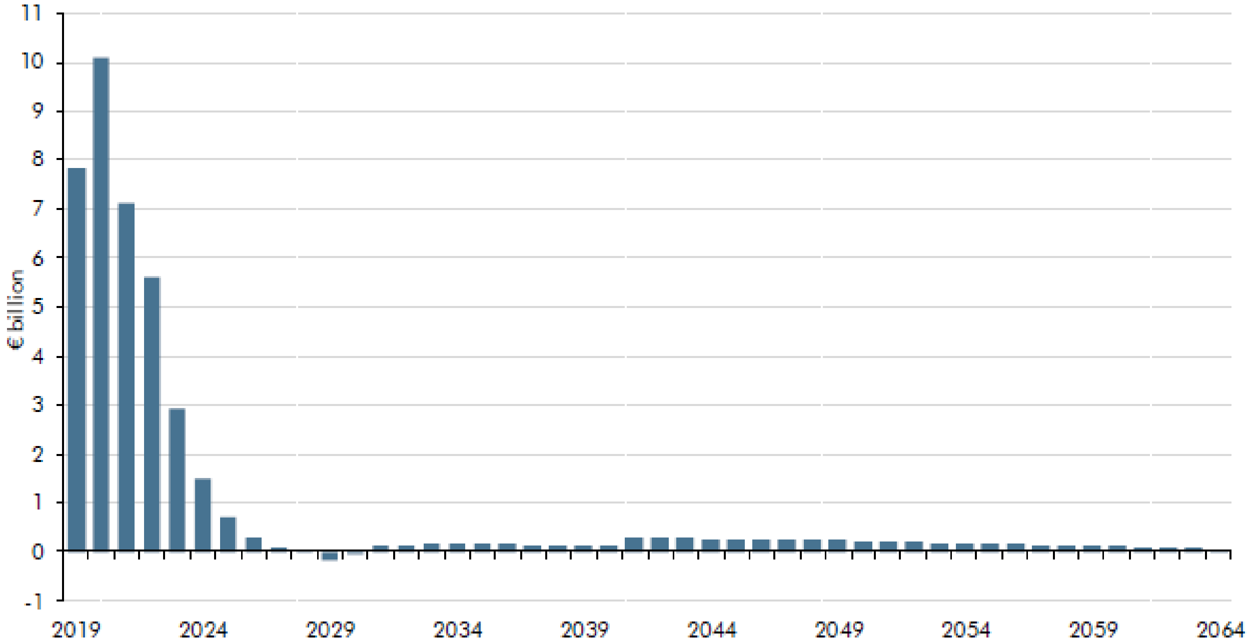
Table 2: UK Payments to the European Union (€ billion)

	Outturn 2016	Estimate 2017	Forecast 2018	Forecast 2019	Forecast 2020	Forecast 2021	Forecast 2022	Forecast 2023
REMAINING EU MEMBER STATE								
Contribution before abatement	24.5	19.0	21.3	24.1	24.3	24.0	23.7	23.5
Less: Abatement	6.7	5.1	4.8	4.7	5.4	5.3	5.2	5.2
Gross contribution	17.8	13.8	16.5	19.4	19.0	18.8	18.5	18.4
Less: Public sector net receipts from EU	4.3	5.6	5.6	6.3	6.6	6.6	6.6	6.7
Public sector net contribution	13.5	8.3	10.9	13.0	12.4	12.2	11.9	11.7
Less: Private sector receipts from the EU	2.8	1.7	1.7	2.0	2.0	2.0	2.0	2.0
Total UK net contribution	**10.7**	**6.5**	**9.2**	**11.1**	**10.4**	**10.1**	**9.8**	**9.7**
LEAVING THE EU								
Contribution before abatement	24.5	19.0	21.3					
Less: Abatement	6.7	5.1	4.8					
Gross contribution	17.8	13.8	16.5					
Less: Public sector net receipts from EU	4.3	5.6	5.6					
Public sector net contribution	13.5	8.3	10.9					
Less: Private sector receipts from the EU	2.8	1.7	1.7					
Total UK net contribution	**10.7**	**6.5**	**9.2**					
Net MFF contributions				8.1	10.4	0.0	0.0	0.0
Net RAL contributions				0.0	0.0	7.6	5.8	3.1
Payments in relation to assets and liablities				-0.3	-0.3	-0.4	-0.2	-0.2
Annual path of financial settlement payments				**7.8**	**10.1**	**7.1**	**5.6**	**2.9**

Source: Office for Budget Responsibility (2018), Table B.1, Chart B.3, and Twitter Chart, 13 March.

Figure 3 plots the OBR's (2018) estimates of the time profile of financial settlement payments, beginning from 30 March 2019 (i.e. after Brexit but before detachment). These payments are heavily bunched in the final two years of MFF 2014-20 and in the next three years when much of the estimated €256.4 billion post-2020 RAL is expected to be disbursed. From 2025 annual payments fall below €1 billion. The draft Withdrawal Agreement (European Commission, 2018, Article 135, para 5(b)) contains a provision that the UK could then ask to settle all outstanding pension liabilities in five equal annual instalments.

Figure 3: The Time Profile of Exit Payments (€ billion)

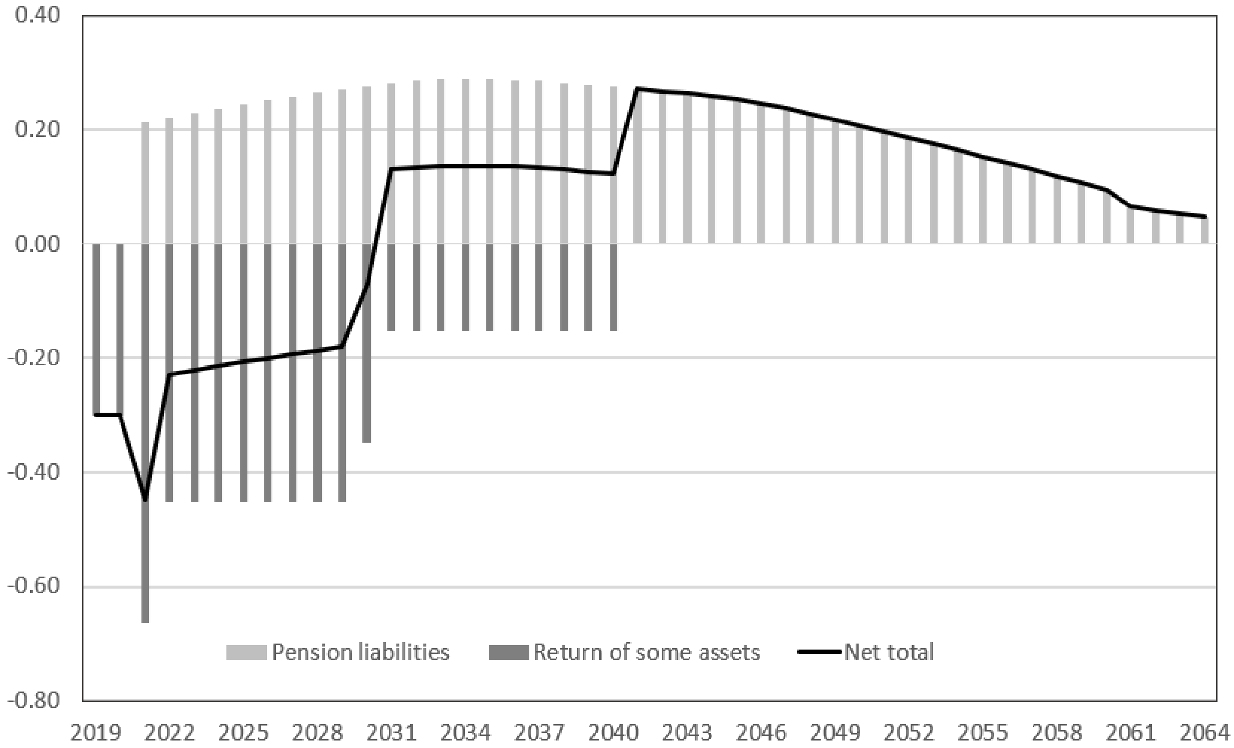


Source: Office for Budget Responsibility (2018), Chart B.3

Whereas Barker (2017, shown here as Table 1) had suggested considerable numbers for the UK's share of Liabilities and Contingent Liabilities, Figure 4 suggests that the settlement of non-MFF and non-RAL liabilities involves numbers that are small in this context. Above the horizontal axis is plotted the UK's payment of its share of EU pension liabilities, running on until 2064. There is no mention in the draft Withdrawal Agreement (European Commission, 2018) of the UK paying compensation for the relocation of the European Banking Authority (Paris) or the European Medicines Agency (Amsterdam).

Below the horizontal axis is plotted the UK's receipts from reimbursements related to its stake in certain EU assets. The solid black line shows the net position, which turns negative in 2031. The most important inflow relates to repayment in 11 instalments of €0.3 billion and one of €195.9 million of the UK's paid-in capital in the EIB. This capital was contributed in years from 1973, but returns in much depreciated currency representing a fraction of the potential market value of the UK's stake of 16.11%. The UK remains liable up to its subscribed capital of €39.15 billion until the EIB's projects as at 29 March 2019 have ceased to be at risk. It is likely that other asset returns have been agreed on disadvantageous terms for the UK because current values are not being used. For example, in 2021 the UK will receive €55.51 million for its 13.6743% stake in the ECB.

Figure 4: Profile of payments with regard to liabilities and assets (€ billion)



Source: Office for Budget Responsibility (2018), Chart B.2, with simplifications.

CONCLUSION

This analysis of the UK's exit charge not only draws conclusions about this specific case, but also raises wider issues for public sector accounting research. Examining the issues through the lenses of the four modes of government accounting brings these into focus. Data have become available that EU institutions and governments would either not calculate (on grounds of hypotheticality) or would refuse to release (on grounds of 'national' interest).

Without the 2008 global financial crisis and the 2009 eurozone crisis, the EU's development path would have been different, thereby avoiding the further disengagement of the UK (Laffan and Schlosser, 2016). Similarly, without the 2010-16 period of post-crisis UK fiscal austerity, it is unlikely there would have been a Brexit majority, even if internal Conservative Party calculations had led David Cameron to call an In-Out Referendum. Over the last century, periods of UK fiscal squeeze have only lasted two to three years (Hood and Himaz, 2017), the present one being shallow but much longer in duration. The Brexit Referendum was in part an electoral backlash against elites and experts unconnected with EU membership. The UK Government thought that it could deal bilaterally with Member States, by-passing the EC, a tactic which underestimated the cohesion generated by survival through the eurozone crisis.

All public spending numbers are large, and the lack of public understanding of their relative importance has a distortionary effect on public debates (Authors, 2012). Moreover, the numerical significance of the net budgetary contribution and of the exit charge has been so exaggerated in UK politics that any number had become politically toxic. Insiders know the fiscal irrelevance of the annual net contribution and of the exit charge compared to other likely effects of Brexit, yet some had been willing to accept far larger damage to UK public finances by risking a cliff-edge exit with no agreement.

The postponement of *de facto* Brexit to 31 December 2020 reduced the size of the exit charge because of €18.5 billion being incurred between 30 March 2019 and 31 December 2020, when the UK will be treated financially 'as if' a Member State. The treatment of the UK's stake in the EIB is disadvantageous to the UK, one of the clearest indicators that this is viewed by the EU27 as secession. A future risk to the UK is that the outturn exit charge will be higher if Contingent Liabilities, prominent in Table 1 (Barker) but missing from Table 2 (OBR), were to crystallize on a large scale.

It is budgeting that really matters in the EU, when that is understood to include the MFF (D'Alfonso and Sapala, 2015). Much negotiating conflict could have been avoided by an early UK offer to meet its net contribution for the last two years (2019 and 2020) of the 2014-20 MFF, and its share of RAL from 2021-onwards. This was conceded in Theresa May's Florence speech, the EU27 then insisting on the transition period ending on 31 December 2020, the same day as the MFF. The departure of a large net-contributing Member State has long-term implications for the fiscal sustainability of the EU budget and EU institutions more generally. Belated acceptance by the UK that it would have to honour obligations under MFF 2014-20 will smooth the adjustment process but not resolve the long-term fiscal issue. By removing one of the most aggressive hawks on EU spending, Brexit may shift the balance of power away from Northern Europe, with conflicts over redistribution under MFF 2021-28 overlapping with those over threats to judicial and media independence in Eastern Europe. The notion of fiscal sustainability that shaped the EU negotiating position was a narrow one relating only to the 2014-20 MFF.

This analysis emphasizes the importance of consolidation and the temptations that public decision makers face to put activities off-balance sheet. Bergmann et al. (2016) attribute the growing attention in OECD countries to consolidated government financial reporting to the increasing fragmentation of government, in part due to the influence of New Public Management. Consolidated information can provide an overview of the financial performance and position of government which the accounts of individual entities cannot do. As accruals-based government financial reporting takes hold, consolidation brings useful information about the 'whole picture' (Bergmann, 2014; Authors, 2011), bringing to the fore activities that would otherwise not be visible. Faced by such constraints, governments often seek off-balance sheet mechanisms to achieve policy objectives without the transactions being recorded as public expenditure or as public debt. Both financial reporting and statistical accounting are vulnerable, meaning that constant vigilance by standard setters is essential.

The EU uses the 2012 Fiscal Compact to tighten its fiscal control over Member States, including surveillance of contingent liabilities. Because the UK exercised its veto, the Fiscal Compact was implemented through a 2012 intergovernmental treaty. It represents a stricter version of the EU Stability and Growth Pact, accompanied by tighter enforcement by the EC. Yet, as Figure 2 demonstrates, the EU itself has developed off-balance sheet devices. The EIB is not consolidated in the accounts of the EC, and the European Fund for Strategic Investments (EFSI) is a joint venture between the EC and the EIB. Infrastructure projects can then be delivered in Member States through EFSI projects, including Public-Private Partnerships that are designed to meet the criteria established by Eurostat (2016). This allows off-balance sheet treatment in statistical accounts, whatever the financial reporting treatment under IPSAS32. There is no super-consolidation of EU institutions comparable to the UK Whole-of-Government Account.

A warning to accounting standard setters and to public sector accounting researchers is that, in particular political circumstances, expert opinion can be trumped by lack of understanding and/or wilful misinterpretation of data. The technical accomplishment of the UK's financial reporting changes has not been matched by success at communicating government financial performance. The questions of accessibility, intelligibility and actual use should be high on the agenda of standard setters, governments and public sector accounting researchers.

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