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The EU's Increasingly Complex Finances: A Ticking Bomb?[*]

KEY MESSAGES

- **The EU's finances have become more complex because of a proliferation of off-budget mechanisms alongside the traditional budget. Most of these new mechanisms involve borrowing and lending activities**
- **The agreement of the Next Generation EU response to the pandemic accentuates the trend towards off-budget mechanisms. It also means the EU has to borrow directly from financial markets to finance grants to member states, instead of using its own revenues**
- **Increased resort to borrowing raises problems of legitimation, because the role of the European Parliament is more limited in relation to borrowing mechanisms than the powers it has over the annual budget and the multiannual financial framework**
- **Servicing the EU's new borrowing and repaying the debt over the coming decades will place demands on future EU budgets. However, there is resistance to increasing the budget, while adopting new resources to fund it is politically challenging**
- **For these reasons, there will be pressures to rethink the EU's finances and to focus more on EU-level public goods. Both will require bold decisions and efforts to overcome the bias towards the status quo of recent decades**

The EU budget is invariably among the most hotly contested issues in European governance. It pits reluctant net contributors against recipients of EU spending, advocates of shifting the focus of EU expenditure programs to the challenges of today against those accustomed to receiving support for Cohesion Policy and farm subsidies, and even some regions against their national governments. Yet although the headline total of the EU budget is a very large number – payments in 2023 are planned to reach EUR 168.6 billion, higher than the projected nominal GDP of 10 member states in 2023 – it is just one percentage point of EU GDP.

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At this level, what the EU budget can realistically fund is limited, in stark contrast to the capacities of the highest levels of government in both federal and unitary countries. A chart published by the Federal Reserve Bank of St. Louis shows[1] that net outlays of the US federal government, which had fallen from a peak of 40.7 percent of GDP at the end of World War II to 10.8 percent in 1948, then fluctuated between 16.1 percent and 22.2 percent in the five decades following the end of the Korean War. However, in 2009 (the global financial crisis) the figure rose, temporarily, to 24.3 percent before returning to the previous range, then surged to a peacetime peak of 31 percent in 2020 (the pandemic).

By contrast, when the EU is confronted with exceptional crises, the scope for any EU-level budgetary response is measured in small fractions of a percentage point of GDP.Instead, any fiscal response has to come from the individualmember states and, in recent crises, it is often the countriesmost in need of a fiscal stimulus that are least able to provide it. This creates demands for an EU-level response, but they cannot be met because there is a capability-expectations gap,[2] Zin that the EU has neither the budgetary resources nor a legal framework that allows it to act decisively. Any form of fiscal stimulus, in particular, is precluded. The reasons are many but derive mainly from the reluctance of member states to delegate enhanced budgetary power to the EU. Figure 1 illustrates the quandary.

To try to solve the quandary, the EU has resorted to funding mechanisms outside its traditional budgetary framework. Examples include the bailout funds during the sovereign debt crisis of the early 2010s, the Facility for Refugees in Turkey in 2016 and, most recently, the various instruments created in response to the Covid-19 pandemic. In each case, the solution adopted can be defended, especially where action has to be urgent, albeit with concerns about ad hoc governance mechanisms and risks for the EU's core budget. However, the agreement in 2020 on the Next Generation EU package (NGEU), made in response to the pandemic, was a qualitative shift in the use of off-budget funding mechanisms. Its novelty was to allow the Commission to borrow directly from the financial markets, to fund not just loans to member states, but also grants.

This paper examines the consequences of this evolution of the EU's finances, focusing on two dimensions: the threats posed to the coherence of the main EU budget, and the range of governance complications.

[*] This paper draws on presentations made by the author to the European Parliament Budget Committee in June 2022 and February 2023. It does not necessarily reflect the views of the Committee or the Parliament.

[1] https://fred.stlouisfed.org/series/FYONGDA188S.

[2] The phrase was first coined by Christopher Hill in relation to EU attempts to develop its international role (Hill 1993).

The next section provides a brief overview of the background and the political economy factors that inhibit change in the budget. It then turns to the complexity of dealing with a proliferation of borrowing and lending mechanisms;[3] conclusions complete the article.

BACKGROUND

Since a major reform enacted in 1988, the EU budget has been set within a multiannual financial framework (MFF) which establishes ceilings for various headings of expenditure. By far the biggest are for Cohesion Policy (mostly targeted at relatively less prosperous regions) and direct payments to farmers. Indeed, from 1988 to 2020, some 75 percent of EU spending was on these two headings, including a related budget line of support for rural development, with the share of Cohesion Policy gradually rising over the years, but support for farmers and rural development remaining above 30 percent of the total up to the end of the 2014–20 MFF.[4] In the current MFF, for the 2021–2027 period, these headings will still account for two-thirds of EU spending.

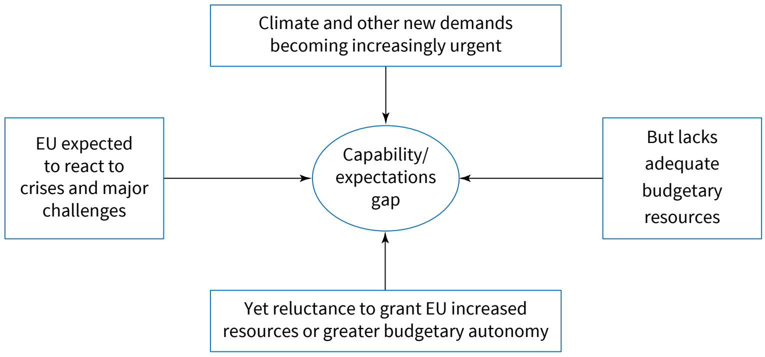
After 1988, the number of member states grew from 12 to 28 before Brexit intervened; the "1992" program to complete the single market was (largely, even if gaps persist) completed; the euro became the currency of, now, 20 member states; and the last fifteen years have seen a succession of crises. While it is true that many changes of detail have been enacted, in broad terms it is remarkable how little the EU budget has changed.

The reasons are not hard to find. First, the reluctance of member states to delegate budgetary powers to the EU, noted above, keeps the scale of the budget low. Path dependency is a second explanation because it is so hard to alter existing lines in the budget. Then there is the expectation of juste retour, the notion beloved of all Finance Ministers that they have to ensure an acceptable net balance between what their country pays into the EU and what it receives from it, irrespective of how the money is spent (Heinemann et al. 2020). These and other factors favor status quo as the outcome of successive MFF negotiations. Moreover, especially in the current period of fiscal stringency, a trilemma has emerged in which net contributor member states want to curb what they remit to the EU, defenders of existing policies (both member states and sectoral interests) want to retain what they have, while others want the EU to spend more on emerging priorities. Only two out of three can be satisfied.

However, there has long been a second dimension to the EU's public finances, consisting of borrowing and lending operations, especially through the European Investment Bank (EIB). These had previously attracted hardly any of the acrimony surrounding the MFF (Laffan 1995). Latterly, though, this has begun to change with the recognition that the "galaxy" of EU financial mechanisms has become what the subtitle of a European Court of Auditors report (ECA 2023) calls "a patchwork construction," beset by procedural and accountability challenges.

Figure 1

The EU's Budgetary Quandary



Source: Author's compilation. © ifo Institute

THE GOVERNANCE CHALLENGES ASSOCIATED WITH INCREASED BORROWING AND LENDING

The proliferation of these off-budget mechanisms had been captured in a chart developed by the secretariat of the EP's Budget committee in 2017,[5] already at that time reflecting an unease about the use of mechanisms over which the Parliament had much more limited oversight than it does with the MFF. The main concern was about legitimation of measures offering financial support for EU policies for which the Commission and, especially, the Council were in the driver's seat while the Parliament was sidelined. Other sources of disquiet included potential contingent liabilities and the resort to diverse procedures or Treaty articles to launch the funds.

NGEU, although formally a temporary mechanism, accentuates these concerns. In EU jargon, the money raised to fund it is classified as external assigned revenues (EAR), a category that has been used, notably, for the payments made by non-EU countries (for example, Norway) towards EU programs in which they participate, such as the Horizon research program. EAR are recognized in the EU's Financial Regulation (Article 21.2) but had been only a small proportion of the aggregate revenue. However, they are at odds with one of the core principles of the EU budget, universality, which dictates that all revenues should go into a common pot and, thus, not be hypothecated to par-

[3] Begg et al. (2022), a study for the European Parliament, provides details.

[4] Data for the last 20 years is brought together in a spreadsheet made available by the European Commission, https://commission.europa.eu/strategy-and-policy/eu-budget/long-term-eu-budget/2014-2020/spending-and-revenue_en.

[5] It shows the sheer variety of mechanisms, ranging from the Facility for Refugees in Turkey to the various funds created for bailouts during the sovereign debt crisis, https://www.europarl.europa.eu/cmsdata/113502/WS percent20galaxies percent20EU percent20Budget_17012017.pdf.

ticular policies. Small amounts of EAR could reasonably be overlooked from this perspective as reflecting specific circumstances, but funding on the scale of NGEU cannot so easily be dismissed.

Other budget principles are also being compromised. Unity requires that there be a single budget, but NGEU can be construed as a parallel budget on a similar scale to the MFF. Transparency is also at risk to the extent that funds supporting similar policy objectives – notably the green and digital transitions – adopt different rules of implementation, as seen in the rules applicable to NGEU and Cohesion Policy (within the MFF). There is also legal ambiguity about whether borrowing to fund EU policies is allowed, although Article 5 of the Own Resources decision (the legal text which governs the arrangements around the EU's revenues, formally ratified in 2021[6]) provides a form of derogation for NGEU, referring to the borrowing being temporary and for the sole purpose of addressing the consequences of the Covid-19 crisis.

EU borrowing takes distinctive forms. The loans to member states under NGEU are back-to-back (the EU borrows and lends on to the member state, which then has to repay) and, in principle, expose the EU to financial risk only in the rather unlikely event of a default by the recipient. When it was launched, the historically low interest rates meant that the Commission, with its AAA classification from rating agencies, could borrow very cheaply compared with some of the more fiscally stressed member states, in effect enabling them to fund certain public investments on more favorable terms than if they had borrowed themselves. Most of the many other borrowing mechanisms are also back-to-back as explained in the 2023 overview by the European Court of Auditors,[7] although the report also draws attention to differences in the detail.

By contrast, borrowing for the grant component of NGEU has to be serviced and, in time, repaid. The money for this will have to come from future EU budgets after 2027, notwithstanding the fact that this relies on a deal (the next MFF) which is unlikely to be struck until 2026 at the earliest and subsequent iterations of it up to 2058. The inter-institutional agreement on NGEU stipulates that this "should not lead to an undue reduction in programme expenditure or investment instruments under the multiannual financial framework" (European Union 2021, 28).

NEW EU OWN RESOURCES

A key part of the Own Resources decisions ratified in 2021 was to provide for the introduction of new own resources – revenue sources assigned to the EU level to fund EU spending – which would be hypothecated to the NGEU repayments. A casual reader might infer that by agreeing to new resources, the risks to existing EU spending would be nullified, but one further line in the agreement is also worth noting: "It is also desirable to mitigate the increases in the GNI-based own resource for the member states." To put this in context, the great bulk of current funding of the MFF comes from what are referred to as "national contributions," of which a resource calibrated on the gross national income (GNI) of member states accounted for over two-thirds of all own resources: EUR 104 billion of a total of EUR 154 billion in 2022. Projected figures for 2023 are EUR 108 billion and EUR 157 billion.

Efforts to identify and introduce new own resources for the EU have gone on, sporadically, ever since the 1988 reform of the EU budget, but in all that time, only one has been introduced (in 2021): a levy based on the weight of unrecycled plastic in each member state. The proceeds of this levy have raised an average of around EUR 6 billion per annum, about 4 percent of total own resources. Moreover, no fewer than 17 member states have their ex ante contributions under this heading abated, reducing its value by some EUR 710 million each year. Plainly, therefore, much more will be needed if the aim of using new own resources to repay the NGEU borrowing is to be realized.

Obvious questions are "what" and "when"? At the end of 2021, the Commission presented proposals for a first "basket" of new own resources, comprising:

- 25 percent of the revenue from the EU's Emission Trading Scheme (ETS). These revenues are currently allocated to the member states which auction the permits, with a small proportion earmarked for the European Investment Bank to use for the EU Innovation and Modernisation Funds;
- 75 percent of the revenue from a European carbon border adjustment mechanism (in effect a tax on products with high embedded carbon emissions imported from third countries); and
- 15 percent of the residual profits of large multinational companies, payable to countries where products are consumed, as a result of an OECD/G20 decision (European Commission 2021).

According to the Commission's estimates, the annual yield from these three resources would be, respectively, EUR 9 billion, EUR 0.5 billion, and EUR 2.5–4 billion, making a total of EUR 12–14 billion. However, a proportion of the ETS revenue is expected to be used for a new Social Climate Fund, operational starting in 2026 and intended to shield vulnerable households from higher energy costs resulting from the expansion of the ETS to include road transport and energy costs. A statement on the Commission website[8] reveals that this new fund will "mobilize EUR 86.7 billion from 2026 to 2032" – EUR 12.3 billion per annum, albeit with

[6] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0570.
[7] Op. cit.

[8] https://climate.ec.europa.eu/eu-action/eu-emissions-trading-system-eu-ets_en#documentation.

co-financing from member states. Unless the member state contributions constitute a high share, the net revenue from the ETS will be substantially eroded.

Two problems are immediately apparent. First, the likely proceeds from these three resources will fall well short of what will be needed to pay off the NGEU borrowing, especially if the ETS revenue goes largely to the Social Climate Fund. The original headline total of NGEU borrowing was EUR 750 billion at 2018 prices, with EUR 390 billion for grants and the balance of EUR 360 billion for back-to-back loans to member states. A 2 percent per annum allowance for inflation has taken the nominal value of the debt above EUR 800 billion, to be repaid over thirty years. Assuming no costs to the EU budget of the loan component, repayment of the money borrowed for grants, if amortized at a steady rate, will be on the order of EUR 14–15 billion per annum – at least 7 percent of the annual budget.

The second immediate problem is that both the ETS and the CBA have to be thought of as "Pigouvian" taxes; such taxes have a dual aim of raising revenue and deterring socially damaging practices. If they succeed in the latter aim, the revenue they raise will tend to fall – perhaps not dramatically in the short run, but enough over time to call into question their ability to provide a steady revenue stream. To the extent that this happens, other resources – most likely the GNI resource; in other words, payments from national treasuries – would have to make up the difference.

More fundamentally, the political narrative behind using new own resources to meet the costs of NGEU is flawed because it disguises the associated burden on taxpayers or national treasuries. New own resources may limit the calls on the GNI resource, but it is a statement of the obvious that they displace the burden to other taxes. NGEU was undeniably a worthwhile and timely initiative, important for the European "project" in demonstrating a capacity to respond to crisis, but to revive an old aphorism, there is no such thing as a free lunch.

POLICY CONCLUSIONS

Muddling-through is often the default in EU decision-making and is undeniably exemplified in developments in the Union's finances. A strong status quo bias in successive rounds of MFF negotiations and a lack of an overarching strategy in establishing new, off-budget mechanisms testify to a caution in finding enduring solutions, but also contribute to a growing incoherence in the financial architecture. Ad hoc responses to crises, though well-intentioned, have been the norm rather than the exception and one of the proposals in the recently published proposals for the mid-term review of the current will add another: a new fund for the reconstruction of Ukraine (European Commission 2023). The proliferation of such funds will leave a legacy of unresolved problems and unintended consequences that will have to be confronted before they spiral out of control. Two of the most salient are the costs of financing and legitimation.

The recent rise in interest rates in response to the surge in inflation has altered the favorable arithmetic of 2020 for debt service and could become a sizeable burden on the MFF in future. Again, some illustrative numbers can be instructive. For EUR 800 billion of debt, every percentage point of the interest rate means an annual debt service charge of EUR 8 billion, already more than the proceeds of the plastics resource. Even if only the grant component of NGEU is taken into account, the annual cost for each percentage point of interest would be at least EUR 4.2 billion. With interest rates at 4 percent or above, the burden will be substantial and, although an optimistic view that central banks may succeed in returning to a 2 percent inflation target is not implausible, it is likely to be a slow process.

The legitimation question has multiple dimensions. Many of the loan-based mechanisms in the galaxy of EU finances were agreed on at speed, principally by the Council, but with only limited involvement of the European Parliament in decision-making or subsequent oversight. In many cases, a credible justification can be advanced about the necessity of acting urgently. However, the outcome is that significant EU policies are being funded by mechanisms that are not subject to the same scrutiny as spending from the MFF. Some of the policies in question have similar objectives, especially in relation to the green and digital transitions, but are administered in different ways. In addition, legitimation is called into question by the diversity in legal bases used for different instruments.

Politically and institutionally, a new approach is now needed for the EU's finances. Overcoming the strong status quo bias is always difficult, but likely new demands on the EU will also require fresh thinking on how to structure new mechanisms and, as discussed by Buti et al. (2023), to give greater priority to European public goods, as opposed to national public goods funded by the EU. A third of a century on from the last major reform of the MFF, are decision-makers ready to confront these challenges?

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