EU BUDGET POLICY BRIEF

THE EVOLVING NATURE OF THE EU BUDGET

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Budget

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1. INTRODUCTION

SUMMARY

The EU budget has evolved over the decades in terms of its financing, expenditure components and functions. In spite of its relatively small size compared to Member States' budgets, the multiannual financial framework has a considerable structural and macroeconomic impact which is substantially reinforced with NextGenerationEU. However, the composition of EU budget expenditures and especially revenues has not changed very much over time. Moreover, the EU budget's limited flexibility, while related to its role of supporting long-term investments and necessary for financial predictability, has made it harder to respond to a rapidly changing environment. Going forward, a number of questions remain open, including the future of the EU budget's own resources system, the implications of NextGenerationEU for future policy action, how the EU budget can maximise its socio-economic relevance, its role in the EU's economic governance and how to ensure a more coherent EU financial architecture.

The EU budget is at the heart of EU policy action and plays a key role in the process of European integration. By financing EU programmes, the budget supports the EU's political priorities and contributes to the EU's structural transformation and economic growth. Also for this reason, major reforms of the Union have been accompanied by reforms of the EU budget.

The multiannual financial framework (MFF) for 2021-2027 presents several novelties compared to the past. First, it is by far the biggest EU multiannual budget ever, amounting to EUR 2.018 trillion in current prices when considering the MFF and NextGenerationEU. Second, for the first time, with NextGenerationEU the EU will issue common debt to finance spending programmes through the EU budget. Third, it is the first budget for the EU with 27 Member States after the departure of the United Kingdom. Fourth, for the first time since 33 years it includes a new own resource - a national contribution based on non-recycled plastic packaging waste - with additional new own resources to be proposed to help repay the NextGenerationEU debt. Fifth, for the first time there is a general regime of conditionality to protect the Union's budget, establishing respect for the rule of law as an essential precondition for sound financial management and thus as a requirement for receiving EU funding. Finally, the 2021-2027 MFF expenditures have a stronger focus on EU added value.

In spite of these novelties, some challenges remain, in particular given the traditional inertia of the EU budget's expenditure, and most notably revenue components and its relatively small size compared to Member States' budgets. The MFF still amounts to around 1% of EU gross national income (GNI), excluding NextGenerationEU, which is temporary.

This policy brief describes how the EU budget has gradually evolved and proposes issues for future reflection and debate. Section 2 describes the evolution of the EU budget from a historical perspective, and the challenges arising from the trade-off between budget stability and flexibility as well as the evolving EU priorities. Section 3 focuses on the 2021-2027 MFF and NextGenerationEU. Section 4 analyses the EU budget's impact and the novelties in its financing. Section 5 provides some basic questions for future discussion.

2. THE EU BUDGET: A GRADUAL PATH TO CHANGE

The EU budget has gradually evolved in step with the European integration process. The separate budgets created with the European communities in the 1950s were merged in different steps and finally became a single budget only in the 2000s. Major changes in the revenue and expenditures were made in the 1980s with the Delors I and II packages. On the funding side, the own resource based on Member States' GNI was introduced with the Delors I package in 1988 and has been the first, and only, major reform to date. On the expenditures side, the common agricultural policy (CAP) dominated the budget until the 1980s, and has since then gradually decreased in relative terms, largely to the benefit of cohesion policy and, to a lesser extent, new emerging policies.

After the introduction of the GNI-based own resource, progress to reform the revenue side of the budget was quite limited. This own resource strengthened the revenue side of the budget, but it rapidly became the main source of financing, representing 80% of revenues. By contrast, traditional own resources (TOR, i.e. custom duties and sugar levies) represented on average about 11% of total revenues (Graph 2.1).

The EU budget's dependence on national contributions fuelled the claims for a *juste retour* (i.e. a 'fair return') or for limiting gross contributions. The original aim of the GNI-based contribution was to ensure that the financing of the EU budget would be predictable. But as a result of its introduction, Member States increasingly measured the benefits from their EU membership by simply comparing the contributions to the EU to the direct cash receipts coming from EU programmes, ignoring the substantive benefits of joint action. This approach became even stronger as cohesion policy gained weight in the budget and in the absence of a reform of the own resources system. This was also a departure from the approach of the TOR, which stem from a common policy (the customs union). Financially as well, the incidence and the proceeds of TOR cannot be easily attributed to any particular Member State [1]. The proposals to introduce new sources of revenue, first in the 2004 own resources report and later in the 2014-2020 MFF, did not receive the necessary unanimous support [2].

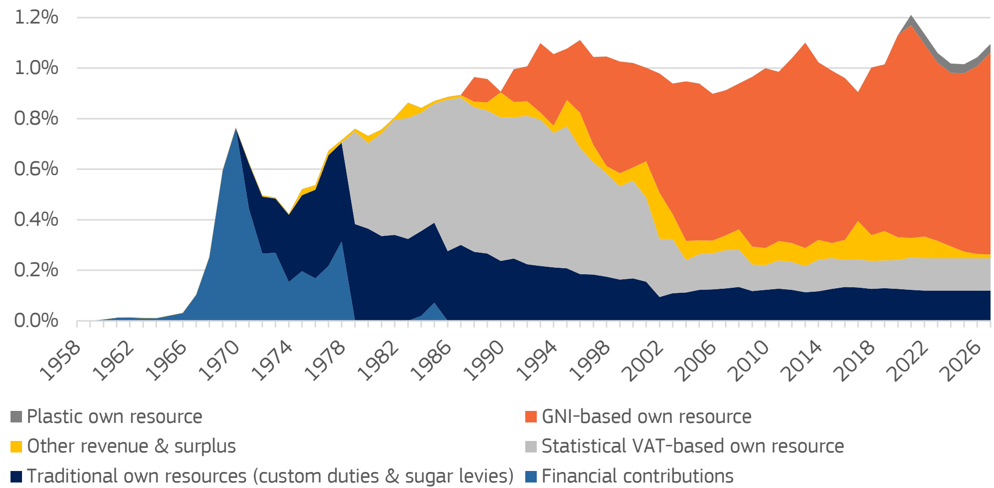
The Delors reform also brought with it the concept of a *global own resources ceiling* to strengthen budgetary discipline by setting a maximum limit on the own resources that could finance the EU budget in any given year.

(1) European Commission (2016) Future financing of the EU – Final report and recommendations of the High Level Group on Own Resources, December 2016.

(2) See COM(2004)505 final, vol. I.

Graph 2.1. Sources of financing of the EU budget, 1958-2018

Source: European Commission, AMECO

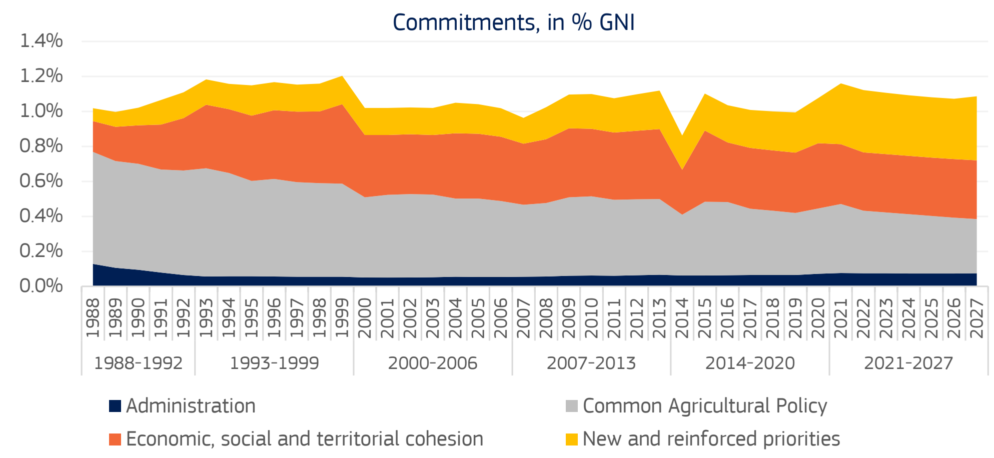


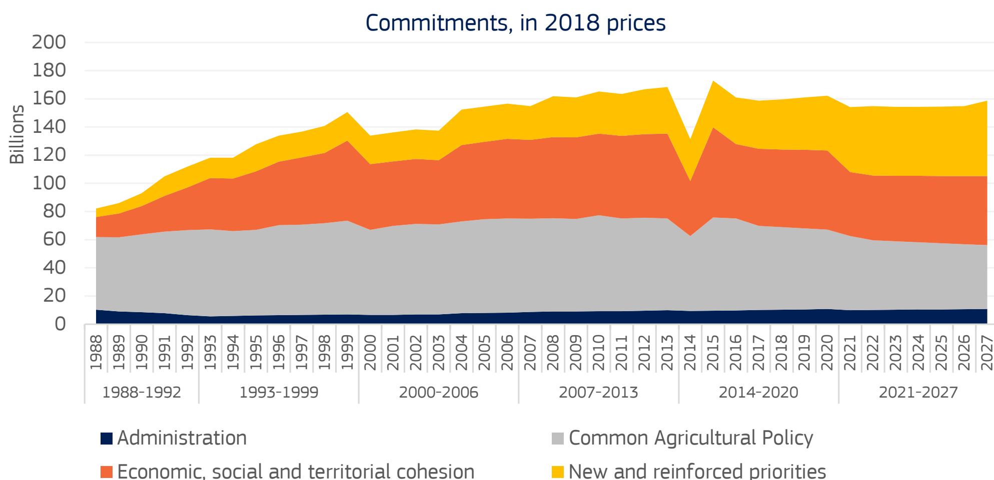
Expenditures developed in line with EU policy priorities over the decades (Graph 2.2). The common agricultural policy has been traditionally the major spending block of the EU budget. However, the 1986 enlargement and the Single European Act paved the way for a reform that would ultimately extend EU expenditure beyond agriculture. The scope of EU competences broadened, and cohesion policy started gaining ground. The 1980s also saw the launch of the first Europe-wide framework programme for research (1984) and the launch of the Erasmus programme (1987). The 2004-2007 enlargements further strengthened the role of cohesion policy, in combination with successive EU strategies to support jobs and growth. As shown in Graph 2.2, the CAP only started a declining trend in constant prices in 2016.

Graph 2.2. Main categories of expenditure of the EU financial frameworks (1988 – 2027) [(3)]

Source: European Commission, AMECO (August 2021).

Note: Data are based on the financial perspective/ framework ceilings in commitment appropriations, current prices - including adjustments for enlargement, reprogramming for late adoption of national programmes and MFF annual technical adjustments, where applicable.



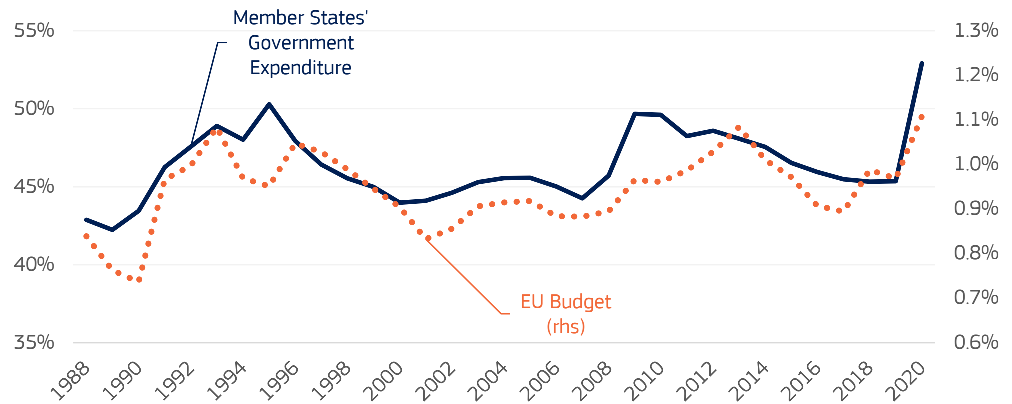


(3) The drop in 2014 was due to the late adoption of the legislation for the 2014-2020 MFF, when amounts in shared management (mostly cohesion) initially planned to be used in 2014 were transferred to 2015-2017.

Graph 2.3. Member States' government expenditure and EU budget (% GDP), 1995-2019

Source: European Commission.

Note: 'EU Budget' refers to total budget payments in the year.



The Lisbon Treaty (2009) brought new policy priorities more prominently to the forefront, including climate, migration, research and innovation. But they have only slowly gained ground in the EU budget. The reason for this has been the overall stable size of the EU budget relative to GDP (Graph 2.3) combined with a predominance of expenditures for agriculture and cohesion policies, which comprise pre-allocated national contributions and have been strongly favoured by Member States. By comparison, EU Member States' government expenditure was close to 46% of GDP on average between 1988 and 2020. The limited size can be explained by the EU budget's strong dependence on national contributions in the absence of sizeable and genuine EU own resources.

In addition, with a multiannual perspective, the EU annual budgets operate in a stable framework over the reference period – which has traditionally been 7 years. For Member States, this gives certainty and predictability for the planning of their national budget contributions. For the EU as a whole, a multiannual perspective avoids recurrent complex negotiations. However, the result is that the EU long-term budget is much more prescriptive than Member States' multiannual budgetary frameworks, as most of the financial possibilities for the coming 7 years are de facto pre-established, including through 'pre-allocated national envelopes' for agricultural and cohesion policies.

There is a trade-off between the multiannual budget having stability and predictability and it being able to address unexpected large shocks. For example, the response to the 2008 financial crisis and the sovereign debt crisis was mostly off-budget. The MFF was amended in 2009 to include a EUR 5 billion 'European economic recovery plan' (0.5% of the MFF), but the sovereign debt crisis that hit several EU Member States and the associated economic crisis required a much more substantial financial and reform effort. Euro area Member States first agreed on two temporary funding programmes: the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM). They were replaced in 2012 by a permanent mechanism, the European Stability Mechanism (ESM), with a maximum lending capacity of EUR 500 billion. The ESM, however, is an intergovernmental organisation falling outside the scope of the EU budget framework.

The EU's ability to respond to evolving needs and priorities has been largely dependent on using the limited flexibility embedded in the EU budget (Box 1) as well as additional, largely off-budget tools, institutions and instruments. Different tools, institutions and instruments, often outside the EU budget and not governed by the same rules, complement the EU budget [4]. Additional funding is provided by the European Investment Bank or other bodies based on intergovernmental agreements. EU trust funds and other facilities such as the EU Facility for Refugees in Turkey have been created to pool money from the EU budget, Member States and other donors to address external crises. An example of a successful novel tool is the European Fund for Strategic Investment: the EU budget leveraged EIB lending through a EUR 26 billion guarantee, which allowed over EUR 500 billion in investments to be mobilised between 2015 and 2020 [5]. This extended financial architecture has allowed the Union to mobilise additional funding, but it has added to the complexity of EU finances. At the same time, these new methods of delivery can be highly efficient, as they maximise the investments that the EU budget can trigger.

(4) COM(2017)358 final.

(5) https://www.eib.org/en/publications/efsi-the-legacy

USING FLEXIBILITY UNDER THE 2014-2020 MFF

Early on, the 2014-2020 multiannual financial framework was put to the test. All the flexibility provisions under 'special instruments' were exhausted by the end of the period – which also showed their limitations. These instruments, which are over and above the expenditure ceilings of the long-term budget, can mobilise additional financial support in case of specific unforeseen events, such as natural disasters and emergencies, or new policy needs.

Without these instruments, the Union would not have been able to react to the same extent simply because the spending ceilings decided in 2013 for key policy areas (growth and jobs, migration and security, cooperation with third countries) could not cater for new needs. The flexibility toolbox allowed the Union to launch new initiatives – such as the European Fund for Strategic Investments or the Youth Employment Initiative – and react swiftly to crises. An additional EUR 9.3 billion were mobilised to support Member States and non-EU countries in dealing with the asylum and migration crises.

The EU budget was mobilised to respond quickly and flexibly to the most pressing needs brought by the COVID-19 pandemic. All means and flexibilities were used. Moreover, proactive budgetary management ensured speedy and effective implementation of the 2020 budget: nine amending budgets were adopted as proposed by the Commission, more than in any other year in the 2014-2020 period. By the end of April 2020, the following measures entered into force:

- the Coronavirus Response Investment Initiative under cohesion policy, facilitating flexibility arrangements and mobilising resources for Member States to support healthcare, small businesses and workers;
- reactivation of the Emergency Support Instrument to fight the cross-border health emergency;
- additional financing for the Union Civil Protection Mechanism / rescEU to provide immediate disaster relief to the most affected areas;
- extension of the EU Solidarity Fund to cover major health crises in addition to natural disasters.

However, as these measures were not sufficient to address the social fallout of the pandemic, a novel financial instrument – the support to mitigate unemployment risks in an emergency programme (SURE) – consisting of up to a total of EUR 100 billion in loans to Member States, was also created, and came into force in May 2020.

3. THE 2021- 2027 MULTIANNUAL FINANCIAL FRAMEWORK AND NEXTGENERATIONEU

Negotiations for the 2021-2027 MFF took place at a time of dynamism for the Union, but also of great challenges. This section outlines the main challenges faced in preparing and negotiating the EU budget for 2021-2027 as well as the main novelties that the agreed package offers as a response.

3.1 Preparing an MFF to address new challenges in and outside Europe

This is the first MFF with a European Union at 27 amid significant cross-border challenges. The United Kingdom's withdrawal from the European Union meant the loss of a significant contributor to the budget, and at the same time, the MFF needed to be sufficiently ambitious, resourced and flexible to manage new priorities and deal with new political challenges.

Modern challenges are increasingly transnational in nature, and EU action can bring significant value added. EU added value is the value (in terms of e.g. output, employment, but also non-economic dimensions) created through EU intervention (e.g. legislation, expenditure, action plans, etc.), in addition to what would have been otherwise created by Member State action alone.

These challenges include:

- **Climate change:** climate change and environmental degradation pose a serious threat. The estimated investment needs across the EU to address the risks associated with climate change and reach the EU's 2030 climate and environmental policy goals are significant, amounting to EUR 470 billion per year [6].

- **The digital transformation:** digitalisation has been transforming global societies, and the COVID-19 pandemic has accelerated this trend. In the area of digitalisation, the EU should close the technological innovation and investment gaps with global competitors. The European Commission estimates investment needs in this field at about EUR 125 billion per year [7].

- **Security and defence:** instability in Europe's neighbourhood and new forms of terrorism and cyber threats are examples of how the global context has changed. In addition, equipment and research and development costs in the defence sector have increased.

(6) European Commission (2020a) SWD(2020)98 final.

(7) European Commission (2020a), ibid.

- **Migration and refugee flows:** the refugee flows and migration that came to the fore in 2015 confirmed the need for action at EU level. Migration and border management will continue to remain a long-term challenge for the Union and require adequate European funding. This is especially true given the demographic dynamics and instability in Europe's neighbourhood and increasing humanitarian needs in third countries.

- **The need for a stronger Europe in the world:** The volatile and complex nature of external relations and geopolitics called for a stronger Europe in the world with an adequate, flexible and simplified budget.

- **Rule of law:** as part of the evolving efforts towards sound financial management and respect of the rule of law, there was growing support to link the disbursement of EU funding to compliance with the rule of law in EU Member States.

Last but not least, the COVID-19 pandemic and associated crisis and its socio-economic consequences have created unprecedented needs. In the second quarter of 2020, GDP in the EU dropped 13.8% compared to 2019. The EU provided an immediate response to the pandemic (see Box 1) and presented a comprehensive recovery plan.

3.2 The agreed 2021-2027 MFF: novelties and a few missed opportunities

The 2021-2027 MFF and NextGenerationEU can be considered a paradigm shift in light of the magnitude of the challenges. Even if designed as temporary, some of the features of NextGenerationEU will leave a permanent mark on future long-term EU budgets and the political and policy debates surrounding it. Broadly speaking, the novelties of this response concern the size of the budget, the expenditure components, revenue and qualitative elements.

3.2.1 Size

The 2021-2027 budget amounts to EUR 2.018 trillion in current prices (1.8% of the EU's GNI). This includes a EUR 1.21 trillion MFF and EUR 807 billion for NextGenerationEU, representing the biggest package ever financed under the EU budget. As the largest programme in NextGenerationEU, the Recovery and Resilience Facility (RRF) will distribute up to EUR 723.8 billion in grants and loans to Member States for investments and structural reforms.

This results in an EU budget of macroeconomic relevance. With NextGenerationEU, the EU budget can also exert a meaningful stabilisation function to counter the impact of the COVID-19 crisis. In this regard, an important novelty in the EU's response to the crisis is that the expenditure financed by the RRF through grants will not affect national deficits or debt because the financing comes from the EU. Therefore, the Facility is expected to provide substantial fiscal support to the economy, which is particularly relevant for EU Member States with less fiscal space.

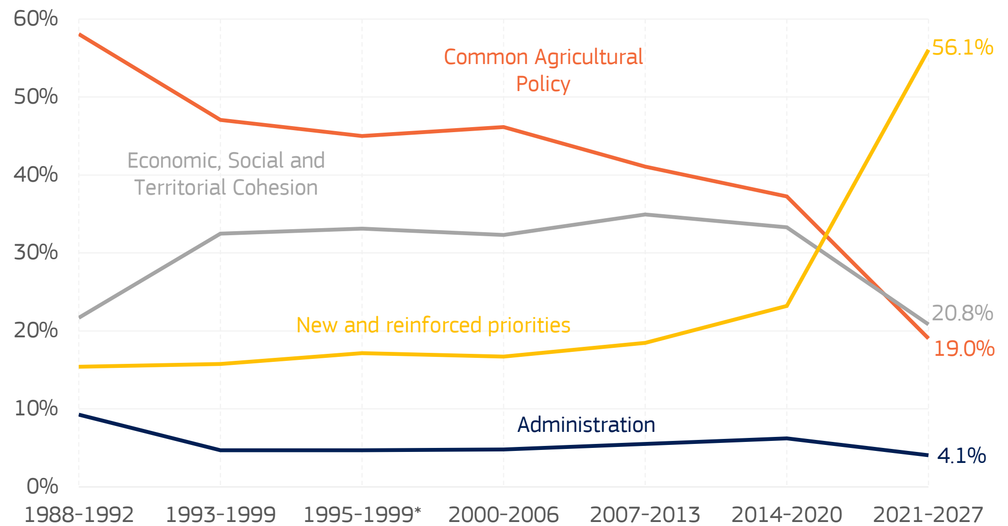
3.2.2 Expenditure components

Over 50% of the long-term EU budget and NextGenerationEU will support modern policies (Graph 3.1). For the first time, the MFF allocations to policies other than agriculture and cohesion policy account for the highest share within the MFF, i.e. 31.9% (see Graph 3.2). The EU's geopolitical role is reinforced through external action instruments, through NDICI-Global Europe and as a result of the impact of the EU bond issuances that NextGenerationEU brings on global capital markets.

Graph 3.1. Share of the main policy areas in the MFFs (with NextGenerationEU)

Source: European Commission

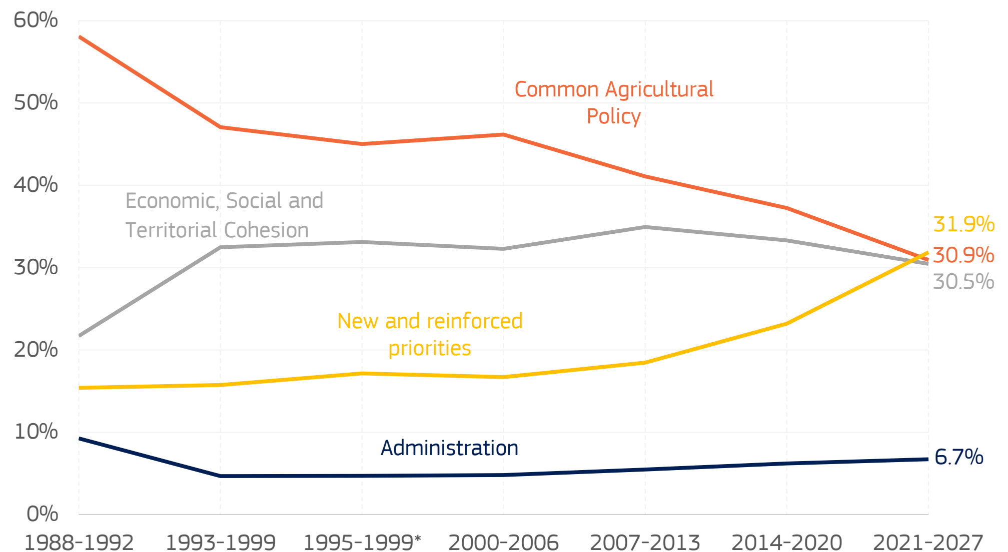
Note: Data are based on the financial perspective/ framework ceilings in commitment appropriations, current prices - including adjustments for enlargement, reprogramming for late adoption of national programmes and MFF annual technical adjustments, where applicable.



Graph 3.2. Share of the main policy areas in the MFFs (without NextGenerationEU)

Source: European Commission

Note: Data are based on the financial perspective/ framework ceilings in commitment appropriations, current prices - including adjustments for enlargement, reprogramming for late adoption of national programmes and MFF annual technical adjustments, where applicable.



The 2021-2027 MFF and NextGenerationEU are expected to foster the structural transformation of the EU economy and its societies. 30% of the EU budget (both MFF and NextGenerationEU) will go to fight climate change. In addition, 20% of the RRF will be invested in the digital transformation. Section 4.2 discusses more in detail the role of the MFF in structural transformation.

In spite of this evolution, the changes remain of an incremental nature compared to previous MFFs. This is in large part due to the fact that Member State unanimity is required to approve the MFF. For many Member States, the focus in the 2021-2027 MFF remained on pre-allocated amounts. For others, the debate was centred on national contributions and the objective of keeping them at a low and steady level. In interinstitutional discussions, an important priority of the European Parliament was to increase the allocation for specific spending programmes. Because of all these developments, the programme funding amounts in the 2021-2027 MFF are especially rigid.

The Commission had proposed greater flexibility in the MFF and a reinforcement of the EU's capacity to react to new and emerging priorities and/or emergencies through 'special instruments'. Special instruments can be triggered to respond to unforeseen unfavourable events such as natural disasters and are over and above the expenditure ceilings of the long-term budget, both for commitment and payment appropriations. The maximum total amount that can be used for special instruments in 2021–2027 is approximately EUR 16 billion against the Commission's May 2020 proposal of EUR 38 billion [8]. The Commission had also proposed a mid-term review of the MFF in 2023, as was the case in 2014-2020. The review then had been instrumental in boosting the EU budget's flexibility to respond to unforeseen events. These proposals were not accepted, which will likely limit the Union's capacity to respond to new or emerging needs in a complex global environment, and could lead to politically complex revisions of the MFF over the seven-year period.

3.2.3 Financing the EU budget

The new EU budget requires an ambitious financing system. NextGenerationEU will be financed by raising funds on capital markets. The Own Resources Decision[9], which entered into force on 1 June 2021, empowers the Commission to act on behalf of the Union and borrow up to EUR 806.9 billion on financial markets until 2026. The EU was not new to borrowing on financial markets. But the size of this temporary programme, which comes on top of SURE, and its use to finance grants to Member States, are unprecedented for the EU (see Section 4.3). The political agreement to allow borrowing for spending was a real game changer also for stabilising tensions in financial markets. The own resources ceiling was increased to 1.4% of EU gross national income to underpin the financial backing of EU Member States to a Union of 27 in a volatile economic environment and further unforeseen circumstances. An additional temporary increase of 0.6% of EU GNI was granted to guarantee NextGenerationEU repayment obligations and to ensure the Union retains its strong credit rating while expanding its debt issuance programme.

Union borrowing will also help to make the EU budget the world's greenest budget. Union borrowing on capital markets for NextGenerationEU will raise up to EUR 250 billion in green bonds – 30% of the total issuance. This will make the EU the biggest issuer of green bonds on financial markets, thus further consolidating the Union's commitment to fighting climate change on the financing side of the budget.

(8) The amounts are expressed in 2018 prices. The Brexit Adjustment Reserve is not included.

(9) Council Decision (EU, Euratom) 2020/2053.

Member States also agreed on committing to reform the system of own resources. The new Own Resources Decision entered into force in June 2021, simplifying the VAT own resource and introducing a new own resource based on non-recycled plastic packaging waste. This is a novelty, given that since the 1980s, reforms of the own resources system had been extremely limited. The plastic-based own resource reinforces the link to EU policy objectives that are mainly supported via the expenditure side of the budget. It will also support the EU binding targets to achieve 50% of recycling by 2025 and 55% by 2030. Moreover, as part of the interinstitutional agreement of 16 December 2020 between the European Parliament, the Council and the Commission, the Commission committed to propose new own resources to support the repayment of NextGenerationEU and will present its proposals before the end of 2021.

However, Member States could not agree to a full modernisation of EU revenue by abolishing the system of budget discounts. With the end of the United Kingdom's rebate and the reformed and modernised expenditure side of the new MFF, the Commission in its 2018 proposal suggested gradually phasing out all other correction mechanisms. While Member States agreed to a significant simplification by transforming all corrections into lump sum discounts to some Member States' GNI-based gross contribution, they could not reach a consensus on their reduction over time.

All in all, the GNI contribution in the 2021-2027 MFF will still represent about 70% of total revenues. Yet, a thorough transformation of the own resources system, which would move the emphasis away from national contributions and towards more 'genuine' own resources, could improve the financial autonomy of the EU budget. In addition, new own resources should be used to support EU policy objectives from the revenues side. The EU budget's impact could benefit if the revenue and the spending side evolved at the same pace in line with EU policy needs and priorities.

Section 4.3 discusses the innovative revenue aspects of the EU budget more in depth.

3.2.4 Qualitative innovations

Firstly, the framework for protecting the EU budget against fraud and irregularities has been reinforced. The new Regulation [10] on a general regime of conditionality for the protection of the Union's budget will complement existing tools to further protect the EU budget. This legislation makes the disbursement of EU funds from the MFF or NextGenerationEU conditional on respect of the rule of law principles. In addition, controls and audits will be supported by improved data availability on projects, beneficiaries, contracts and contractors that might be susceptible to risks of fraud, conflict of interest and irregularities. To that end, a single data-mining tool for the European Structural and Investment Funds, the common agricultural policy and the RRF has been put in place.

(10) Regulation (EU, Euratom) 2020/2092.

Secondly, the European Development Fund (EDF) budgetisation puts an end to a lengthy political debate on its integration within the EU budget. This change matters quantitatively (estimated at around EUR 30 billion over 7 years) and qualitatively. In fact, it helps in simplifying the EU financial architecture and aligning decision-making with the growing co-decision process and the European Parliament's related growing scrutiny over EU legislation and spending instruments. Moreover, it makes it easier to monitor progress on the EU commitment to devote 0.7% of gross national income to official development assistance.

Thirdly, the RRF introduces a novel method of delivering EU funds, whereby payments are made when Member States achieve reform and investment targets. Member States drew their own national plans for investments and structural reforms, and the Commission and the Council subsequently reviewed and endorsed these plans. Importantly, Member States will receive financial support for implementing structural reforms, which are crucial to foster growth and reinforce the link between the EU budget and the EU economic governance processes (European Semester). The Social Climate Fund [11], which will help alleviate the social consequences of the climate transition, has been recently proposed to follow the delivery model of the RRF.

Finally, the European Commission has published its budget performance framework, putting performance at the heart of the budget implementation. The published performance framework [12] underlying the 2021-2027 MFF and NextGenerationEU comprises all the tools and procedures needed to set objectives and to measure and monitor the progress towards them, with the objective of ensuring that spending EU resources brings maximum value for EU citizens.

(11) COM(2021)568 final.

(12) Communication from the Commission to the European Parliament and the Council on the performance framework for the EU budget under the 2021-2027 MFF – COM(2021)366 final.

4. THE IMPACT OF THE EU BUDGET

4.1 A budget with a macroeconomic impact and generating value added

In spite of its relatively small size, the EU budget has a considerable macroeconomic impact and contributes to the creation of 'EU value added'. As a community of rules, EU added value stems largely from the Union's regulatory power. Yet, the budget plays an important role, in that it provides resources to those areas where EU added value is highest. In this section, we discuss how EU funds can foster growth through investment in physical and human capital, which contributes to increased capital formation and labour productivity. This aspect is even more relevant in the 2021-2027 period through NextGenerationEU. Moreover, to promote convergence and social, economic and political cohesion, the EU budget has an important redistributive component, in particular through cohesion policy. Finally, it also has an indirect impact on fiscal policy.

4.1.1 Fostering economic growth

A number of studies have tried to measure the growth impact of EU integration and of EU funds, in particular cohesion policy [13]. They provide heterogeneous and sometimes contradictory findings, owing to the differences in data sets, analytical methodologies, and periods observed. Fidrmuc et al. (2019) find positive and significant growth impact from EU regional funds due to cross-country and cross-region spillovers, and confirmed earlier literature results suggesting that the positive effect on growth depends on Member States' own institutional quality. Indeed, previous studies had found that the positive impact of EU regional aid is conditional on the presence of sound institutions, decentralised government and high human capital stock [14]. Moreover, EU-level RDI is of a high European value added due to its strong economies of scale and efficiency gains. Analysis has shown that the EU funds for research and development have a significant impact, given that for every EUR 1 invested, EUR13 was generated in increased added value in the business sector [15].

A deeper look at EU programmes confirms the need to consider the EU budget's impact in a holistic manner, to the benefit of all Member States. First, the resources that the EU budget mobilises go beyond the direct budget transfers: significant resources are mobilised through financial instruments that crowd in private investors, and the funding mobilised by these instruments rivals in size with the EU budget itself. Financial instruments are in general designed to counter suboptimal investment situations and benefit all Member States, and in some cases (as e.g. in the case of the European Fund for Strategic Investment) some of the countries that contribute the most to the EU budget because of their relative prosperity are among the main beneficiaries of such financial flows [16]. In R&D, where returns to investment and attraction of capital are higher in more advanced countries, the main beneficiaries of such financial flows mobilised by

(13) A review is provided by, inter alia, Campos et al. (2014) and Fidrmuc et al. (2019).

(14) See Rodríguez-Pose and Garcilazo, 2015; Bähr, 2008; Rodriguez-Pose and Fratesi, 2004.

(15) Núñez Ferrer, J., Katarivas, M. (2014).

(16) See EIB (2021) 'Evaluation of the European Fund for Strategic Investments 2021'.

the EU budget are also these countries. Second, measuring the impact of EU funds simply based on budget transfers ignores the coordination, spillover and scale effects of EU action. These are especially relevant given the high degree of economic integration among EU countries: for instance, recent analysis suggests that the EU-wide GDP impact of NextGenerationEU is one third larger when explicitly accounting for cross-border spillovers [17].

The EU budget and NextGenerationEU are expected to have a significant impact in the recovery from the COVID-19 crisis. The MFF and NextGenerationEU can support the recovery via three channels: (i) by boosting aggregate demand; (ii) by supporting the most hard-hit countries, especially with NextGenerationEU; (iii) by strengthening the growth potential of the Union thanks to investments and structural reforms (Section 4.2). Overall, the RRF is expected to have both a short-term (through demand from higher public and private investment) and a medium-to-long-term impact on EU GDP (i.e. higher potential growth thanks to the investments and reforms). Even before its implementation, it made an economic impact by positively affecting expectations. Overall, the European Commission's 2020 Autumn Forecast estimated that NextGenerationEU could increase real GDP in the EU by around 2% if used for productive new investments that would not have been financed otherwise [18]. Structural reforms, whose effects are difficult to estimate, are expected to further increase growth [19].

The EU budget's impact on growth comes mainly through its investment programmes, and the EU budget helps to cushion the contraction in investment during a crisis. The EU budget's impact on investment is compounded by Member States' co-financing and in many cases also by the leverage effect of financial instruments crowding in funds from partnering institutions and private investors. EU funds also helped to put a floor to the contraction in public investment in EU Member States during the global financial crisis in 2008-2009 and the 2012-2013 recession. This was especially the case for the Member States hardest hit by the crisis. In Ireland, Portugal, Spain, Greece and Italy, EU investment funds (before taking into account national co-financing) represented on average more than one third of public investment during the global financial crisis (2009-2014) and post-crisis (2015-2019) years [20]. With NextGenerationEU, public investment might reach its highest levels ever in some Member States. This shows how the EU budget can have a counter-cyclical role.

However, NextGenerationEU is not fully a macroeconomic stabilisation instrument. NextGenerationEU is expected to accelerate the recovery after COVID-19. But funds have only started to be injected in the second half of 2021, i.e. after the peak of the crisis [21]. This is necessarily a consequence of the lengthy agreement and adoption process of the full 2021-2027 MFF. Moreover, based on the current agreement, NextGenerationEU is *una tantum* (i.e. a 'one-off'), which implies that, should a large negative shock comparable to that of COVID-19 occur under the next MFF, a similar tool would not be directly available.

(17) Pfeiffer et al. (2021).

(18) The IMF and the ECB proposed similar estimates (see Bańkowski et al., 2021). Other estimates point to an even larger effect: for instance, S&P Global Ratings estimates that GDP could increase as much as 4.1% by 2026.

(19) Pfeiffer et al. (2021), ibid.

(20) If we add national co-financing, this share increases to over 50%.

(21) C. Fuest (2021).

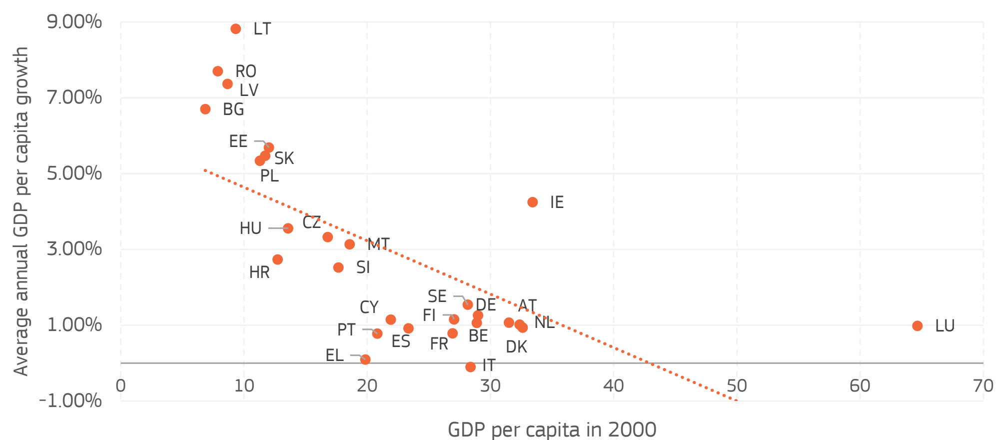
4.1.2 Promoting convergence between Member States

The EU budget is also a tool to foster convergence. One of the objectives enshrined in the Treaty on the Functioning of the European Union (TFEU) is to reduce economic disparities in the EU. Indeed, there has been a trend towards convergence between Member States in the EU (Graph 4.1), as the largest increases in real GDP per head are observed in those Member States with the lowest initial levels. The generalised trend towards convergence, however, masks strong differences across countries, in particular between central and eastern European Member States that have generally continued on their path to convergence to EU-27 average income, and southern European Member States, especially over the last decade [22]. Many factors are at the roots of this convergence process. But the EU budget and in particular EU structural funds played a role, as countries with lower GDP per capita also generally received higher funds relative to their GDP (Graphs 4.2-4.3) [23].

Graph 4.1. Convergence in GDP per capita across EU Member States, 2000-2019

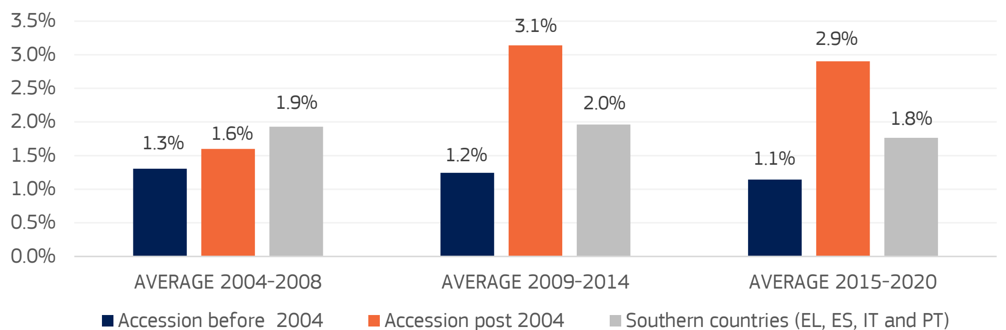
Source: AMECO and European Commission staff calculations.

Note: GDP per capita is expressed in thousands of purchasing power standards (PPS) at 2015 prices.



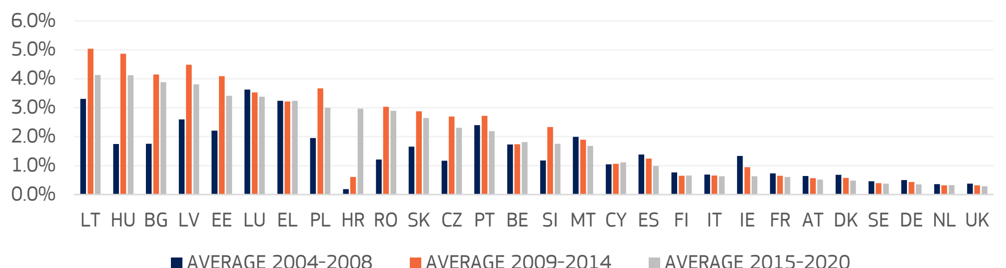
Graph 4.2. EU budget payments/GDP, country groups.

Source: European Commission – DG BUDGET and AMECO.



Graph 4.3. EU budget payments/GDP by country.

Source: European Commission – DG BUDGET and AMECO.



(22) European Commission (2017), SWD/2017/0330 final.

(23) See, for example, San Juan Mesonada and Sunyer Manteiga (2021).

4.1.3 Supporting national fiscal policies

The 2021-2027 MFF and NextGenerationEU will have an indirect impact on Member States' fiscal positions. The economic crisis resulting from the COVID-19 pandemic caused an increase in government deficit and debt levels, given the necessity to provide fiscal support. According to the European Commission Spring 2021 Economic Forecast, government deficits could reach 8% of GDP in 2021 in the EU (compared to 0.6% in 2019) and government debts over 102% of GDP. In this context, ensuring GDP growth above interest rates is crucial for debt sustainability. In this respect, the agreement on the 2021-2027 MFF and NextGenerationEU provided strong reassurance to markets and economic actors, and drives investor confidence in the EU. Moreover, high-quality, productive investments supported by NextGenerationEU can lift potential growth, thus contributing to this objective. The MFF and NextGenerationEU will also contribute to a supportive fiscal stance in 2021 and 2022 [24], as the expenditure financed by NextGenerationEU will have limited or no bearing on Member States' public finances. Moreover, it will prevent further divergence caused by the crisis, since several countries with more limited fiscal space were also among the hardest hit by the crisis.

4.2 A budget that fosters structural transformation

The 2021-2027 MFF and NextGenerationEU are expected to support structural transformation and have an impact on growth also in the medium-to-long run. This transformative function is analysed here with a focus on the green and digital transitions, the support for reforms in Member States as well as the EU budget support for policies having EU added value and pursuing Commission priorities.

The challenge of climate change has no borders and requires substantial investments and regulatory actions beyond Member State level. 30% of the EU budget including NextGenerationEU will be spent to fight climate change and help meet the targets agreed in the European Climate Law. Moreover, in 2026 and 2027, 10% of the annual spending under the long-term budget will help to halt and reverse the decline in biodiversity. The role of the EU budget in fighting climate change can also be seen on the revenue side of the budget. As mentioned in Section 3.2.3, the EU will raise up to EUR 250 billion on capital markets in green bonds to finance NextGenerationEU between 2021 and 2026. This is expected to have significant positive effects on the market for green financing, which is likely to generate positive spillovers into transition-relevant financing in the private sector. Moreover, the new own resource based on non-recycled plastic packaging waste is expected to encourage Member States to reduce packaging waste and stimulate the transition towards a circular economy. The Carbon Border Adjustment Mechanism, part of the 'Fit for 55' package proposed in July 2021, and the own resource based on emissions trading to be proposed in the coming months will also contribute to the fight against climate change.

(24) COM(2021)500 final.

The digital transformation will be supported through investments in digital infrastructure, digitals skills, high-performance computing capacities, the digitalisation of national administrations, artificial intelligence and cybersecurity, among others. Funds will be channelled through NextGenerationEU (20% of the RRF will be allocated to the digital transition) and through the MFF, and will be used, for example, to set up a dedicated Digital Europe programme and for expenditures under Horizon Europe, the European Space programme, and the Connecting Europe Facility – Digital.

Through the RRF, NextGenerationEU will support reforms addressing some of the long-standing structural impediments to Member States' potential growth and inclusion. These barriers to growth existed, in large part, before the COVID-19 economic crisis, as they were highlighted, for example, in the country-specific recommendations issued to Member States within the European Semester process. But the crisis made addressing them even more urgent. The novel delivery method of the RRF comes with the ambition to overcome the somewhat sluggish reform record observed in recent years across Member States [25]. Key areas for reform include education, health, the business environment, employment, public administration and the financial sector. The Technical Support Instrument under the MFF will also assist Member States in designing and implementing reforms.

Reforms are also needed to tackle growing inequalities, one of the main challenges to the global economy and society. These inequalities have been aggravated by the COVID-19 pandemic. Besides RRF, the European Social Fund Plus will play a role in building social protection and developing a skilled and resilient workforce. The reinforced Erasmus+ will also focus more on inclusion through a dedicated framework to increase participation among people with fewer opportunities. The Just Transition Mechanism (and Fund) as well as the recently proposed Social Climate Fund will target the socio-economic impact of the transition towards climate neutrality. Finally, the agreement on the MFF also includes for the first time a commitment to develop a methodology for measuring gender expenditure, including the promotion of gender mainstreaming within the EU budget.

4.3 EU revenues creating more added value

As discussed in Section 3.2.2, the 2021-2027 MFF has introduced important novelties on the revenues side. These include a new own resource (a national contribution based on non-recycled plastic packaging waste), the issuance of debt to finance NextGenerationEU and an agreement to consider additional new sources of revenue for the EU budget, closely linked to policy priorities, to help repay the NextGenerationEU debt.

Under the 2021-2027 MFF and NextGenerationEU, the EU budget can also help to generate EU value added through its revenue side. This can be the case through three channels: (i) fostering the EU policy priorities; (ii) pooling resources for EU Member States on financial markets and (iii) increasing the international role of the euro.

(25) COM(2020)150 final.

The revenue side of the EU budget can cater to the objective of the green transition, which is high on the EU agenda. The new own resource based on non-recycled plastic packaging waste is a step in the direction of supporting EU policy priorities from the revenue side of the budget, in spite of the limited size of the new own resource. The decision to raise up to EUR 250 billion in green bonds will also contribute to the EU's climate objectives.

Common borrowing to finance NextGenerationEU has a double dividend: it provides resources for EU policies and generates a tangible economic benefit, as the EU can finance itself at lower rates than the average of its Member States. The issuance of common EU bonds to finance NextGenerationEU has attracted strong interest by investors, thanks to which the Commission has obtained very favourable pricing conditions. The transactions performed by September 2021 were all substantially oversubscribed, as it had also been the case for the bond issuances under SURE. By the end of 2021, the Commission expects to have raised some EUR 80 billion in bonds, to be complemented by short-term EU-Bills, as per the funding plan published in June 2021 and updated in September 2021. The favourable pricing conditions are beneficial for Member States that requested access to loans under the RRF. But they are also beneficial for the EU as a whole, as the grants will be repaid by the EU budget. Similarly, financial assistance through SURE has generated budgetary savings of EUR 8.2 billion in interest payments for the 19 beneficiary Member States [(26)].

The 2021-2027 MFF and NextGenerationEU create a new role for the Commission, which will become an important player on financial markets as both a borrower and a lender. The EU already issued bonds to finance macro-financial assistance (MFA), balance of payments (BoP) assistance, and the European Financial Stabilisation Mechanism (EFSM) and provided loans to Member States and neighbourhood countries through these programmes. However, these amounts are small compared to NextGenerationEU [(27)]. Common bonds were also issued to provide loans to Member States under the temporary SURE programme created as part of the response to the COVID-19 pandemic's economic fallout. With NextGenerationEU, the Commission will adopt an annual decision setting its maximum borrowing capacities, and 6-monthly funding plans will map the borrowing to be undertaken in the coming 6 months, within the boundaries set by the annual borrowing decision. Repayment of the borrowing will take place by 2058 at the latest.

(26) COM(2021) 596final.

(27) As of end-2020, the European Commission had EUR 46.8 billion in outstanding borrowing under the EFSM, EUR 5.8 billion under the MFA, and EUR 200 million under the BoP facility.

THE EU BUDGET CONTRIBUTING TO A STRONGER INTERNATIONAL ROLE OF THE EURO

The euro is the second most widely used global currency after the dollar, but its weight, particularly in terms of denomination currency of international financial assets, could still be increased. In the last quarter of 2020, the euro represented 21% of global foreign exchange reserves. It is currently a dominant or anchor currency at a regional level, in particular for some EU non-euro countries, as well as in the Western Balkans and for the countries that use the CFA franc in Africa. However, its use outside this region remains quite limited.

Increasing the euro's international role could have substantial benefits, and the Commission is working on additional measures to promote the use of the euro globally [1]. The possible benefits include lower (cross-border) transaction, risk management and financing costs, seigniorage revenues from issuing currency and greater economic sovereignty. Increased usage would also decrease the impact of foreign exchange price shocks and alleviate the effects of asymmetric shocks, in particular those linked to monetary policies by third countries. These benefits seem to outweigh the costs, such as pressure on currency appreciation in times of stress.

The MFF and NextGenerationEU have the potential to make EU economies more resilient and increase the international role of the euro. First, the euro bond market is currently very fragmented, which also explains why the international role of the euro is so limited compared to the dollar. NextGenerationEU issuances will increase the supply of highly-rated euro-denominated bonds: by putting NextGenerationEU borrowing on top of existing EU programmes (EFSM, MFA, BoP and SURE), the total outstanding volume of EU bonds could peak close to EUR 1 trillion in 2026. This will increase the liquidity of euro bonds markets by providing a significant supply of an EU-level 'safe' asset. Further steps towards completion of the Capital Markets Union will also contribute in this sense. Second, the EU will raise up to EUR 250 billion on capital markets in green bonds to finance NextGenerationEU between 2021 and 2026. This will make it the biggest green bonds issuer in the world and contribute to the euro's leadership in this market segment. Third, NextGenerationEU will foster investments and structural reforms that will increase the resilience and potential growth of EU economies, making them more attractive for international investors.

(1) European Commission (2021a), The European economic and financial system: fostering openness, strength and resilience, COM(2021)32 final.

The issuance of EU bonds under NextGenerationEU can increase the international role of the euro and is interlinked with the Capital Markets Union (CMU). The large bond issuance is an opportunity for the EU financial system, as it will mean more available high-credit quality euro-denominated securities. These securities can be used, for example, by global investors and central banks in collateral and repo transactions, and as a means to increase currency diversification. International, as well as European, operators may also benefit from the potential establishment of a new benchmark to price their assets and liabilities, disentangling their investment yields or borrowing costs, respectively, from those of a specific Member State. This way, the issuance of EU bonds would be a catalyst for a stronger international role of the euro, which in turn can be beneficial for the EU economy, in particular by reducing funding costs for EU households, businesses and sovereigns (see Box 2). At the same time, deep and liquid capital markets are key both to raising the necessary funding for the EU and for its recovery and long-term growth.

New own resources could help to repay NextGenerationEU. The European Parliament, the Council and the Commission agreed on a roadmap to introduce new own resources [28], and the Commission intends to present a balanced basket for new own resources by the end of 2021. In the current set-up, NextGenerationEU debt will start being paid after 2027, with the new multiannual financial framework. However, the legislation [29] enables repayments to start already before the end of the 2021-2027 MFF, provided *'that new own resources have been introduced after 2021'*.

(28) Council Decision (EU, Euratom) 2020/2053

(29) Interinstitutional agreement of 16 December 2020

5. OPEN QUESTIONS FOR THE FUTURE OF THE EU BUDGET

This policy brief has reviewed how the EU budget has evolved over the decades, with a specific focus on the novelties of the 2021-2027 MFF and NextGenerationEU, and how it has been increasingly aligned to the Union's priorities. But it has also showed how the EU budget has generally evolved in an incremental way. For the EU budget to have an increasing macroeconomic relevance and ambition, an appropriate size and composition will have to be ensured. Such reassurance will have to be backed up by an ambitious EU budget financing (revenue) system. Size, composition and financing have until now evolved at different speeds and at a different incremental pace, mainly because of the unanimity needed in the Council to adopt the MFF Regulation and the Own Resources Decision, the latter requiring even national ratification. This shows why the EU budget has undergone an evolution, and not a revolution.

Many questions remain open concerning the role of the EU budget in the future and the issues that will need to be addressed. In no particular order, these include:

First, can the EU budget respond to future challenges and needs within the existing **legal and institutional framework**, or may legal changes be necessary?

Second, how can the revenue side of the EU budget be reinforced with **new own resources**, reducing the reliance **on national contributions**? **Which new own resources**, in light of EU policies and competences, and the Union's political priorities?

Third, can some of the **off-budget tools, institutions and instruments** created over the years – for example the European Stability Mechanism and the European Peace Facility – be integrated in the EU budget in the future? How can the EU budget become more durably flexible to respond to specific needs while at the same time having a more coherent overall framework for the EU financial architecture?

Fourth, how can it be ensured that the EU budget respects the do-no-significant harm principle for all expenditures and maximises the **EU added value**? This issue involves assessing existing programmes (e.g. the common agricultural policy) and delivery methods (including the novel delivery method of the Recovery and Resilience Facility) to identify where EU funding can maximise its impact and added value.

Fifth, how could the funding strategy for NextGenerationEU, over its whole lifetime, make a strong contribution to the **Capital Markets Union and the international role of the euro**, and which conditions would need to be fulfilled to achieve this?

Sixth, is it possible to envision a bigger and more agile EU budget to increase its economic and social impact and its stabilisation role when faced with a shock? Maximising the **socio-economic impact of the EU budget** is crucial to ensure its relevance. This implies having an EU budget that is up to the task of addressing modern challenges like the green and digital transition and economic inequalities, and able to contribute to macroeconomic stability.

Seventh, what role can the EU budget play in an incentive-based, modernised EU economic governance? Which aspects of **'NextGenerationEU' should be retained in the future**? This issue has become especially relevant as the RRF has paved the way for a role for the EU budget in **EU economic governance** and policy coordination and in fostering the adoption of growth-enhancing structural reforms.

These are some of the most pressing questions that, along with others, remain open for future work and will have to be answered not only in relation to how the EU budget evolves, but also in relation to how the EU itself evolves.

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