Chapter Four

The Medium-Term Financial Framework and Annual Budget of the European Union

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Introduction

The process of European integration requires financial resources for its activities and public finances at the EU level; these are implemented through multi-annual financial frameworks and annual budgets, tools through which money is collected and allocated for EU policies and objectives as well as for the tasks transferred to it from the national level. The system of public finances at the EU level as known today is a result of numerous changes and adjustments that have occurred over the last more than sixty years of EC/EU history.

The overall objective of this Chapter[1] is to present the main features of public finances at the EU level. More specifically, the Chapter discusses three topics in the following sections. The first section presents the concept of the budgetary system, its evolution over the decades and its main features. In the second section selected methodological issues associated with financial flows between the EU budget and individual EU member state are outlined. Finally, the third section provides an overview of the recently agreed EU budget characteristics for the 2021–2027 period.

Concept, Evolution and Main Features of the EU Budgetary System

Small Size of the EU Budget

The EU budget is modest in size. As agreed by the member states, in the Own Resources Decision (ORD), the maximum ceiling of the EU

[1] This Chapter is largely based on Mrak (2011) and Mrak and Rant (2018, 2020).

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budget financing was for decades set at 1.24 per cent of the EU GNI. In practice, however, the EU budget has always remained well below that ceiling and amounted to around 1.00 per cent of GNI. As public finances of the EU member states are typically between 40 to 45 per cent of their respective GNI, EU budget is equivalent to just over 2 per cent of the total public finances of the member states. The EU budget does not represent a significant factor in almost any consolidated national public finance category. Three key segments of public finance expenditures in practically any country, i.e., defense, security and public order expenditure, as well as healthcare are not even included in the EU budget while the presence of certain other expenditure items, such as education and housing, is minimal. There is another fundamental characteristic which distinguishes the EU budget from national public finances. In contrast to national public finances which can run deficits, the EU budget is legally required to be in balance each year.

Evolution of the EU Budgetary System

The evolution of the EU budgetary system can be roughly classified into two periods: the first between 1951 and 1987 was characterised by a move towards the unification of budgetary instruments and the crisis of Community finances in the 1980s; the second from 1988 to 2020 has been characterised by features of 1988 EU budgetary reform; and the third one, since 2021 characterised by the recent response at the EU level to the COVID-19 health crisis.

1951–1987 Period. The public finance system of the EC began to develop in early 1950s, when in 1951 the European Coal and Steel Community (ECSC) Treaty was signed. It was followed by the 1957 European Atomic Energy Community (EURATOM) and European Economic Community (EEC) treaties. Each of these treaties envisaged different budgets for a particular Community which led to the co-existence of budgets. The 1965 Merger Treaty incorporated the ECSC and EURATOM administrative budgets into the EEC budget, and five years later, in 1970, the Luxembourg Treaty incorporated the EURATOM research and investment budget into the general budget.

During the first 20 years of the Community's financial system, there were two important developments, to the integration of budgetary instruments.

- The first was the development of common policies. The most no-

table events with considerable financial consequences were probably the creation of the instrument for implementation of the common agricultural policy (CAP) as well as the establishment of two funds for implementation of the cohesion policy These two policies still constitute about 80 per cent of current EU budget expenditures.

- The second development was that the initial system of contributions through which the budgets of all the three Communities were financed by the member states soon proved to be insufficient and unsatisfactory. The need for a better and more efficient system, which would provide sufficient resources, gradually, led to a reform of budget financing. Through the 1970 Luxembourg Treaty, a system of so-called own resources was introduced.

The processes of unification of the budgetary instruments, development of common policies and progress towards financial autonomy were inevitably connected with hard negotiations. The legal, political and institutional structure for governing Community's finance established in early 1970s soon proved to be unsustainable over a longer period of time. Relations both among member states, as well as among the European institutions involved in budgetary adoption procedure, gradually worsened and finally turned into an open conflict. Between 1980 and 1988, the approval of several annual budgets of EU was delayed long enough so that provisional arrangements in the form of so-called 'twelfths' had to be applied for several months.

1988–2020 Period. Following the EC enlargement with Spain and Portugal in the 1980s, the conclusion of the Single Economic Community and taking into account the above-mentioned annual budget negotiations problems, the EC embarked on a major reform of its budgetary system that has, by and large, remained unchanged since then. This system consists of two components:

- *Multi-annual financial framework.* The strategic course of the EU public finances is determined in a multi-annual financial framework (MFF). The MFF is basically an agreement among the institutions on budgetary priorities facilitating the budgetary procedure and the management of various programmes. Within the framework of the MFF, the maximum volume and the composition of the main EU budget expenditure items called 'headings'

are capped. The MFF is a product of an inter-institutional agreement between the Commission, Council and Parliament. Until now, Community/EU institutions have adopted five MFFS. The first one had duration of 5 years (1988–1992) while all the other four covered a 7-year period (1993–1999, 2000–2006, 2007–2013 and 2014–2020).

- *Annual budget.* Implementation and operational details of the EU budgetary system are elaborated in the annual budget that must be consistent with the MFF.

2021–2027 Period. In this period, the EU budgetary system, which consists of the 'core' MFF and an entirely new instrument, will be not only substantially larger than ever before, but it will also provide, for the first time, a framework for the EU itself to borrow and to perform a role of a common counter-cyclical instrument (European Commission, 2018a).

Procedures for MFF and Annual Budget Adoption

Multi-Annual Financial Framework. The limits for the annual budget are set by the MFF on the expenditure side and by the Own Resources Decision (ORD) on the revenue side with both of them required to be adopted with unanimously in the Council. This prerequisite of unanimity is one of the main reasons why MFF negotiations usually turn into one of the most complex negotiations among the EU member states, even at the European Council level where political clearance has to be achieved. In contrast to the period prior to the Lisbon Treaty when the importance of the Parliament in the MFF decision-making process was rather symbolic, with this Treaty its role has strengthened significantly as the Parliament has to formally adopt the agreement reached by the European Council.

Annual Budget. The procedures are comparable in many respects to the procedures at the national level. The EU budgetary procedure consists of two main phases. Preparation of the budget for the year N starts with the *proposal of the Commission* submitted by the end-April of the year $n - 1$. In the second phase, *Council and Parliament discuss the proposal and adopt the budget* with the required majority by the end-December of the year $n - 1$.

EU Budget Expenditure

In the early decades of the Community, CAP absolutely dominated EU budget expenditure. More recently, due to several enlargements of the

TABLE 4.1 The 'Three Large Expenditure Headings' in MFFS 2007–2013 and 2014–2020

Heading	2007–2013	2014–2020
'Large expenditure heading'	87	86
Competitiveness	9	13
Cohesion policy	36	34
Common agricultural policy	42	39
Others	13	14
Total	100	100
Total (in million EUR)*	983,731	959,988

NOTES Percentage of total. * 'Commitment appropriations,' 2011 prices.

Community/EU and through the introduction of multi-annual financial framework instrument, CAP expenditures have been capped and allowed funding for some other items, especially for the cohesion policy expenditures. During the last three multi-annual financial frameworks, approximately 75 per cent of all EU budget funds has been earmarked for these two policies and another 10 per cent for boosting competitiveness. In addition to these three 'large expenditure headings,' the rest of the budget has been allocated for external EU activities and internal policies as well as for administration purposes. Table 4.1 confirms a strong dominance of the three 'large expenditure headings' in the overall EU budget expenditure structure in the two most recent multi-annual financial frameworks, i.e., in the previous multi-annual financial framework covering 2007–2013 period and the existing one covering the 2014–2020 period.

EU Budget Revenues and Correction Mechanisms

The revenue side of the EU budget has been driven by the continuous attempt to strike a compromise between the financial autonomy of the EU budget and sufficiency of resources for its financing. The budget of the ECSC in the early 1950s was financed through a tax-based 'own' resource (a levy on steel production) while, in contrast, the Rome Treaty stipulated that the EEC budget was financed in a totally intergovernmental way, i.e., through direct contributions from member states. At that time, the EEC budget had no 'own resources' and thus had no financial autonomy from its member states.

It was in 1970 with the Luxembourg Treaty that the EEC budget started to move towards an own resources model. At that time, own

resources included traditional own resources, i.e., customs duties and agricultural levies, and VAT-based revenues from member states. This structure remained unchanged till 1984 when the Fontainebleau Council introduced the UK correction which in fact means a reduction of the UK contribution to the Community budget.

The last major change to the EU budget revenue side occurred in 1988 within the framework of the 1988–1992 MFF which introduced the fourth resource, known today as the GNP/GNI resource. Since then and thus also in the multi-annual financial framework 2014–2020, the EU budget revenue has been made up of four major resources (European Commission, 2011):

- *Traditional own-resources* include customs duties and agriculture levies, and in recent years. In recent year, it has contributed less than 15 per cent to total EU budget needs.
- *VAT-based resource.* Funds levied on the basis of value-added tax defined on the basis of a statistically adjusted VAT base of the member states. In recent years, it has contributed around 10 per cent to the EU budget needs.
- *GNI-based resource.* Funds levied on the basis of the GNI of the member states, i.e. funds earmarked for balancing the EU budget measured in proportion with the GNI of every member state. In recent years, this funding source has participated with around 75 per cent in total funding needs of the EU budget.
- *The UK correction,* as formally the fourth EU budget own resource, but in substance terms a zero sum mechanism.

An integral part of the own resources system is formally also the 'UK correction' as well as a set of 'corrections on this correction.' Introduction of this instrument dates back into early 1970s when the UK joined the EEC. At that time the UK was among the poorest member states but due to the EU budget expenditure bias toward the CAP the country had a negative net financial balance towards the EU budget. As this was considered unfair by the UK authorities and after intense negotiations with other member states the issue was resolved at the 1984 Fontainebleau European Council through the so-called 'UK correction' arrangement whereby UK became entitled to a refund financed by all other member states. The economic logic of the arrangement was that the UK position vis-à-vis EU budget was excessively negative in rela-

tion to its level of development, and that the country is eligible for a rebate on its contribution to the EU budget.

Even though the UK position in terms of its economic development has improved substantially since 1984 eliminating, or at least reducing substantially, the justification for the 'UK correction,' the system remains in place with only minor changes. This can be explained by the fact that the 'UK correction' is an integral part of the ORD for the change of which unanimity is required. The correction mechanism system in place in the multi-annual financial framework 2014–2020 contains in addition to the 'UK correction' and corrections to other four large net payers to the EU budget whereby Germany, Austria, Netherlands and Sweden pay only a part of their normal 'UK correction' funding share also several other 'corrections on corrections' (Mrak & Rant, 2018).

Key Systemic Weaknesses of the EU Budgetary System

The EU budget is one of the most problematic areas of economic management within the EU. At the same time, it is also an area that is extremely resistant to any serious change. Although there have been dramatic changes to the EU itself and its environment in the last 30 years, the EU budget has changed little since its last major transformation in 1988 (Mrak, 2011).

From 1988 until now the EU budget has remained practically unchanged in terms of size and is still at a level of approximately 1% of EU GDP/GNI. Within the budget's structure, CAP and cohesion policy expenditures are still prevalent with a combined share of around 75 per cent of the total. The EU budget is, therefore, strongly dominated by a small number of highly redistributive policies while policies that are broadly recognized as EU wide public goods are poorly represented. Not much has changed on the revenue side of the budget as well as transfers from national budgets still represent by far the most important funding source of the EU budget.

Domination of national contributions on the revenue side of the EU associated with highly distributive character of its main two spending categories – allocation of funds for both CAP and cohesion policy based on the 'country envelope principle' – have resulted in a system where at least the recent three multi-annual financial framework negotiations (for the 2000–2006, 2007–2013 and 2014–2020 periods) were overburdened with very straightforward attempts by individual mem-

ber states to bring back home as much money from the EU budget as possible. This 'juste retour' logic or obsession with net national financial positions has de-facto poisoned the overall EU budgetary debate. Experiences of these negotiations have confirmed a mentality whereby achieving an acceptable net financial position has de-facto become a more important negotiations objective than agreeing about the size and structure of those spending with a high European value added.

In addition to its strong pro 'status quo' bias, the EU budget has become over the recent decades also less and less transparent due to the dominance of net financial position logic in the multi-annual financial framework negotiations. There have been several attempts to address the net financial problem and the highly complex and non-transparent system of EU budget corrections but with no success until now.

Selected Methodological Issues Associated with Financial Flows Between the EU Budget and an EU Member State

'Commitment Appropriations,' 'Payment Appropriations' and 'Actual Payments'

Within the process of using the funds from the EU budget one has to make a clear distinction between so-called 'commitment appropriations' and 'payment appropriations.' The first one represents the legal basis for the use of EU budget funds while the second one refers to planned withdrawals of funds from the EU budget in a particular year.

While 'commitment appropriations' as well as 'payment appropriations' are planning or *ex-ante* categories, 'actual payments' is a category of actual disbursement of funds from the EU budget. 'Actual payments' is, thus, a category which establishes *ex-post* what proportion of 'payment appropriations,' i.e., of planned disbursement, has the country actually absorbed. Higher the absorption capacity of a country smaller the difference between the 'payment appropriations' and the 'actual payments.'

Absorption Capacity

Within the context of the EU's public finances, absorption capacity is defined as the extent to which a state (member or non-member) is able to spend the allocated financial resources fully and in an effective and efficient way. With the experiences gathered over time, the European Commission has arrived at the conclusion that states have a limited capacity to absorb external investment support effectively and efficiently.

Generally speaking, the absorption capacity of an EU member state for the use of EU budget funds has three features. Macro-economic absorption capacity refers to the overall ability of the economy to generate viable investment opportunities that could be financed by external investment support. Since this ability depends on the overall level of development of the economy, it is defined and measured as percentage of GDP. Financial absorption capacity is defined as the ability of an EU member state to provide national co-financing of the EU supported programs and projects. And finally administrative absorption capacity is defined as the ability of authorities in member states to prepare suitable plans and to put in place structure that are necessary manage EU funds effectively and efficiently (Mrak et al., 2015).

'Net Financial Balance'

'Net financial balance' of an EU member state *vis-à-vis* the EU budget is a difference between the volume of EU budget funds the state receives from the EU budget and the volume of funds it pays into the EU budget the national budget. Although the basic logic of the 'net financial balance' is conceptually straight forward, it is associated with several problems at a more operational level. They are a consequence of the fact that one has to clearly differentiate between the following two 'net financial balance' concepts.

- *Calculated net financial balance.* This is a difference between 'commitment appropriations,' which an EU member state will, according to plans, receive from the EU budget in a particular year and the planned contribution of that very state to the EU budget for the same year. The 'calculated net financial position' is, thus, a planning category which is known for every EU member state immediately upon completion of the medium-term financial negotiations.
- *Actual net financial balance.* This is a difference between 'actual payments' which an EU member state receives from EU budget in a particular year and the actual contribution of the same member state into the EU budget. The 'actual net financial balance' is, thus, an ex-post category which can be calculated only after the end of the year/period for which it is calculated. The difference between the 'calculated net financial balance' and the 'actual net financial balance' of an EU member state depends on its absorp-

tion capacity. The higher it is the lower the difference between the two. In case that an EU member state would have a 100 per cent absorption capacity then its 'actual net financial balance' would be equal to its 'calculated' one.

Towards an EU Budgetary Arrangement for the 2021–2027 Period

May 2018 Proposal of the Junker's European Commission for the MMF 2021–2027 Not Adjusted to the Needs in Early 2020

In May 2018, Juncker's European Commission proposed a MFF for the period 2021–2027. The proposal was prepared for a 27-member EU following Brexit and in an environment of intensified international as well as internal challenges for the EU. This in practice means that the proposal worth EUR 1,135 billion was slightly bigger compared to EU-27 spending in 2014–2020 (see Table 4.2). As far as the structure is concerned, the European Commission proposed a re-balancing of spending priorities, reducing the relative weight of the Common Agricultural Policy and Cohesion policy in the budget and increasing spending on new priorities, especially on internal and external security and migration policies.

It was originally planned that the European Council agreement on the MFF 2021–2027 should be reached until the end-2018 and the agreement with the European Parliament before the May 2019 European elections. But the negotiations were *de-facto* postponed until the end of 2019 when the big transition at the helm of the main EU institutions – with newly elected European Parliament, new president of the European Council and the new European Commission, was completed (European Parliament, 2018).

Until March 2020, the MFF 2021–2027 negotiations had followed the path largely predetermined by the Commission's May 2018 proposal. COVID-19 crisis, however, gave a new impetus to the on-going negotiations, opening up the possibility for the new Commission to make innovative proposals to further develop the EU budget. In March 2020, the European Parliament asked the Commission to reformulate and adjust its spending priorities to the new priorities, especially to European Green Deal and digitalisation, and to submit a new MFF proposal. Moreover, in April 2020, the European Council instructed the European Commission to design an entirely new recovery fund that would be in terms of size and its characteristics appropriate to deal with the depth of the COVID-19 crisis. The Commission was also specifically instructed

to articulate the relation of this fund with the MFF, making the fund a part of the overall MFF package to be negotiated. Soon after, Germany and France came out with a joint proposal advocating the establishment of a fund of EUR 500 billion to be financed by joint borrowing of the member states that would importantly hand out money to member states in the form of grants.

This political backing was instrumental for the European Commission to design an entirely new financial package for the 2021–2027 period (European Commission, 2018b). With this unexpected turn of events, the European Commission got an excellent opportunity to redraft the MFF together with the recovery fund and realign it to support the European Green Deal objectives with more appropriate funding from the EU level.

May 2020 Proposal of von der Leyen's European Commission for the 2021–2027 EU Budgetary System

In May 2020, the European Commission presented its new financial proposal for the forthcoming medium-term period. The proposal consisted of two components (see Table 4.2).

- *MFF.* A revised 2021–2027 MFF with 'commitment appropriations' of EUR 1,100 billion, a slight decrease against the May 2018 proposal.
- *Next Generation EU.* However, in addition to the 'core' MFF and as part of the EU budget, there was an entirely new component, a EUR 750 billion recovery instrument called the 'Next Generation EU.' The instrument would be debt-financed and the financial support would be partly allocated through grants (EUR 500 billion) and partly through repayable loans (EUR 250 billion). Spending should be aligned with the EU policy goals, in particular with green and digital transitions. It was supposed to focus on the first years of recovery, rather than becoming permanent. Repayment of the debt would not begin before 2028.

The December 2020 Final Agreement

In July 2020 EU leaders agreed on both financial instruments proposed by the European Commission after long and difficult negotiations. The MFF is worth EUR 1,074 billion for the 2021–2027 period and is slightly lower than that proposed by the Commission. The 'Next Generation EU'

TABLE 4.2 EU Budgetary Arrangement for the 2021–2027 Period

Headings	(1)	(2)	(3)			(4)		
	MFF	MFF	MFF	NGEU	Total	MFF	NGEU	Total
1. Single market, innovation & digital	116	166	141	70	210	133	11	143
Horizon Europe	67	87	81	14	94	76	5	81
2. Cohesion, resilience and values	387	392	379	610	989	378	722	1.100
Cohesion policy	369	332	323	–	323	330	–	330
Recovery & resilience instrument	–	–	–	560	560	–	673	673
Grants	–	–	–	310	310	–	313	313
Loans	–	–	–	250	250	–	360	360
REACT EU	–	–	–	50	50	–	48	48
3. Natural resources and environment	400	337	357	45	402	356	18	374
Common agricultural policy	383	324	333	15	348	336	8	344
Just transition fund	–	–	10	30	40	8	10	18
4. Migration and border management	10	31	31	0	31	23	0	23
5. (Resilience), security and defence	2	24	15	10	25	13	0	13
6. Neighbourhood and the1world	96	109	103	15	118	98	0	98
7. European public administration	71	76	75	0	75	73	0	73
Total	1,082	1,135	1,100	750	1,850	1,074	750	1,824

NOTES Column headings are as follows: (1) 2014–2020 (EU-27), (2) Commission proposal, May 2018, (3) Commission proposal, May 2020, (4) European Council agreement, July 2020.

(NGEU) remained at the proposed EUR 750 billion level for 2021–2024 though with a structure that under the pressure of the so-called 'frugal four' countries – the Netherlands, Sweden, Austria, and Denmark – changed towards a higher proportion of loans. Their total volume increased to EUR 360 billion, which means that the grant segment was reduced to EUR 390 billion, in view of the 'frugal four' below the psychological EUR 400 billion limit.

Table 4.2 provides an overview of how the EU financial package 2021-2027 was developed from the Commission's first proposal of May 2018, reflecting the pre-COVID-19 situation, to its second proposal of May 2020 and to the July 2020 agreement at the European Council level. The budget now incorporates the European Green Deal and digitalization development priority as well as the new reality caused by the COVID-19 (Mrak & Rant, 2020).

After tense negotiations between the Council and Parliament in autumn 2020, the EU financial package for the period 2021–2027 was finally approved in December of that year (EU budget for 2021). The package is, indeed, very different from its predecessors and represents the most substantial conceptual change of the EU budget since the introduction of the MFF instrument in the late 1980s. The EU budget will be in the forthcoming years not only significantly larger than in the past but it will also provide, for the first time in history, an institutional framework for the EU to borrow in order to fund grants on such a large scale. Further on, the package, especially its European recovery facility component, is the first EU's common counter-cyclical instrument and is not associated with austerity provisions. On the contrary, it is targeted to fight the COVID-19 crisis and to finance growth-enhancing investment opportunities complemented with structural reforms.

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