THE EUROPEAN ELECTIONS AND THE EU'S FUTURE ECONOMIC CAPACITY

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The forthcoming European elections will have a decisive impact on the economic capacity of the European Union (EU) over the next decade. The result of the vote will determine the balance of power among the parties with representation in the European Parliament – the foundation on which the legislation that the European Commission proposes will rest. One of the commission's main priorities will be drafting the proposal for the new multiannual financial framework (MFF) The commission also plays a crucial role in overseeing economic governance and compliance with EU fiscal rules.

The EU's budget cycle (seven years) and political cycle (five years) do not coincide. This means that the next executive branch of the EU, whose term will cover the period 2024-2029, will be responsible for executing what remains of the current budget (MFF 2021-2027) and drawing up the following one (MFF 2028-2035). The next commission's work on the budget will begin immediately upon election in order to be ready to submit the multiannual financial framework package for interinstitutional debate in mid-2025. That debate usually lasts between a year and a half and two years, meaning the new regulatory framework should be accepted no later than mid-2027 so it is ready for implementation as of 2028.

The most important components of the MFF are the Regulation, which sets the EU's spending ceilings, and the Decision on own resources, which establishes the EU's sources of revenue. The regulation is approved unanimously by the Council of the European Union, while the European Parliament can approve or reject the council's position, but not modify it. The own resources decision requires the unanimous approval of the council, an opinion from the parliament and ratification by all the member states (in accordance with their constitutional requirements) before it can enter into force.

Budget challenges

Setting EU revenue and expenditure is a hugely important milestone, because once established it is politically very difficult to make substantive changes. Exceptionally, the budget was boosted by €64.6bn in the mid-term revision of the MFF 2021-2027, by an additional amount of nearly 9% over the 2024-2027 budget. A total of €10.6bn came from existing funding and the rest from member states' national budgets. Of this amount, €50bn went to the Ukraine Facility and the rest to other priorities such as strategic technologies and migration. Given the decision must be unanimous, agreement was only possible after overcoming Hungary's veto in an initial vote.

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This lack of budget flexibility could be sidestepped during the pandemic, however, because COVID-19 struck in early 2020, just before the approval of the MFF for 2021-2027. That allowed for the creation of an extraordinary facility, the Next Generation EU (NGEU) funds, which expanded the EU budget by 66%. Still, the NGEU funds were approved because they were considered an exceptional circumstance[1], with the pledge there would be no repeat in the future. To make sure of that, and to preclude increasing contributions to the European budget from national funds during the crisis, the EU turned to issuing debt, repayment of which will begin in 2028 with the new MFF and run until 2058.

The EU budget has remained at 1% of EU GDP since the end of the 1980s and clearly does not suffice to tackle emergencies[2] and support the EU's new political priorities, prominent among which are the green transition, defence and industrial policy. According to Mario Draghi, a former president of the European Central Bank, the EU needs investment of €500bn a year to stay in the technological and digital race with the United States and China, a third of which should be public and ideally European funds to avert a subsidy war among the member states. In other words, according to Draghi the European institutions need to invest an amount equivalent to the EU's annual budget just to remain in the strategic contest among powers.

Regarding the financial assistance to Ukraine, the Ukrainian Ministry of Finance estimated that in 2024 alone the country needs around €34bn in external contributions to cover the bulk of the economy's deficit. That is equivalent to 20% of the European budget for this year, which reveals the enormous challenge facing the EU to back Ukraine collectively should the United States drastically reduce its financial support. The figure is close to the 0.25% of EU GDP that Estonia has proposed the European countries allocate to Ukraine. As well as finding funding for these two major priorities, the EU must also meet other challenges such as the repayment of the NGEU funds debt and the appropriation for its migration policy.

How to obtain more resources?

If the EU is serious about its commitments, it must put its money where its mouth is and provide financial resources for its latest priorities in the new MFF. Its main options are either boosting revenue by raising member states' contributions, making use of common debt or increasing the EU's own resources, since the EU cannot incur a deficit. Or it could cut expenditure elsewhere.

In Europe, country of origin determines political party preferences for the various options more than affiliation to a particular political group. Parties on the right of the political spectrum in the centre and north

1. COVID-19 was considered an exogenous and unforeseen shock that had an uneven impact on the member states, which could not be accused of mismanagement. The creation of the NGEU facility did not mutualise pre-existing debt and the European funds were not considered to cause moral hazard (incentives for less fiscal responsibility).
2. The European budget's flexibility mechanisms amount to €21bn (2% of the MFF for 2021-2027). Additionally, the European Commission can only ask the member states for up to 0.3% of their gross national income (GNI) to tackle economic, geopolitical, health contingencies or unexpected events of any other nature. This amount is the difference between the maximum that in exceptional circumstances the member states can contribute to the MFF for 2021-2027 (2% of GNI), the expenditure commitments provided for in the budget (1.1% of GNI) and the 0.6% set aside to back the increase in EU debt because of the NGEU funds.

of Europe are generally against increasing EU spending, while the same parties in the south of Europe are more inclined to boost the EU's financial capacity, as could be seen in the negotiations over the NGEU funds. The member states have more sway over budget matters than the European Parliament because their contributions are the chief source of EU budget funding, and they have the right of veto.

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While it may be the preferred option for many governments, there is limited scope to reallocate expenditure. The biggest items in the European budget are the common agricultural policy (CAP) and the cohesion funds. The CAP has gone from accounting for over 60% of the MFF in the 1980s to a little less than 30% at present. Judging from the recent protests by European farmers and the speed with which political parties of various persuasions agreed to make concessions, such as modifying the CAP[3] or reintroducing import restrictions on Ukrainian agricultural products, agricultural policy as an adjustment mechanism appears to have little traction in future budget negotiations. The European Parliament and the countries from the south and east of Europe, meanwhile, champion maintaining the cohesion funds (which account for another 30% of the current budget) as the primary tool for reducing the economic and social disparities between regions. What's more, a future EU enlargement to incorporate eight new countries with economic and social indicators well below the European average will bring major adjustments in the beneficiaries of the cohesion funds. And as the mid-term revision of the MFF for 2021-2027 showed, there is little wiggle room for adjustment in the rest of the items as a means of freeing up funds.

The main alternative would be for member states to increase their contributions to the EU, but they are reluctant, partly because of the fiscal challenge they face at home. The fiscal rules featured in the Security and Growth Pact start up again this year, pressuring governments to reduce spending and investments. And all this is set to take place against a backdrop of an ageing population eroding European tax frameworks (strongly geared to taxing labour) and a green and digital transition shrinking traditional tax bases (2023 Strategic Foresight Report). In addition, countries must accommodate greater spending in other areas like defence. Several governments, such as those of Denmark, Sweden, the Netherlands or Austria, are adamant that, other than to help Ukraine financially, the new priorities must be funded by cutting spending elsewhere.

Another option would be common debt issuance, similar to the borrowing undertaken for the NGEU, as Estonia, France and Poland have proposed to cover military investments.[4] But several countries, Germany especially, oppose increasing common debt. Its finance minister, Christian Lindner, who belongs to the Free Democratic Party (FDP), and the conservative CDU are particularly vocal opponents. It should be noted here that Germany has a debt brake limiting budget deficits to 0.35% of GDP enshrined in the constitution and that in late 2023 the German Constitutional Court ruled it was illegal to reallocate debt unused during the pandemic to the creation of a fund for climate action and modernising its industry. Germany, the biggest contributor to the EU coffers, will hardly adopt a looser financial position in Europe when its debt is restricted and it faces budgetary woes at home.

3. The measures include dropping the requirement for farmers who receive CAP subsidies to set aside part of their land for biodiversity, minimise tillage and rotate crops between seasons to prevent the loss of nutrients.

4. Estonia has proposed the creation of a European fund of €100bn.

Lastly, there is the option of increasing the EU's own resources. This is a recurring debate among the European Commission, European Parliament and the member states. The first two advocate making the European budget more independent of the member states, while the member states are fearful of losing sources of revenue. In June 2023, the commission proposed expanding the current own revenue sources (from customs duties, a small share of VAT receipts and a levy on non-recycled plastic packaging waste) with the transfer to the EU budget of 30% of revenue generated from emissions trading (ETS), 75% of the revenue from the new Carbon Border Adjustment Mechanism (CBAM) and 0.5% of the theoretical base of company profits in the EU. Given that changes in taxation require unanimity, the commission is making the case for introducing "rates" or "mechanisms" as sources of revenue.

While other sources of funding exist, their potential is limited. The European Peace Facility, for example, which is funded outside the EU budget, has been expanded to €17bn to accommodate €11bn in military support for Ukraine and maintain the other ten military operations in which the EU is participating. But this facility accounts for just a small fraction of the €143bn that the EU and the member states have allocated to helping Ukraine in the last few years. This contribution would have been impossible without the direct collaboration of the member states, as it is equivalent to over 80% of the EU's annual budget. Given the scale of things, while the possible agreement to use €3bn from the interest generated from frozen Russian funds to arm Kyiv may be a necessary step, it is a drop in the ocean and, as the European Central Bank has said, there are important legal and monetary concerns over making use of the €191bn in frozen Russian assets. These funding difficulties have also raised the pressure on the European Investment Bank (EIB) to open up to funding security-related projects and help mobilise private capital in defence investment.

The solution? Move forward together or separately

In the absence of enhanced EU mechanisms, the differences between countries' fiscal capacities will be more evident and divergences between member states will increase. The EU will find it hard to measure up to its international commitments and geopolitical ambitions. There will be notable disparities in defence spending depending on a country's risk perception, and tensions between industrial policy and competition policy will increase, harming the single market and European competitiveness. A multi-speed EU driven by "coalitions of the willing or able" is not necessarily a negative thing, but an EU running at too many speeds runs the risk of stalling.

Ultimately, the EU faces the pressing need to increase its common budget and its own sources of funding in view of the limits to reallocating expenditure and the reluctance of the member states to raise their direct contributions or sanction the creation of a new common borrowing mechanism. The upcoming elections are important because without a favourable political climate that enables a shift from unanimity to a majority vote on budgetary issues, for example, it is hard to conceive of a reform of the budget (Buti, 2023) that is vital if the EU is to rise to the challenges before it.

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