EXECUTIVE SUMMARY
Study for the BUDG committee

European Parliament

The impacts of recent inflation developments on the EU finances

Abstract

The focus of this study is the effect of inflation on the ongoing implementation of the current MFF on an aggregate level. The relevant inflation impacts and the channels via which they take effect are presented and analysed for the MFF and the EU revenue system. The study then maps and discusses policy options to mitigate these effects regarding the ongoing MFF and NGEU implementation, as well as with a view to the ongoing MFF mid-term revision.

Background

Since autumn 2021 all Member States have been affected, albeit to different extents, by extraordinarily high inflation rates. These inflation surges impact public finances in the EU at the level of Member States, but also EU finances via various channels. Specifically, high inflation rates in the EU erode the firepower of the Multi-Annual Financial Framework (MFF) as well as the European COVID-19 Recovery Instrument (EURI) NextGeneration EU (NGEU), and they have an impact on the structure of EU revenues.

Aim

Regarding the **objectives**, this research study aims to provide a granular assessment of the impacts of inflation as of 2021 on the MFF and on the EU budget, including EURI-funded NGEU programmes. The study has two main objectives:

Firstly, the study explores the impact of inflation on the various elements of the EU budget (the ongoing MFF and the system of own resources) on an aggregate level. Moreover, two case studies illustrate the effects of the current inflation surge on National Resilience and Recovery Plans on which the implementation of NGEU is based.

Secondly, the study identifies policy options to cushion off adverse effects of inflation in the implementation of the ongoing MFF and NGEU, also with a view to the ongoing MFF mid-term revision, along with policy options for preventive measures to be considered in the post-2027 MFF and the related EU programmes, as well as in the EU revenue system.

Findings

Recent inflationary developments in the EU

In 2021, Europe experienced an unprecedented sharp rise in inflation, driven by soaring energy prices, which rebounded from their low levels during the COVID-19 pandemic demand slump. During the lockdowns imposed to prevent the spread of the virus, private households shifted their demand structure from services

Policy Department for Budgetary Affairs
Authors: Margit SCHRATZENSTALLER et al.
Directorate-General for Internal Policies
PE 756.629 - November 2023

to goods. This consequently stressed supply chains and added price pressure on energy and other commodities. In 2022, energy prices got further impetus from Russia's invasion of Ukraine. The HICP's energy component experienced year-on-year price increases of around 40% for many months. Average EU inflation prior to the current bout of inflation was the highest at 4.3% in August 2008, whereas it reached its most recent peak in October 2022 at 11.5%. The high inflation environment in the last two years has also led to the biggest dispersion of inflation rates observed in the last 20 years. The accumulated inflation across the EU for the MFF 2007-2013 period was 17.0%, while the accumulated inflation across the EU for the MFF 20142020 period amounted to a mere 6.5%. In comparison, for the first 2.5 years of the current MFF 2021-2027 the accumulated inflation in the EU is already at 23.7%.

MFF expenditures

At the time the current MFF was compiled, a yearly inflation rate (e.g. HICP and GDP deflator) of 2% was assumed. Expenditure positions have been adjusted accordingly to compensate for the loss of purchasing power. This built-in 2% price rise is able to bolster an implicit cumulated loss in the MFF budget's purchasing power (without NGEU) of EUR 92.9 billion between 2021 and 2027.

In the wake of the COVID-19 pandemic, supply chain disruptions led to a sharp rise in internationally traded goods which was intensified further by Russia's invasion of Ukraine. Consequently, not only did consumer prices soar at unprecedented rates but many other prices did as well. This strong price rise incurred stronger losses of purchasing power than those factored in and compensated by the 2% automatic deflator. In its mid-term review, the Commission estimated an additional loss of EUR 74 billion. A more detailed analysis in the underlying study calculates a total loss of EUR 109.5 billion instead, with the largest relative losses to be observed in Cluster 10 "Migration", Cluster 5 "Regional Development and Cohesion" and Public Administration. The additional funds proposed by the Commission in its mid-term review would reduce the overall loss by EUR 27.5 billion, while increasing the purchasing power of some clusters as compared to the original MFF budgeting.

The impact of inflation on the MFF is not limited to EU expenditure but extends through grants and co-financing activities in the Member States. The recent price increase reduces the purchasing power not only of MFF expenditures but also of NGEU and of co-financing funds, thus increasing the overall loss of purchasing power further. However, an estimation of this additional loss goes beyond the scope of this study.

The strong increase of the GDP deflator can be expected to decrease the volume of the MFF in percent of GNI until 2027 to 0.96%, which is below the 1.05% of GNI envisaged when agreeing on the MFF 2021-2027.

EU revenue system

EU revenues in total are not affected by inflation as their overall amount is determined by expenditures as fixed by the MFF based on a 2% GDP deflator. However, inflation will change the contribution of the various financing sources to EU revenues, i.e., the structure of EU revenues, and accordingly Member States' shares in overall revenues.

Consumer price inflation will increase **the shares of the VAT-based own resource, custom duties based on ad valorem rates, and taxes on EU staff salaries, while the share of the GNI-based own resource will shrink in a high inflation environment.** The share of the plastic own resource will decrease in any case if the call rate is not adjusted based on the 2% deflator or the actual inflation rate. The revenues from the remaining elements of "other revenues", which are independent of inflation, will not be influenced by higher inflation; but their shares will decrease.

Higher consumer price inflation – as compared to the year before – will increase a Member State's VAT-based own resource payments. If it is affected by an above-average rise in inflation, this Member State will experience a rise in its share in VAT-based own resource payments as well.

As an upward shift in the average EU inflation rate will increase total revenues from the VAT-based own resource, overall revenues from the GNI-based own resource will decrease. Member States with a GDP deflator above the EU average will see an increase of their shares in the reduced overall GNI-based own resource revenues, which could eventually result in an increase of their contribution in absolute terms as well.

An above-EU-average increase of the GDP deflator in one Member State increases the share of this Member State in overall GNI-based own resource payments and decreases it for other Member States where GDP deflators are below the EU average.

This mechanism also works when considering the lump sum corrections of GNI-based own resource payments for several Member States. Whenever the GDP deflator of a Member State eligible for a rebate is above the EU average, the share of this Member State in GNI-based own resource payments increases, while the share of all other Member States where GDP deflators are below the EU average is reduced.

The GNI-based resource is based on a Member State's national income, with richer countries having to pay a larger share per capita than poorer ones. This effect is distorted by the following constellations:

- Due to a stronger increase in consumer price inflation, overall revenues from the VAT-based own resource are increasing, thus reducing the gap to be closed by the GNI-based own resource.
- Poorer countries experience above-average consumer price inflation and hence must contribute a larger share to overall VAT-based own resource payments.
- Poorer countries experience an above average rise in their GDP deflator which increases their share in overall GNI-based own resource payments.
- Member States which are eligible for a lump sum reduction of their GNI-based own resource contribution benefit more than in the past year from this rebate if their GDP deflator is below average because their rebates are adjusted regularly based on the EU average of the GDP deflator.

This study does not find that poorer Member States have seen their share in the MFF finances increasing, but it clearly shows that eastern Member States had to pay an extra inflation-induced contribution to the budget in 2021 and 2022. Their consumer price inflation, as well as their GDP deflators, were in both years clearly above the EU average, and the EU-wide increase of the consumer price inflation reduced the amount to be covered by the GNI-based own resource.

Regarding the impact of inflation on the adjusted first basket of new own resources suggested by the Commission in June 2023, it is plausible to assume that neither the ETS- nor the CBAM-based new own resource are directly influenced by inflation, whereas revenues from the own resource based on the corporate sector are likely to follow inflation in the longer run. Therefore, the proposed three new own resources of the adjusted first basket should be rather resilient to inflationary developments.

The second basket of new own resources originally envisaged in the IIA shall comprise taxes on financial transactions as well as on the corporate sector. Moreover, further options have recently been put forward in the academic and policy debate. Some of these new own resource options relate to bases that directly react to inflation. This concerns financial transactions whose nominal value can be expected to grow with inflation. Thus, the share of revenues from an own resource based on financial transactions in overall revenues (which under the current system grow at 2% annually) would increase for an inflation rate above 2%.

Case study 1: impact of inflation on the Bulgarian National Recovery and Resilience Plan

The case study on the impact of inflation on the Bulgarian National Recovery and Resilience Plan finds that the overall price of the projects in the Bulgarian National RRP can be expected to increase by an accumulated 30.9% throughout the years, which amounts to an average annual inflation between 2022 and 2026 of around 5.53%. This is much higher than the 2% annual inflation target embedded in the MFF and RRF automatic indexation component, which would amount over the five years to an accumulated inflation of 10.4%.

These inflationary developments will either reduce the real value of the projects envisaged under the RPP and therefore the volume of deliverables, will make them infeasible to implement, or will necessitate some upwards adjustments to their funding. The biggest contribution to these increased costs comes from projects with a high share of activities related to construction, and these projects also account for a considerable share of the overall RRP volume in comparison to projects less affected by inflation.

Member States will have to choose between three options when addressing the inflationary challenge. They can either increase the funding using national, as well as additional EU funding, they can drop specific projects which have become unrealistic in the timeline of the RRP, or they can reduce the quantitative commitments taken in terms of milestones and targets. Inevitably, Member States will have to make difficult choices balancing these three options, while still achieving the overall goals of the RRP to contribute to green and digital transition and enhance the resilience and competitiveness of their economies. According to the case study for Bulgaria, the proposed amendments to the Bulgarian RRP include both the reduction and the cancellation of certain projects which have become infeasible.

Case study 2: impact of inflation on a specific partnership agreement and related operational programme for Spain

The case study on a specific partnership agreement and related operational programme for Spain finds that, while the Multiregional OP 2014-2020 faced a range of challenges stemming from the recent inflation-driven cost increases, the most pronounced difficulties were concentrated in construction and infrastructure projects within priority areas 06 (Preserving and protecting the environment and promoting resource efficiency) and 07 (Promoting sustainable transport and removing bottlenecks in key network infrastructures). These challenges led to problems in the construction contracts which subsequently resulted in delays in project implementation. Some projects had to renegotiate contracts due to financial pressures. In some cases, contracted firms withdrew from projects due to the unanticipated rise in energy and construction material prices, leading to contract termination. On other occasions, there was a lack of tenderers during the procurement processes due to the lack of interest on the side of construction companies stemming from a low profitability. Reprogramming aimed at adjusting the fund allocations was needed in the case of priority areas 06 and 07, whichwere characterised by low absorption rates, especially in the case of regions in transition. A certain number of projects will be phased out into the next funding period 2021-2027 to avoid their cancellation, ensure successful completion and maximise the investments.

The impact of inflation on research and innovation (R&I) projects seems to differ from those on other priority areas within the OP. Indeed, priority area 01 related to R&I did not necessitate significant reprogramming or fund reallocation. However, inflation might pose unique challenges for innovative companies, particularly small and medium-sized enterprises, for which the price increases are more complex to pass on to the final consumer. Furthermore, despite the increased allocation of EU funds to R&I, inflation might have diminished the real value and purchasing power of this budgetary expansion, potentially jeopardising R&I funding which relies heavily on EU resources.

Measures adopted at EU level contributing to addressing the inflation-driven challenges include the possibility of 100% co-financing and the possibility to transfer certain large-scale projects from

MFF 2014-2020 to MFF 2021-2027. Making additional funds available to compensate for the increase in energy and material costs and the possibility of price revisions in public work contracts were among the measures adopted at national level. Nevertheless, analyses conducted by the Ministry for the Ecological Transition and the Demographic Challenge suggest that having an additional year for expense certification could significantly enhance performance, especially in the case of projects within priority area 06 whereby inclusion of other types of actions in the field of biodiversity or the circular economy would be difficult as they would entail a change in the programme's strategy.

Policy options

Based on the assessment of the impact of inflation on MFF expenditures and EU revenues as well as on the case studies, policy options for mitigating the impact of inflation on the EU budget and on national programmes are developed. These policy options are informed by desk research and expert interviews conducted for the two case studies, as well as with a representative of the European Court of Auditors. They can be summarised as follows:

Policy options for the implementation of the ongoing MFF 2021-2027

- **Use of existing margins and various flexibilities.** To compensate for inflation-induced budgetary pressures as well as real losses of pre-allocated funding, margins and various flexibilities (the Flexibility Instrument, thematic special instruments, other flexibilities) could be used.
- **Redeployment of pre-allocated funds across headings.** The re-allocation of pre-allocated funds from clusters where room for "doing more with less" is larger than in others, inter alia due to their sheer size, would be another option to avoid cuts in smaller expenditure items that deliver important contributions to European added value and to urgent challenges the EU is confronted with. Concretely, such a shift could consist of re-allocating funds from the Common Agricultural Policy (CAP) or cohesion funds to clusters that are particularly important regarding strategic EU goals but are rather under-funded (e.g. research and innovation or the Connecting Europe Facility (CEF)).
- **Increase of selected cluster ceilings based on the actual inflation rate.** The ceilings of clusters with a particularly significant contribution to European added value (e.g. Horizon Europe or the CEF) or to particularly urgent challenges (e.g. Migration) could be adjusted according to the relevant inflation rate, while other ceilings would continue to be adjusted by the 2% deflator.
- **Establishment of a EURI thematic special instrument over and above cluster ceilings.** The establishment of a EURI special instrument would remove the budgetary pressure caused by the unexpected increase of interest payments.
- **Increase of Heading 7 "European administration".** To mitigate the budgetary pressure with Heading 7 "European administration", a mixture of expenditure increases and savings could be envisaged.
- **Assessment of the impact of high inflation on the EU budget over several years.** The Commission should monitor and assess the impact of high inflation on the EU budget during the remaining duration of the current EU budget, as a basis to come forward with instruments and approaches to cope with adverse effects of inflation on the EU budget.

Policy options for the EU revenue system

- **Reduce the weight of the VAT-based own resource.** To mitigate undesirable redistributive effects of an inflation-induced shift in EU overall revenues across Member States, the weight of the VAT-based own resource could be reduced by decreasing the current call rate of 0.3% or by reducing the current cap of 50% of the VAT base.

- **Accelerate the introduction of the new own resources contained in the adjusted first basket of new own resources.** The revenues from these new own resources could be used to finance the inflation adjustment of certain MFF clusters, a EURI thematic special instrument, the (advanced) repayment of EU funding costs, or the increase of the flexibility instruments without having to raise GNI-based own resource payments.
- **Automatic inflation adjustment of call rates that are denominated in absolute values.** To avoid the devaluation of revenues from own resources for which call rates are denominated in absolute values (currently the plastic own resource), the call rates should be inflation-adjusted regularly.

Policy options for the implementation of national RRPs

- **Application of different indexation methodologies.**
- **Permission for contracting ministries or institutions to identify the necessary cost adjustments themselves.** Regarding the national RRP, where project implementation is still at its early phase or has not yet started, the contracting ministries or institutions could be permitted to identify the necessary cost adjustments themselves.
- **Funding for indexation through additional national financing from Member States' budgets.**
- **Funding for indexation through the additional resources from RePowerEU.**
- **In the face of significant delays in the implementation of projects for the RRP, Member States can and should adjust their national RRPs accordingly and justify if some projects have become unrealistic timewise or financially for Member States.**

Policy options for the implementation of operational programmes

- **Possibility to transfer certain large-scale projects from one MFF period to another.**
- **Flexibility in reallocation of funds and enabling 100% co-financing rates.**
- **Provision of additional funding to compensate for the increase in energy costs.**
- **Revision of public work contracts.**

Policy options to make future EU budgets more resilient to inflation

- **Replace the current 2% deflator by adequate inflation indicators to adjust EU budget expenditures to inflation.** To avoid losses in purchasing power and budgetary pressures caused by high inflation, and to preserve the EU's ability to react to unforeseen developments requiring additional interventions, MFF ceilings as well as the various flexibility instruments should be adjusted to actual inflationary developments by using adequate inflation indicators.
- **Implement additional new own resources.** Additional new own resources should be implemented, preferably new own resources that are associated with steering effects supporting important EU objectives and whose revenues develop in tandem with inflation. Where needed and possible, their design should avoid the negative effects of inflation (e.g. by automatically adjusting call rates denominated in absolute values to inflation).
- **Adjust call rates denominated in absolute values automatically to inflation.** To avoid the devaluation of revenues from own resources for which call rates are denominated in absolute values, call rates should be inflation-adjusted automatically.

- **Implement a special instrument for interest expenditure over and above MFF ceilings.** A permanent special instrument should be established that covers funding costs incurred by EU borrowing (particularly within NGEU, but also within the envisaged Ukraine facility and other existing and future EU debt operations).

Envisage a comprehensive review and modernisation of the outdated accounting framework of the EU budget. A solution that would be more ambitious than the implementation of additional special instruments (for example a special thematic EURI instrument covering EU funding costs) and, more generally, reacting in an ad-hoc manner to upcoming unforeseen challenges and events within a piecemeal approach, is the comprehensive modernisation of the accounting framework of the EU budget, which could be integrated in the ongoing efforts to strengthen the performance orientation of the EU budget.

Disclaimer and copyright. The opinions expressed in this document are the sole responsibility of the authors and do not necessarily represent the official position of the European Parliament. Reproduction and translation for non-commercial purposes are authorised, provided the source is acknowledged and the European Parliament is given prior notice and sent a copy. © European Union, 2023.

Administrator responsible: Francisco PADILLA OLIVARES Editorial assistant: Adrienn BORKA
Contact: Poldep-Budg@ep.europa.eu

This document is available on the internet at: www.europarl.europa.eu/supporting-analyses