BRIEFING

Requested by the BUDG committee

European Parliament

The impact of inflation on the EU budget

KEY FINDINGS

- **On the expenditure side,** the aggregated and expected inflation of 2022 and 2023 will diminish the originally expected yearly real value ('purchasing power') of the **EU budget's expenditure programmes by 10 to 20%** in present and future years. The same counts for the values of NGEU allocations.
- The EU budget is capped by the absolute amounts of the MFF ceilings (expressed in 2018 prices). An **ex ante fixed 2% automatic adjustment rate is already factored into the figures** (current prices) used for the financial programming. **As the EU budget is subject to a strict equilibrium principle** ('expenditure driven'), **it will therefore not grow in proportion with GNI or inflation** through higher nominal revenue.
- **The volume and nature of the margins and special instruments does not allow for any significant rectification of the shortfalls within the confines of the MFF**.
- **In most policy areas and intervention modes, the availabilities for spending will be commensurately lower.** Moreover, the EU budget includes non-discretionary items such as EURI repayments that cannot be reduced and which will have to be serviced regardless of MFF ceilings. Strikingly, **the broader stake of the ongoing inflation surge's consequences on planned EU expenditure**, beyond administrative appropriations, **is not addressed explicitly in the most recent Commission's communications on the EU budget**.
- **On the revenue side**, **as income from the VAT- based own resource and customs duties can be expected to increase, the share of GNI-based own resources should decrease correspondingly**. **This should entail some distributive effects,** depending on Member States inflation/growth and relative GNI evolutions.
- **The reductions in the annual GNI contributions granted to certain Member States should increase meaningfully** as such reduction adjusts in line with the GDP deflator, which will be much bigger than the 2% above-mentioned fixed deflator will during the ongoing inflation surge.
- **The headroom** between the own resources ceiling (2,00% of GNI of which 0.6% is earmarked for NGEU purposes) and the MFF payment ceiling **should become bigger** as GNI in current prices is expected to increase roughly in line with nominal GDP.
- **The upcoming MFF review/revision presents an opportunity to assess and to a certain degree, rectify the impact of inflation on the EU budget.**

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Introduction

According to the latest indicators from Eurostat, inflation in the EU reached a level of 10.9% in September 2022 up from 10.1 in the previous month. The euro area annual inflation rate was of 9.9% in September 2022 up from a level of 9.1% in August 2022. The EU as a whole already reached the threshold of 10% inflation rate in August 2022[1]. Inflation is currently at the highest point since Eurostat started recording statistics on the matter. Furthermore, such levels have not been experienced in most Member States since the early eighties.

The ongoing inflation surge is not only unprecedented in the last 40 years[2]. It is also both abrupt and unexpected. Inflation remained in line until end of 2021 with the target set out by the ECB (close, but below 2%)[3], but it started to accelerate at an unprecedented pace from levels that were still below 2% in the summer 2021 to rapidly reach a 5% annual rate by December 2021 and nearly 10% by July 2022[4]**. Furthermore, all forecasts by main EU and international institutions repeatedly and substantially failed to anticipate the extent, the speed and the length of the ongoing inflation surge[5].** Notably, the Commission's Autumn Economic Forecast of November 2021 projected at the time that: "(...) *after reaching 2.4% in 2021, inflation in the euro area is forecast to decline to 2.2% in 2022 and 1.4% in 2023*."

The ongoing inflation surge represents not only a severe challenge entailing far-reaching consequences for household, undertakings and public finances in Member States. As it will be developed in this note, it will also have a lasting impact for the EU budget, and more broadly, on overall EU planned expenditures, including for those incurred in the context of NGEU related programmes.

This note provides a general assessment of the aggregate economic impact of inflation on the EU budget, both retroactively and prospectively (on a scenario-based approach). Against such backdrop, we will briefly underscore that available flexibilities and margins under the current MFF framework are very far from providing for a meaningful room of manoeuvre and tools to tackle adequately such challenge, before concluding with some follow-up remarks.

An overall assessment of the inflation impact on the EU Budget and NGEU related programmes

Article 4 of Council Regulation 2020/2093 laying down the Multiannual Financial Framework (MFF) for the years 2021 to 2027, provides explicitly that each year the Commission, acting ahead of the budgetary procedure for year n+1 shall revaluate **the MFF ceilings and the overall appropriations figures for commitments and payments at year n+1 prices <u>on the basis of a fixed deflator of 2% per year</u>.**

The same deflator applies for NGEU related programmes and envelopes. Article 2 of Council Regulation 2020/2094 establishing a European Union Recovery Instrument to support the recovery in the aftermath of the COVID-19 crisis, provides the same **2% fixed deflator per year shall apply for the purpose of implementing Union programmes listed in paragraph 2 which refer to NGEU specific programmes.** Furthermore, paragraph 1 stipulates explicitly that for commitment appropriations related to such 'NGEU' programmes, the deflator shall apply to the annual instalments. Council Decision 2020/2053 on the system

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1. Historical data series for EU inflation are generally higher than euro area ones. Subject to confirmation by next flash estimates by mid-October 2022, one can therefore assume that annual inflation rates in the EU as a whole may already be close to 11% for the EU in September 2022.
2. A 10% inflation level was experienced for the last time in several countries of the EU in 1982.
3. See: https://www.inflationtool.com/euro. In the context of its policy strategy review undertaken in 2021, the ECB updated its inflation target that is now defined as a symmetric 2% target over the medium term.
4. The acceleration of EU inflation rates on a yearly basis from 2.1% in July 2021 to 9.8% in July 2022 is even faster than the acceleration experienced during the mid-seventies. See graph 3 of the following document: https://www.cairn.info/calmer-les-prix--9782724619751-page-31.htm. Significantly, such abrupt surge comes after a long period since the euro area crisis, during which the ECB struggled to increase consistently very low inflation rates.
5. ECB's surveys of professional forecasters have been systematically biased all over the inflation surge, including in its most recent published forecasts in the last quarter of 2022. Strikingly, at the beginning of 2022 the inflation forecast for the whole year was of 3%. The same systematic underestimations are observed as regards the forecasts made by the European Commission, the OECD and the IMF, including forecasts published in the last weeks and months (such as the Commission Summer 2022 Economic Forecast that are rapidly outpaced by most recent figures).

of own resources of the European Union (ORD) that empowers the Commission to borrow funds on capital markets on behalf of the Union up to EUR 750 000 million in 2018 prices to address the consequences of the COVID-19 crisis, also foresees that such amount shall be adjusted on the basis of a fixed deflator of 2 % per year. However, EURI related interest rates charges[6] and future repayments constitute non-discretionary expenditure items. Therefore, they cannot be reduced and will therefore have to be serviced regardless of MFF ceilings.

The use of the same deflator therefore means in any case and *mutatis mutandis,* that the impact assessment of the ongoing inflation surge in the EU outlined below also applies to the overall amounts deployed by NGEU programmes.

As outlined above, such deflator was, until end of 2021, in line with the historic evolution of price levels since the early nineties[7]. Moreover, the above-mentioned **Commission's forecast published less than one year ago for the period 2021-2023 foresaw that such fixed deflator would still be in line with the evolution of consumer price levels during that period. However, the inflation surge of the last four quarters has drastically changed the landscape.** As we will develop, this means in practice that the real value of maximum amounts available under MFF ceilings for budgetary appropriations will be subject to a meaningful cumulative reduction, as of 2022 onwards.

By end 2021 EU annual inflation reached a 5% rate, while the average annual rate for EU inflation in 2021 was of 2.6%. For the sake of simplification, it can be assumed that such average annual inflation roughly reflects the decrease in real value of expenditure incurred during the year 2021[8]. Under such assumption, the application of a 2% deflator means that the real value of appropriations included in the 2021 budget was still rather modestly below the implicit expectations embedded in the 2020 MFF when the 2021 EU budget was established. The Financial Programming is indeed based on current figures from the very beginning, i.e. already factoring in the 2% deflator each year.

However, inflation expectations underpinning the 2022 EU budget (as mentioned above, the Commission's forecasted a 2.2% inflation rate for 2022 at the end of 2021) have been very significantly out of touch with realised figures. The annual EU rate of inflation in September 2022 was already at 10.9%, and although the accuracy of expectations ahead have become for obvious reasons controversial, it seems reasonable to assume, as most analysts henceforth do, that inflation will remain more entrenched than previously assumed[9]. Even if one assumes that inflation may have peaked at current levels, the average annual inflation rate in the EU during 2022 is already of 7.6%. Therefore, in such scenario, annual inflation by the end of the year will quite probably reach double-digit rates. It is indeed likely that inflation levels during the last quarter of 2022 may still be higher than during the last quarter of 2021 when month-to-month rates were well below the rates of the last couple of months.

Furthermore, as the MFF deflator is fixed at yearly rate 2% for the whole 2021-27 period, the impact of the ongoing surge will accumulate in the coming years, even in the optimistic scenario of inflation coming back to target in the short to medium-term (the baseline assumption of the ECB and the Commission is that inflation will reach again levels close to the target by 2024).

[6] Such charges at least partially evolve in line with financial market conditions which have recently adjusted upwards in the current inflationary context

[7] From a retrospective point of view, a 2% deflator would be therefore consistent with a small 0.1 yearly increase in the real value of maximum expenditure allowed by a 2% fixed deflator as average inflation since 1991until 2021 in the EU was around 1.9%, representing roughly a compounded 4% increase after 30 years. However and notably, if one adds a projected 10% inflation rate for 2022, the deflator implies already a meaningful decrease of such real value of maximum expenditure, as with the inclusion of 2022 average annual inflation reaches a 2.18% rate. **In other words, the inclusion of a single additional year invalidates retrospectively the argument that past gains in real value of maximum expenditure would offset recent losses.**

[8] Such assumption is obviously a simplification, as incurred expenditure is not necessarily evenly distributed along the year. The same goes for inflation as rate changes during the year do not necessarily follow a linear pattern. Nevertheless, such simplification provides a reasonable heuristic approximation to the fact that the overall real value of expenditure depends both on the points in time when it is incurred and the respective amounts.

[9] A commented summary of controversies surrounding inflation developments and forecasts definitely deserves a standalone briefing that goes belong the scope of this note. Two EU specific developments can however be underscored. According to Eurostat, energy and food items still account in September 2022 for more than 60% inflation rates. Furthermore, and in contrast with the US, for the moment there is no noticeable wage-inflation spiral in the EU. Such spiral is usually seen as a necessary condition for inflation expectations to become de-anchored.

As already mentioned, inflation forecasts have significantly failed over the last two years on the speed, the extent and the length of the ongoing inflation surge. Such failure commands therefore caution when it comes to assuming forecasts for the years ahead. If one assumes however, as a baseline scenario and for the sake of the exercise, ECB's most recent inflation expectations, including a return of inflation to target by end of 2024[10], this means that the cumulative impact of the ongoing inflation surge will nevertheless continue deepening in the next two years. If such expected figures are compounded with the realised inflation rate for 2021 of 5% and an extrapolation of a 10% annual rate at the end of 2022, this means that price levels by the end of 2024 would have increased by 24.6% since the end of 2020. A fixed 2% deflator would in contrast yield an 8.2% increase for the same period. In other words, under such assumptions, the adjustments determined in the MFF Regulation would only allow for a maximum increase in expenditure that is well below what would be required to preserve the real value of the maximum amounts foreseen in 2020 under the MFF ceilings. **In other words, under such baseline assumptions, the real value of maximum amounts available under both NGEU and under the MFF ceilings for budgetary appropriations from 2025 onwards would be subject to a meaningful reduction of 15%[11]. Such baseline scenario allows us to sketch an 'optimistic' scenario (inflation coming back to target already in 2023) and a 'pessimistic' scenario, where average inflation remains at rates around 5% in both 2023 and 2024. In the first case, the above-mentioned gap would still reach an amount of 12%, whereas in the adverse scenario the gap would be of 20%.**

In brief, the three scenarios referred to above entail all a significant reduction of the real value of maximum amounts available under the 2020 MFF ceilings. In such context, it is therefore quite remarkable that besides a purely generic reference to inflation in the introduction outlining the challenges of the macroeconomic context, the Commission's June 2022 statement of estimates in preparation for the 2023 draft EU budget, only refers a few times to the direct impact of high inflation[12] on EU budget related to administration costs (notably wage indexation and energy related costs)[13]. However, strikingly, the broader stake of the ongoing inflation surge's consequences on planned EU expenditure, beyond administrative appropriations, is not addressed explicitly. This means in practice that the programme statements and performance frameworks will have to be adjusted, for example in view the number of expected output in the coming years.

Based on the above-mentioned scenarios, we will very briefly put in evidence that available flexibilities and margins under the current MFF framework only provide for a very marginal share of the amounts required to address the above-mentioned gap during the coming years.

According to the Commission Amending Letter (AL) 1/2023[14], a margin of EUR 3284 million in current prices is expected to be left under the updated payment ceiling in the Commission's draft EU budget 2023. Furthermore, the Commission's fifth draft amending budget (DAB) for 2022 foresees an unused margin below the 2022 payment ceiling of EUR 3609 million[15]. We will assume a purely counterfactual scenario[16] where the full margins under the ongoing MFF commitment and payment ceilings would be used as of 2023 onwards. Under such assumption, the only amounts available in the framework of the Single Margin Instrument (SMI) for payment appropriations would be the expected unused margin below the 2022 payment ceiling of EUR 3609 million in current prices as well as the unused margins below the commitments

10 ECB staff projections foresee that inflation will reach 5.5% in 2023 and 2.3% in 2024.

11 Such gap will be gradually cumulated from a very small amount on 2021 (see footnote 6) to stabilize afterwards at 15 % per year by end of 2024 until the end of the ongoing MFF assuming that inflation will return to target by 2025 at the latest. Therefore, on top of the 15% gap per year from 2025 to 2027 the gap for 2021 (+- 0.6%), for 2022 (+-10%) and 2023 (around 14%) should also be considered for having an exhaustive view of the average funding gap for the whole ongoing MFF.

12 The word inflation appears in 13 instances in 647 pages.

13 More specifically as regards wage indexation and energy costs.

14 According to the provisions of Article 42 of the Financial Regulation, the Commission may submit amendments to its proposed annual draft EU budget so as to take into account new information not available the draft budget was established in June 2022.

15 The Commission AL 1/2023 foresees an increase in EUR 758 million in commitment appropriations and EUR 2395 million in comparison with its draft 2023 EU budget of June. The European Parliament set on 19 October 2022 the overall level of appropriations for the 2023 draft budget at €187.3 billion in commitment appropriations, representing an increase of €1.7 billion compared to the budget as proposed by the Commission, and at €167.6 billion in payment appropriations. The Council in contrast propose to reduce commitments to €183.9 billion (-0.9 % on the draft) and reduce payments to €165.7 billion (-0.3 %) in comparison with the Commission proposal of June 2022.

16 Such scenario is indeed purely fictional as it is excluded that all margins and flexibilities within the MFF ceilings would be exhausted for the sole purpose of tackling the ongoing inflation surge.

ceilings in 2021 and 2022[17]. If in accordance with the provisions of Article 11 of the 2020 MFF Regulation, the full EUR 3609 million amount is used to adjust upwards the payment ceiling for the years 2023 until 2027[18] and if the full amount under the flexibility instrument[19] is also used in the years ahead, that would **allow for reducing the baseline 15% funding gap identified above by merely 1% per year during the remaining years of the MFF[20].** This should not be surprising as by their nature and volume, these unallocated margins and special instruments are not suited for such a crosscutting compensation purposes to begin with. Rather, they are traditionally used to top up selected priority items in the course of annual execution.

Before concluding this section, it is worth outlining the overall consequences of the ongoing inflation surge when it comes to the revenue side of the equation. As the EU budget is subject to a strict equilibrium principle enshrined in Article 310 TFEU and the Financial Regulation, this means in practice that revenues on aggregate can only increase as much as allowed *ex ante* by the MFF ceilings subject to the above-mentioned adjustments in current prices on the basis of a fixed 2% deflator. In contrast with the budget of Member States, the EU budget is therefore 'expenditure driven', The above-mentioned equilibrium principle in combination with the way the system of own resources is set out in the ORD potentially entails, however, *ex post* distributive consequences as regards respective shares of different categories of own resources, as well between Member States. The ongoing unexpected inflation surge implies that nominal GDP in the EU will growth (also unexpectedly) at a very robust rates in 2022 (around 12%) and in 2023 (above 5%). Consequently, the VAT based own resource and customs duties based own resource should also increase at rates well above the 2% deflator [21]. This means, everything else equal, that the share of GNI-based own resources should decrease correspondingly as the ORD provides that the uniform call rate to Member States' GNI is to be determined pursuant to the budgetary procedure in the light of the total of all other revenue. This should entail distributive effects, depending on Member States respective inflation rates GNI levels.

Moreover, the reductions in the annual GNI contributions granted to certain Member States as provided for in paragraph 4 of Article 2 of the ORD shall be adjusted to current prices by applying the most recent GDP deflator for the Union expressed in euro. Such lump sum will therefore increase meaningfully as the GDP deflator is expected to roughly follow the same pace as inflation.

Finally, it is also worth mentioning that the headroom between the own resources ceiling (2.00% of GNI of which 0.6% is earmarked for NGEU purposes) and the MFF payment ceiling) is also expected to become bigger as GNI in current prices is expected to increase roughly in line with nominal GDP. Such increased headroom theoretically offers an additional leeway for increasing MFF ceilings without affecting negatively the real value of resources over and above these ceilings.

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17 The Commission amending letter 1 to its draft budget for 2023 foresees an unused margin for commitment of EUR 444,9 million in current prices. The DAB 5 for 2022 estimates that the unused commitments for 2022 would be of EUR 622 million in current prices. Finally, the Commission's MFF technical adjustments of June 2022 identified unused commitments in 2021 of EUR 641 million in current prices of which 204 million would remain unused after the AL1 for the 2023 Budget. As we assumed that the 2023 foreseen margin would be used that year, the remaining commitment margin for 2022 and 2021 would amount to EUR 826 million. Such amount would need to be used as corresponding commitments partially matching additional payment appropriations following the deployment of unused 2022 payment appropriations under the SMI assumed in the counterfactual scenario. As for the remaining unmatched payment appropriations, they could theoretically correspond to previous commitment appropriations that could be frontloaded ahead of initially foreseen schedules if procedures required ahead of payment are accelerated.

18 For the sake of the exercise, we will assume that such 3609 million amount is evenly distributed over the 2023-27 period and subject to the deflator adjustment.

19 The Flexibility Instrument can only be deployed up to a maximum amount of 1.01 billion EUR in current prices on a yearly basis. Recital 10 and Article 12 of the 2020 MFF Regulation provides that such instrument should only be used for unforeseen expenditure in a given financial year.

20 Such amount represents the addition of 1/5 of the 2022 expected unused margin for payment appropriations for 2022 in addition to the amount available under the flexibility instrument. In other words EUR 1730 Million in current prices, which is roughly 1% of appropriations for the 2023 budget.

21 As a rule, VAT and customs duties related revenues both increase at rates that are sontrgly correlated to nominal GDP increases. As the ORD provides the application of an ex ante uniform call rate on VAT receipts and customs duties' collected by Member States, this means that an unexpected increase in nominal GDP should yield an unexpected increase in these own resources.

Concluding remarks

In brief, as put in evidence in the previous section and as also emphasized in the BUDG Draft report on *Upscaling the 2021-2027 Multiannual Financial Framework: a resilient EU budget fit for new challenges*[22], the ongoing inflation surge will have a severe and lasting impact for the EU budget. Furthermore, as just outlined in the previous section, the current MFF framework is very far from providing for a meaningful room of manoeuvre and tools to tackle adequately such challenge.

If the purpose is to realign planned EU expenditure with the expectations underpinning the ongoing MFF when adopted, then the 2023 MFF review/revision process represents a key opportunity for comprehensively assessing and rectifying the adequacy of ceilings, flexibilities, as well as the deflator rate.

In any case, to the extent that the ongoing inflation surge is already having a sizable downward impact on planned expenditure, it seems guaranteed that a broad range of EU programmes, such as cohesion funds and NGEU programmes, that involve detailed and complex planning and multiyear instalments, should be reviewed and updated irrespectively of the MFF review process outcome. Committed funds will not have the initially expected economic real value and would thereby allow purchasing way less goods and services than expected. Moreover, as EU expenditure includes non-discretionary items that cannot be reduced (such as, EURI interest repayments), these items will have to be serviced regardless of MFF ceilings. Such items, in addition to other non-discretionary items (such as EU agent's wages or energy bills)[23] are expected to grow well above the fixed 2% deflator and will thereby put a supplementary pressure on discretionary items.

Finally, beyond the general assessment provided in this note, an exhaustive and granular analysis would also be warranted[24]. As inflation does not affect uniformly the economy, certain categories of expenditure and some Member States and regions are and will be more affected than others will. This is notably the case whenever there is a larger than average concentration of projects requiring the purchase of energy intensive goods and services, gross capital formation in infrastructure or the provision of direct income support to farmers in the context of the CAP. Such granular assessment would also represent a key input for the MFF review/revision process itself.

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[22] Paragraph 9 of the BUDG Draft report on Upscaling the 2021-2027 Multiannual Financial Framework, *"Recalls that the MFF is increased annually on the basis of a 2 % deflator applied to 2018 prices; underlines that spiralling energy prices and extreme energy market volatility caused mainly by Russia's decision to cut gas supply have been feeding soaring inflation, with severe impacts on citizens, businesses and consumers; is deeply concerned that such unexpectedly high levels of inflation are placing the MFF under severe strain and reducing its purchasing power further, in a context where its overall level is already lower than previous MFFs; stresses that, in practice, this means that fewer Union projects and actions can be funded, thereby negatively impacting beneficiaries."*

[23] Such administrative expenditures are included in both Heading 7 as well as in chapter 1 of the other Headings of the EU budget.

[24] Among the several issues that such granular study should address, it would be worth developing a scenario-based projection of increases of non-discretionary expenditure (chapters 01 and Heading 7) and borrowing costs so as to estimate their impact on discretionary expenditure *caeteris paribus.* In the same order of ideas, it would also be useful to provide a scenario-based estimation of how the headroom will theoretically evolve drawing on the forecast for payments and inflation. Furthermore, an estimation of the 'revenue side' distributive effects of evolving shares of different categories of own resources, as well between Member States should also be addressed.