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EUROPEAN UNION DEBT FINANCING: LEEWAY AND BARRIERS FROM A LEGAL PERSPECTIVE

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We explore legal leeway for two approaches to debt-financing European Union spending: creation of extra-budgetary, one-off and temporary EU funds to finance European public goods (similarly to NextGenerationEU), and debt-financing the EU's regular budget, hence creating an on-budget, permanent borrowing capacity at EU level.

We find that NGEU could in principle be replicated. This would require an amendment to the Own Resources Decision (ORD) – a unanimous Council decision that designates the main sources of EU financing and requires ratification by each member state – to authorise borrowing and specify how the borrowing proceeds are to be used. However, this approach would be constrained by the legal requirement that financing EU spending through 'other revenues' (as opposed to 'own resources' designated as such in the ORD) remain exceptional. As a result, no permanent EU tasks could be financed through NGEU-like funds and NGEU-like financing could not exceed financing through 'own resources'.

We also find that, while EU primary law does not stop the EU from debt-financing its budget, the scope for EU borrowing would remain severely limited compared to a sovereign state. The permissible amount of borrowing must be specified in the ORD and the EU must be able to meet its debt service in any year, which must be secured by a sufficient amount of (non-borrowed) own resources.

Finally, considerable flexibility exists for the spending of borrowed funds, reg(t of e EmyPe(is)2its)
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1 Introduction

Policymakers appeal increasingly to the concept of European public goods. The European Commission has evoked European public goods in the energy and security sectors by building on the Support to mitigate Unemployment Risks in an Emergency (SURE) mechanism – introduced to tackle some of the labour-market consequences of the pandemic – and to support Europeans and industrial ecosystems in the current energy crisis[1]. The International Monetary Fund (Arnold et al, 2022) and the European Central Bank (Abraham et al, 2023; Freier et al, 2022) have called for the establishment of a fiscal capacity at EU and euro-area level to fund certain public investment categories (particularly climate related). The EU's need to galvanise resources 4 Tc 07 0 Td [(E)-8 (U)-12 (')-13 (s)]TJ -0.001 Tc 0.12 (' Sovereignty Fund'. Meanwhile, EU funding remains dependent on member states, which provide it with resources, as emphasised in 2022 by the German Federal Constitutional Court (GFCC, 2

This paper is not concerned with determining the scope of EU public goods, nor does it address the question which (if any) additional own resources should be given to the EU (Schratzenstaller and Krenek, 2019). Rather, we investigate the legal feasibility of EU borrowing on the capital markets to finance these goods. EU debt issuance is far from novel (Claeys et al, 2023). But the pandemic recovery fund, NextGenerationEU (NGEU) has changed EU borrowing in terms of magnitude and terms of legal design. The pandemic bolstered the view that unforeseen shocks hitting the rise to a solidarity mechanism such as NGEU, given the magnitude of potential funding in the areas of climate, security and social policy.

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2 EU budget law primer[2]

The EU budget system is based on a web of primary and secondary EU laws, and the budget amounts to about 2 percent of total EU public spending. EU revenues, which finance the EU budget, are divided into 'own resources' and 'other revenue' (Article 311 TFEU)

- 'Own resources' are the main sources of revenue and are defined as income streams that are expressly enumerated and described in an Own Resources Decision

Another pillar of the EU budgetary framework is the principle of universality, according to which revenue cannot be used for specific expenditure, ie there must not be any earmarking of revenue.[5] However, there are exceptions to this principle. 'Assigned revenues' constitute a type of 'other revenue' that are used to finance specific items of expenditure rather than the general budget can be paid out as loans to EU countries that will have to be repaid at low interest rates (back-to-back financing) while the remainder can be provided as non-repayable grants (borrowing for spending).

Based on a proposal by the European Commission, the Council's 2020 ORD empowered the EU to issue instruments in capital markets, backed by the EU budget and thus ultimately EU countries. Notably, member states are obliged to step in if no other own resources are created when the EU's debts become due (Blaya, 2022). To provide investors with the necessary confidence in the EU's ability to repay its bonds in full and on time, the 2020 ORD temporarily and exceptionally increased the own resources ceiling by 0.6 percent of EU GNI.[9]

NGEU was a game changer in at least three crucial aspects:

- First, its volume was far greater than any of the debt issuance activities before; its €750 billion dwarfed the EFSM size of €60 billion, the hitherto biggest EU financial assistance programme.

- Second, NGEU shifted away from **back-to-back** lending – whereby both the proceeds of EU debt issuance and the associated debt service are immediately passed on to the country requesting a loan from the EU – towards a diversified funding model that makes the EU a regular bond issuer. This has two important implications. On the funding side, similar to what the ESM has done for years, or sovereign states for even longer, the EU will issue securities between 2021 and 2058 across the entire maturity curve, rather than only when a country asks for a loan (Grund and Waibel, 2023). With regard to expenditure, roughly half of all NGEU expenditure that is passed onto EU countries does not have to be paid back by the recipient EU countries. Such borrowing-for-spending brings the EU budgetary setup, at least temporarily, closer to traditional sovereign finance operation.

- Third, the EU will have to repay NGEU bonds up to 2058 that were issued to finance spending between 2021 and 2026, epitomising a long-term structural shift in how the EU finances itself.

3.2 Using NGEU funds

The expenditure side is regulated by Regulation (EU) 2020/2094 (EURI), based on Article 122 TFEU. This regulation identifies the measures to facilitate the recovery from the pandemic, allocates the borrowed funds to the EU's recovery programmes and clarifies that funds are raised as external assigned revenue (Council Legal Services, 2020). Article 122 TFEU, which is also referred to as a 'solidarity clause', justifies the financing of targeted and temporary economic the RRF Regulation (Regulation (EU) 2021/241). As noted above, the RRF Regulation builds on the EU's competence to strengthen economic cohesion in line with Article 175 TFEU, underscoring a broader trend in European economic policymaking (Steinbach, 2017; Fabbrini, 2022). If they wanted to access loans or grants under the RRF, EU countries had to submit recovery plans in which they committed to reforms or investments in common priorities – money is delivered upon verification of compliance with milestones and targets (de Gregorio Merino, 2021).

3.3 Repeating NGEU?

There is no general barrier to adopting an NGEU-type approach for the purposes of financing specific future expenditures of the EU. This would require an amended ORD in accordance with Article 311 TFEU, which would authorise borrowing up to a maximum amount and for a specific purpose, and adjust the own resources ceiling to ensure the borrowing can be repaid.

However, replication could raise concerns on at least two levels, depending on the volume of an off-budget fund as well as its raison d'être:

1. Article 311 TFEU unambiguously identifies own resources as the primary instrument to finance the EU budget. This primacy would be challenged if a large and increasing portion of EU expenditure were to be financed off-budget via other revenue, including borrowing, rather than own resources.

2. NGEU expenditure is justified by the occurrence of an exceptional event (the COVID-19 pandemic) and the need to address the consequences without increasing the pressure on the finances of EU countries when their budgets are already under pressure. The key legal question is whether an NGEU-like mechanism must operate within the

subsequent years. If debt issuance was classified as an own resource, as discussed below, this restriction would no longer be binding.

This has major implications for the repeated use of the off-budget structure. The legal expectation is that after the initial large impulse of NGEU, other revenues would decline to a fraction of own resou until NGEU is repaid entirely in 2058. Consequently, if the NGEU model were to be replicated to finance public goods in the coming years – as proposed, for example, by the ECB in the form of an EU Climate Fund (Abraham et al, 2023) – the quantitative limit postulated by the GCC becomes binding. Accepting the principle that other revenues are capped at the size of the MFF, or even below, would suggest that for the budgetary period until 2027 very little space is left for debt financing programmes.

b) The exceptional character underpinned by a suitable legal basis

The second point of contention in repeatedly using the NGEU model is its frequently invoked 'exceptional' character[14]. The chief legal concern is whether the ORD itself, based on Article 311 TFEU, was by itself sufficient to justify NGEU borrowing or whether it should be read in conjunction with Article 122 TFEU, which would limit such borrowing operations to address exceptional circumstances or natural disasters. The issue is complicated by the fact that previous EU borrowing programmes operated outside the own resources framework, using the budgetary headroom of the EU budget, relying on Article 122 TFEU (EFSM) or other primary law provisions (such as the predecessor of Ar 175 TFEU extent that a Treaty norm offers a competence for the EU to allocate common funds to EU countries, there should be no discrimination between the origin of the financial resources as debt-funded resources or regular own resources.

This means that the EU has discretion to design spending programmes of debt-financed resources raised as other revenues under the narrow conditions of Article 311 (see Section 3.2). Programmes pursuing objectives of cohesion, akin to macroeconomic programmes addressing cross-border smoothening, may be justified under Article 175 TFEU. The climate emergency may justify a spending programme under Article 122 TFEU. Environmental spending programmes more generally could be initiated under Article 192 TFEU. Transnational infrastructure can be financed on the basis of Article 171 TFEU, and trans-European research can be financed on the basis of Articles 179 and 173(3) TFEU.[18] No matter which primary law basis one invokes to justify a spending programme, any spending of debt-financed resources must be fully aligned with the ambit of the primary law legal basis (Leino-Sandberg and Ruffert, 2022).

Finally, every (re)distribution of EU funds must be held against the benchmark of the no-bailout clause in Article 125 TFEU (EFCC, 2022). Any significant debt-financed spending programme may create tension with this provision. Under NGEU, the redistributive effect has been significant, as the centrally coordinated debt financing offers relief to EU countries' budgets, especially when grants (rather than loans) are allocated. Article 125 TFEU was a key concern during the EU debt crisis when financial aid was set up to address imminent liquidity (and solvency) issues in EU countries, as its function was primarily to support national budgets. By contrast,(ds)-2 ( )10 (m)-5 (us)-2 (t)-4 (b)11 (e)-5 :

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significantly boosts the democratic legitimacy and restores the institutional balance that the NGEU's Council-focused process has arguably dented.

- Second, given that Article 310 TFEU requires all revenue and expenditure to be shown in the budget, there would be full transparency, including oversight by the European Court of Auditors (Blaya, 2022).

- Third, NGEU has distorted the budgetary preference for own resources (on-budget) over other revenue (off-budget) stipulated in Article 311 TFEU (requiring that "without prejudice to other revenue, the budget shall be financed wholly from own resources"). Integrating debt funding in the budget by making it an own resource would re-align the relationship between other revenue as the secondary source and own resources as the main element of EU budget financing. Off-budget financing could assume its pre-COVID-19 role, allowing for limited borrowing to finance very specific expenditures (as defined in Article 21 of the EU Financial Regulation).

Additionally, as was the case for NGEU, EU countries, including their parliaments, will remain in full control of the EU's revenue from borrowing operations via the ORD. The Commission would only be authorised to borrow up to a pre-defined limit. This would alleviate concerns consistently uttered by the GFCC throughout a series of judgements during the EU debt crisis. Under national constitutional law, only foreseeable and sufficiently quantifiable liabilities of the German budget vis-à-vis the EU would be permissible [illegible] under the narrow German legal benchmarks.

guarantee of payment" provided by the member states (Council Legal Services, 2020). There is no easily discernible reason why replicating this could be Article 122 TFEU, but other primary

Shortcomings	-

category in the ORD stays within the limits of the own resources ceiling, revolving debt issuance may become an option.

On the expenditure side, borrowed funds may be used to finance any regular EU budget expenditure, though direct financial assistance is constrained by the no-bailout provision (the ESM remains the vehicle to channel financial assistance to EU countries under strict conditionality). Given that all EU expenditure must comply with EU primary law (but secondary EU legislation), there is no need for an additional legal basis for spending borrowed resources. Alternatively, if politically desired and to address residual legal concerns, earmarking of borrowed debt to certain EU-budget expenditure is feasible, but would require modification of the EU Financial Regulation.

https://www.bundesverfassungsgericht.de/SharedDocs/Entscheidungen/EN/2022/12/rs20221206_2
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Annex: Relevant EU Treaty articles

Article 122 TFEU

1. Without prejudice to any other procedures provided for in the Treaties, the Council, on a proposa from the Commission, may decide, in a spirit of solidarity between Member States, upon the measu appropriate to the economic situation, in particular if severe difficulties arise in the supply of certain products, notably in the area of energy.

2. Where a Member State is in difficulties or is seriously threatened with severe difficulties caused b natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, financial assistance to the Member State 2. W1 (ic)

It shall be established for a period of at least five years.

The annual budget of the Union shall comply with the multiannual financial framework.

2. The Council, acting in accordance with a special legislative procedure, shall adopt a regulation laying down the multiannual financial framework. The Council shall act unanimously after obtaining consent of the European Parliament, which shall be given by a majority of its component members.

The European Council may, unanimously, adopt a decision authorising the Council to act by a qual majority when adopting the regulation referred to in the first subparagraph.

3. The financial framework shall determine the amounts of the annual ceilings on commitment appropriations by category of expenditure and of the annual ceiling on payment appropriations. The categories of expenditure, limited in number, shall correspond to the Union's major sectors of activi

The financial framework shall lay down any other provisions required for the annual budgetary procedure to run smoothly.

4. Where no Council regulation determining a new financial framework has been adopted by the e the previous financial framework, the ceilings and other provisions corresponding to the last year of that framework shall be extended until such time as that act is adopted.

5. Throughout the procedure leading to the adoption of the financial framework, the European Parliament, the Council and the Commission shall take any measure necessary to facilitate its adoption.

Article 314 TFEU

The European Parliament and the Council, acting in accordance with a special legislative procedur shall establish the Union's annual budget in accordance with the following provisions.

5. The Conciliation Committee, which shall be composed of the members of the Council or their representatives and an equal number of members representing the European Parliament, shall hav the task of reaching agreement on a joint text, by a qualified majority of the members of the Council or their representatives and by a majority of the representatives of the European Parliament within twenty-one days of its being convened, on the basis of the positions of the European Parliament and the Council. The Commission shall take part in the Conciliation Committee's proceedings and shall take all the necessary initiatives with a view to reconciling the positions of the European Parliament and Council.

6. If, within the twenty-one days referred to in paragraph 5, the Conciliation Committee agrees on a join text, the European Parliament and the Council shall each have a period of fourteen days from the d of that agreement in which to approve the joint text.

7. If, within the period of fourteen days referred to in paragraph 6:

(a) the European Parliament and the Council both approve the joint text or fail to take a decision, or if one of these institutions approves the joint text while the other one fails to take decision, the budget shall be deemed to be definitively adopted in accordance with the joint text; or

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