An uncompromising budget

The EU response to the COVID-19 crisis has so far been weak. Zsolt Darvas considers the Next Generation EU proposal, and feels that an opportunity has been missed to reform the EU budget

Apart from decisive European Central Bank measures, the EU-wide response to the COVID crisis had been rather weak until the Commission put on the table a drastically new proposal: the creation of a new recovery facility, 'Next Generation EU', that would borrow money in the name of the EU to finance EU-wide expenditures.

The changes to the proposed standard seven-year budget that primarily focuses on long-term structural issues are however generally small, and funding reductions are compensated by new funds from the recovery instrument, suggesting that an opportunity is missed to reform the EU budget.

Summary

The overall proposal has a number of useful aspects and some limitations. Main advantages:

- 'Next Generation EU' financed by long-term EU borrowing would include €440 billion grants, €60 billion guarantees and €250 billion loans, in addition to the standard seven-year budget.

- Two-thirds of the new €440 billion grants would be channelled via the proposed new Recovery and Resilience Facility, which increases transparency. The rest will be scattered all over in existing EU budget programmes, possibly to deploy them faster or to increase the chance of acceptance of the whole package by pleasing member states unhappy about previously proposed cuts.

- 'Next Generation EU' aims at macroeconomic stabilisation while boosting green and digital transitions.

- Funding is increased for external actions, research and health, which is welcome.

- The current 2020 EU budget is increased by €11.5 billion.
- Some useful new own resources are proposed, which help align EU revenues with EU goals and might also trigger behavioural changes, such as lower pollution.
- Leaving out earlier proposals for the 'euro area budget' is not a big loss due to their inferior design; focus should be concentrated on the new recovery facility.
- The boldness of the recovery facility proposal can boost confidence with positive impacts on the economy.

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Limitations:

- Though macroeconomically significant, the overall measures announced remain below what the dire economic situation would necessitate.
- Due to the administrative processes, programme design and approval, actual pay-outs will not be frontloaded but spread over a number of years.
- The proposed €250 billion loans are a less useful mechanism than the grants.
- The proposal misses the opportunity for a more fundamental reform of the EU's budget, including the Common Agricultural Policy.
- Only the new own resources that are paid by non-EU entities will help the financing of the general EU budget and loan repayment for 'New Generation EU'. Own resources coming from EU-based entities and governments would only change the distribution of overall national contributions.
- The Just Transition Fund to alleviate the socio-economic impacts of the transition towards climate neutrality is heavily front-loaded to 2021-2024, even though the green transition will have a longer time frame.
- Rebates would stay. This may be designed to alleviate opposition to a more fundamental reform of the MFF and help some countries accept the whole plan.

Table 1. Comparison of the May 2018 and May 2020 MFF proposals for commitment appropriations (in 2018 constant prices

	2018 MFF proposal for 2021-2027	2020 MFF proposal for 2021-2027	2020 Next Generation EU proposal for 2021-2027		
			Grants	*Guarantees*	*Loans*
Research and innovation	91.0	87.7	13.5		
European strategic investments	44.4	30.8		56.3	
Single market	5.7	5.8			
Space	14.4	13.4			
Regional development and cohesion	242.2	237.7	50.0		
Recovery and resilience		18.2	310.0		250.0
Economic and Monetary Union	22.3				
Investing in people, social cohesion and values	123.5	116.4			
Agriculture and maritime policy	330.7	340.2	15.0		
Environment and climate action	5.1	15.3	30.0		
Migration	10.0	12.1			
Border management	18.8	17.7			
Security	4.3	4.6			
Defence	17.2	9.5			
Resilience and crisis response	1.2	4.3	9.7		
External action	93.2	89.2	15.5*		
Pre-accession assistance	12.9	12.9			
European public administration	75.6	74.6			
Margins	22.2	9.6			
Total	1,134.6	1,100.00	443.7*	56.3*	250.0

*Note: Insufficient information does not allow splitting the 202102027 MFF proposal between grants, guarantees and loans. * The €15.5 billion external action component of Next Generation EU fund also includes guarantees, but their amount is not specified.*
Source: Author's compilation based on Commission Communications COM(2018) 321 final (page 30) and COM(2020) 442 final (page 20).

- Little information is provided about EU budget revenues; the earlier proposal to derive an EU revenue stream based on the common consolidated corporate tax base is dropped; nothing is said about what proportion of customs duty revenues could be kept by member states as 'collection costs'.

- The proposal also misses an opportunity to improve on the EU's outdated budgeting methodology.

- The proposal is also still incomplete as underlying calculations and proposed regulations are still to be detailed, perhaps because of time pressure.

The MFF saga

Debates around the EU's seven-year Multiannual Financial Framework (MFF) for 2021-2027 dragged on for more than two years after the Commission made its first proposal without reaching an agreement.

Member states were bickering about macroeconomically irrelevant points such as whether the size of the budget should be 1.00%, 1.08% or 1.12% of gross national income (GNI), which gaps are several factors smaller than any planning error in a national budget.

The most contentious issues led to a dead end: the assessment of EU added value of some spending like in agriculture; concerns about the proper use of some funds; proposed cuts to agricultural and cohesion policy spending; increases in spending on new priorities like the fight against climate change; linking EU funds to the respect for rule of law; the elimination of rebates; establishing new revenue sources; the euro area budget; the increase in national co-financing of cohesion projects etc.

While these disputes remain today, the coronavirus pandemic has completely changed the economic and social outlook as the EU is expected to suffer from a very deep recession, jobs and well-being are at risk, and hard-hit regions might fall behind.

Soaring public debt levels in some countries might trigger sovereign debt crises with potentially devastating social, economic and political consequences, not only for the countries concerned but for the EU as a whole.

EU-wide response so far

The EU reacted by relaxing state-aid and fiscal rules to allow governments to subsidise businesses losing revenues. Such rescues are welcome as they keep the productive and human capacity ready to take off when the recovery starts.

Moreover, stimulus in one country helps other EU countries through spillover effects. However, uneven state supports across the Union risk undermining competition in the single market, as also argued by Guntram Wolff.

The European Central Bank addressed the economic fallout by significantly expanding asset purchases, relaxing bank capital rules, offering credit to banks with a subsidy and accepting an even broader set and less credit worthy collateral from banks.

In contrast, the rest of the European response has been rather weak so far. Not much could have been done with the 2020 annual EU budget because all ceilings had been fixed in 2013, when the 2014-2020 MFF was agreed.

The Commission took several initiatives that were well made, even if they cannot make a big difference for member states' public finances: mobilise all unused funds, allow reallocations between and within programmes, simplify access criteria, provide liquidity by delaying the repayment of unspent pre-financing and abolish national co-financing of EU cohesion spending.

Overall, the Eurogroup's €540 billion package is feeble.

- €240 billion is a new pandemic credit line from the European Stability Mechanism (ESM) for eurozone members, which offers cheap loans for 10 years amounting to maximum 2% of GDP of each country to cover pandemic-related healthcare costs. Its usefulness can be questioned, considering that no country has yet applied for it in the two weeks since it became operational.

  Applying for an ESM loan could signal that the country has weak public finances ('stigma effect'), which could reduce demand for the credit line. Also, pandemic-related healthcare costs so far have been well below 1% of GDP, so the potential interest saving from a small credit line is miniscule.

- The €100 billion temporary Support to mitigate Unemployment Risks in an Emergency (SURE) for all EU countries is just a small step forward, as it can at best lead to marginal interest savings.

- The European Investment Bank's €200 billion extra liquidity support to hard-hit small and medium-sized enterprises in the EU, though welcome, would not significantly alleviate the fiscal burden of high-public debt countries.

The recovery fund proposal and the counter-proposal

The Franco-German temporary recovery fund proposal of 18 May 2020 put an entirely new alternative on the table:

€500 billion joint borrowing would finance EU budgetary expenditures for the most affected sectors and regions, involving redistribution between EU countries.

This was rightly hailed as a defining moment in the Union's history as it proposed to implement actual EU spending instead of loans or the usual EU financial trick that trigger large amounts of private investments from little EU money guarantee. This said, €500 billion (or about 3.6% of EU GDP), though a macroeconomically significant amount, was not as high as the severity of the COVID induced crisis would have warranted in my view.

The Franco-German proposal also aimed to integrate the fund into the EU's multiannual budget, foster green and digital transitions, strengthen research and innovation, support structural reforms, and ensure fair taxation and a common consolidated tax base.

A counter-proposal by the so-called 'frugal four' – Austria, Denmark, the Netherlands and Sweden – called for a *"modernised EU budget"* that reprioritized existing spending. It was in essence a call for a substantial reshuffle of current EU spending. The four countries also called for a temporary recovery fund which only provides loans and avoids any mutualisation of debt; they stated that the overall level of standard MFF (not considering the recovery fund) should not be more than 1.00% of GNI; and insisted that the EU budget rebates from which these countries benefit must remain.

The 27 May 2020 new MFF proposal

The European Commission revealed its new MFF proposal on 27 May 2020. The proposal needed to combine two features: medium- and long-term structural spending, which is the main scope of the 'standard' seven-year MFF; and, for the first time in the history of the Union, macroeconomic stabilisation at the EU level. It includes two main elements:

- The standard seven-year MFF for 2021-2027, amounting to €1,100 billion at constant 2018 prices, or €1,240 billion at current prices, which could be around 1.12% of EU GNI[1] and to be financed, as usual, by some direct EU budget revenues and member state contributions.

- The new and temporary 'Next Generation EU' instrument for 2021-2024, amounting to €750 billion at constant 2018 prices, or €809 billion at current prices. Out of €750 billion, about €440 billion would be grants, €60 billion would be guarantees and €250 billion would be loans[2]. The EU would borrow long-term to finance this instrument. While most of the commitments for this instrument would be made in 2021-2024, actual pay-out would spread over more years.

Somewhat misleadingly, the Commission's communication adds a third item, the €540 billion Eurogroup measures discussed above, that mostly constitute of loans and thereby differ from EU budget expenditures. As argued, very few countries can be expected to draw on the ESM credit line and SURE, which are part of these €540 billion earlier measures. Therefore, much less than €540 billion are likely be actually used.

In addition to the above proposals, which apply for the period starting in 2021, the Commission also proposes to amend the current multiannual financial framework 2014-2020 and make an additional €11.5 billion in funding available in 2020, reflecting the urgency of the situation.

'Next Generation EU' – the new recovery instrument

This new facility is, like the Franco-German proposal, a bold, macroeconomically relevant, positive step forward. However, considering the severity of the current crisis, on its own it remains below the levels needed for a stimulus to be efficient.

This instrument is aimed at macroeconomic stabilisation and financed by EU borrowing on capital markets. It almost fully incorporates the Franco-German proposal of €500 billion EU spending, apart from the fact that €60 billion of the €500 billion amount would be guarantees instead of EU spending.

€250 billion loans would also be available in the scheme, though this component is less useful. Some countries could benefit from cheaper borrowing from the EU than from the market, but since interest rate differentials are generally low, the benefit would be small.

However, the most fiscally-stretched countries could still benefit from long-term EU borrowing, since they would have to raise less from the market in the meantime. This can help public debt management. Whether borrowing from the EU budget under 'Next Generation EU' would carry a 'stigma' effect similar to what the literature suggests for borrowing from the IMF remains an open question.

It is so far impossible to evaluate the extent of possible redistribution via 'Next Generation EU' because the communication is not clear on this point apart from stating that *"It will be available to all member states but support will be concentrated in the parts of the Union most affected and where resilience needs are greatest."*

Countries would have to prepare recovery and resilience plans as part of their National Reform Programmes, which would be assessed in the European Semester process. Thereby, the Commission, the Council and the European Parliament will have control over the allocation of the funds. The EU support would be released in instalments depending on progress made and on the basis of pre-defined benchmarks.

The three arms of the 'Next Generation EU' instrument

Arm 1: Supporting member states to recover (€415 billion grants and €250 billion loans)

- The 'Recovery and Resilience Facility' is the largest component of the 'New Generation EU instrument', with €310 billion grants and €250 billion loans. Its goals are to support investments and reforms essential to a lasting recovery; improve the economic and social resilience of member states; and support the green and digital transitions.

- REACT-EU aims to achieve a quick response while the other instruments are put in place. It increases cohesion policy support by €5 billion as soon as 2020 via a revision of the current 2014-2020 MFF and by €50 billion in 2021-2022;

- The already planned Just Transition Fund would be significantly boosted by €30 billion, to reach a total value of €40 billion in 2021-2027;

- The European Agricultural Fund for Rural Development would benefit from an additional €15 billion to support farmers and rural areas in making the structural changes necessary to implement the European Green Deal.

Arm 2: Triggering private investments (€56 billion guarantees)

- The proposed new Solvency Support Instrument (€5 billion in 2020 by modifying the current MFF and then €26 billion from the 'Next Generation EU') aims to mobilise private investment in struggling companies by providing partial guarantees against losses. Altogether, €31 billion from the EU budget will provide a guarantee of €75 billion to the European Investment Bank Group, which in turn will leverage this guarantee up to €300 billion investment. Therefore, financial engineering aims to increase actual EU money by 10-fold;

- InvestEU programme, already agreed by the co-legislators, would be boosted by €3 billion to trigger private investment of €240 billion;

- The new Strategic Investment Facility will get another €15 billion as an additional window under InvestEU to support building strong and resilient value chains across the EU and enhance the autonomy of the Union's single market. This could generate €150 billion private investments.

Arm 3: 'Learning the lessons from the crisis': mix of measures related to health, protection, research and external actions (€39 billion mostly for grants, but some of this amount is for guarantees)

- A new EU4Health programme with a total funding of €4 billion, of which €7.7 billion would be financed from the New Generation EU instrument, to enhance EU health crisis prevention, preparedness and response;

- rescEU, the EU's civil protection mechanism to finance investments in emergency response infrastructure, transport capacity and emergency support team, is to be reinforced by €2 billion;

- Horizon Europe is proposed to be boosted by €5 billion to reach a total envelope of €94.4 billion, to increase European support for health and climate-related research and innovation activities;

- To strengthen external actions, €5 billion would be allocated to the neighbourhood instrument (including a new External Action Guarantee) and €5 billion to humanitarian aid.

Composition and timing of EU spending

Disbursement from the Recovery and Resilience Facility is not expected to be frontloaded (Table 2). Only 6% is expected to be actually paid out in 2021, and about half between 2023-24. REACT-EU, which is supposed to be fully committed in 2021-2022, could help frontloading, but its firepower is less than one-sixth of the Recovery and Resilience Facility. Thereby, the total €440 billion grant component of 'Next Generation EU', which is 3.2% of annual GNI, will be distributed over a number of years, with the largest pay-outs expected in 2023-24.

Two-thirds of the grant component of the 'New Generation EU' instrument are included in the Recovery and Resilience Facility. One third of the grants is used to top up various existing facilities. Though this will make it difficult to disentangle the temporary recovery measures from the more long-lasting 'standard' EU budget expenditures (see Table 1), this method offers some advantages. Existing EU programmes are up and running and can be deployed fast.

Table 2. Expected annual breakdown of the Recovery and Resilience Facility disbursements

	2021	2022	2023	2024	2025	2026	2027	Later years
Grants - Commitments	39%	40%	10%	10%	0%	0%	0%	
Grants - Payments	6%	16%	23%	26%	18%	8%	3%	1%
Loans - Commitments	50%	50%						
Loans - Payments	15%	28%	25%	23%	10%			

Note: The table on page 40 of regulation proposal COM(2020) 408 final.
Source: This facility is proposed to include €310 billion grants and €250 billion loans (at 2018 constant prices).

Moreover, countries that complained about EU expenditure cuts in the 2018 proposal might find it advantageous that the new recovery facility increases these spending categories, which might in turn increase the chances that the whole package is accepted. Allocating more funds to EU public good such as research in health, resilience, and the green and digital transitions is welcome.

More generally, the recovery facility aims at combining macroeconomic stabilisation with the goals of green and digital transitions, which is welcome too. By attaching green conditions to state aid, governments can promote companies' economic and environmental viability thereby accelerating the adoption of low-carbon and circular technologies, which are important EU goals, as argued by Dirk Schoenmaker. The same principle should be extended to EU-financed programmes.

The new proposal to increase the allocation from the Just Transition Fund (JTF) from €10 billion to €40 billion is welcome, considering that this is positive EU-wide initiative (Cameron *et al*), which had been allocated a rather small amount in the initial January 2020 proposal.

However, the JTF seems to be heavily frontloaded as the increase would be financed by the Recovery and Resilience Facility, which is available for the next four years. While frontloading macroeconomic stabilisation would be important, frontloading JTF is inconsistent with its objective to alleviate the socio-economic impacts of the transition towards climate neutrality.

The green transition it is meant to accompany, will not be that frontloaded; neither its social impacts. Moreover, important changes are needed for the country allocations to avoid undue concentration of this funding in some member states, as Cameron *et al* argued. The Commission's communication does not foresee such changes.

The proposed increased funding of external actions is a positive aspect and corrects to some extent the timid 2018 proposal. The EU Commission thus proposes to take a greater responsibility for helping our less fortunate neighbours and other parts of the world.

Reinforcing EU's health capacities is obviously welcome, as the coronavirus pandemic revealed that the EU can play an important role in addressing public health crises.

The proposed overall amount of the 'standard' seven-year MFF, €1,100 billion, is slightly lower than the €1,1134.6 billion proposal made two years ago (both are at 2018 constant prices). In the meantime, GNI forecasts were revised downward and the current proposal as a share of GNI (estimated at 1.12%) is practically the same as the 2018 proposal as a share of GNI (1.11%)[1].

Otherwise, the differences between the May 2018 and the May 2020 proposals are generally small and wherever a somewhat larger cut is proposed, this is compensated by top-ups from the 'New Generation EU' instrument. This suggests that the current opportunity for a more fundamental reform of the EU's budget was missed.

Leaving out the 2018 proposal for the 'euro area budget' is not a big loss, given that its proposed design was disappointing. The so-called Budgetary Instrument for Convergence and Competitiveness (BICC) seemed to replicate existing EU budget facilities without a meaningful redistribution across countries.

The pandemic-induced emergency has not led to more wide-ranging changes to the EU's Common Agricultural Policy even though the European value added of support for farmers is questionable (see our paper with Guntram Wolff). Importantly, CAP is ineffective and possibly counterproductive in achieving the goal of greening European agriculture.

It would have been desirable to reallocate farmers' earnings subsidies to correcting market failures and promoting public goods, such as environment and biodiversity, and, like in the US, insuring against large risks such as earthquakes and animal disease epidemics.

National co-financing of earnings subsidies is another missed reform opportunity.

Little is said about the other major EU budget spending item, cohesion policy, beyond that the Commission is currently adjusting its earlier proposals.

The role of new own resources

Little information is provided about the financing of the EU budget, beyond reaffirming some useful proposals already made in 2018 (a simplified value added tax-based own resource, a non-recycled plastics packaging waste levy and a revenue based on the EU's Emissions Trading System) and naming some new possible revenue sources (a carbon border adjustment mechanism, a levy on large companies and a digital tax).

While the 2018 revenue source proposals were positive (see our blogpost with Grégory Claeys), there is a debate on the desirability of carbon border adjustment. Aligning EU revenues with EU goals is sensible and might trigger behavioural changes, such as lower pollution.

The 2018 proposal to derive an EU revenue stream based on the common consolidated corporate tax base is dropped, even though we had a positive view of this proposal earlier. The commission communication contains the somewhat misleading claim that new direct EU budget revenues (called 'own resources') will 'help' the repayment of EU borrowing for the New Generation EU instrument 'in a fair and shared way'. This claim calls for clarification.

Own resources might reduce the contributions by national finance ministries to the EU budget, but do not necessarily reduce the total contribution of the country, if we take into account what companies, which are subject to the own resources, contribute.

Guntram Wolff highlights that an EU tax on companies would mean that the revenues from such a tax would not accrue to national budgets, implying lower national budget revenues. Some new own resources would even be paid by finance ministries.

Therefore, unless the new resource comes from entities outside the EU, they just change the distribution of total national contributions to the EU budget. Only some of those proposed by the Commission, like the carbon border adjustment mechanism proposal and a new digital tax, would be paid, at least partially, by non-EU based entities and therefore reduce national contributions. Others do not, like the one based on the EU's Emission Trading Scheme and the levy on non-recycled plastic waste.

The rebate compromise

EU budget revenue corrections, or rebates, are granted in a complex and non-transparent system (see here). The rationale for rebates does not correspond to the original idea of the 1984 Fontainebleau Summit, which stated that *"any member state sustaining a budgetary burden which is excessive in relation to its relative prosperity may benefit from a correction at the appropriate time"*: countries that benefit from the rebates are among the most prosperous in the EU and have low public debt levels.

In my view, the largest net contributors might judge that a big share of the EU budget is redistributed to countries for spending that do not constitute European public goods, or that there are risks for their proper use. In this case their attempt to reduce net contributions is understandable.

The May 2020 proposal said that: *"in the present situation, given the economic impact of the COVID-19 pandemic, phasing out of rebates would entail disproportionate increases of contributions for certain member states in 2021-2027. To avoid this, the current rebates could be phased out over a much longer period of time than foreseen by the Commission in its proposal in 2018."* In other words, rebates remain.

Full elimination of the rebates would increase the net contribution of the Netherlands by 0.15% of GNI, of Sweden by 0.12%, of Germany by 0.07%, while it would not change the net contribution of Denmark and would reduce the net contribution of other countries by 0.05%, in each year (see Table 4c here)[3].

Perhaps keeping the rebates will be the price for the approval of the New Generation EU instrument. ■

Zsolt Darvas is a Senior Fellow at Bruegel

Endnotes

1. The Commission has not expressed the overall amount of the proposed MFF as a share of GNI. For my calculations, I used the May Commission forecast for 2021 and assumed that real GNI growth will be 1.5% per year in 2022-2027. Under such a scenario, the €1,100 billion seven-year MMF amounts to 1.12% of GNI. The May 2018 proposal foreseen that the then-proposed €1,134.6 billion overall value would amount to 1.11% of GNI. Between May 2018 and May 2020, GNI outlook deteriorated and thereby a lower amount now accounts for the same share of expected GNI as previously proposed larger amount.

2. The Commission's Communication talks about €500 billion grants, but the detailed description reveals that part of that

would be guarantees.
3. The reason why Denmark would not face any change in net contributions by a complete elimination of rebates is that Denmark is entitled to lower rebates than the Netherlands, Sweden and Germany, but contributes to the rebates of these three countries. Denmark's rebate is projected to be the same as the Danish contribution to the rebates of the three countries in the 2021-2027 MFF. Austria benefitted from temporary reductions in its GNI-based contributions in 2014-2016, but not later, plus benefitted from a reduction in its contribution to the UK rebate, which ends with Brexit. Hence, no rebate is considered for Austria in the post-2020 period.

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