The EU's Big Pandemic Deal: Will It Be a Success?

In the face of an unprecedented economic recession caused by the Covid-19 pandemic, the EU has set up the biggest stimulus in its history - a 750-billion-euro fund called "Next Generation EU" - to support economic recovery. This initiative is ground-breaking as it includes grants and loan facilities for member countries, financed by EU borrowing. It stresses the importance of maintaining economic stability and strengthening social cohesion within the EU, while critics argue that it will undermine financial discipline in the EU and create the conditions for a "transfer union" in which some member states live at the expense of others. This program is designed as a one-time, temporary intervention, but if successful, it will signal a new direction for EU fiscal cooperation.

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The NGEU Economic Recovery Fund

As a response to the recession caused by the corona pandemic the EU has decided to create a large fund called "Next Generation EU" (NGEU) with a volume of EUR 750 bn to support the economic recovery. The fund will be financed by debt issued by the EU but backed by guarantees of the member states.

Views regarding the desirability of funds are divided. Its supporters argue that it is necessary for maintaining Europe's cohesion and the economic stability. Critics object that it will undermine fiscal discipline in the EU and set the stage for a "transfer union," where some member states live at the expense of others.

This paper discusses the financial flows implied by NGEU and the economic rationale for introducing it. The main results of the analysis are as follows. First, although spending financed through the fund will not start before the worst of the crisis is over, it still contributes to fiscal stabilization today, mostly through its effect on expectations. Second, the fund does not operate as an insurance device that would redistribute across countries according to their respective economic losses incurred due to the crisis. Instead, the fund redistributes from member states with high levels of GDP per capita to less affluent countries. Third, attempts to steer national governments toward political priorities defined at the European level such as the Green New Deal of the green and digital transformation of the economy are unlikely to be successful because money is fungible. The member states may replace national spending with money from NGEU and effectively use the funds for other types of spending, to cut taxes or to reduce their debt. This is not necessarily a disadvantage because it is far from clear whether the economic recovery works best if the net recipients use the support they receive via NGEU entirely for additional public spending. Fourth, the critique that NGEU will undermine fiscal discipline in the EU budget is probably overblown because NGEU does not give the EU the right to finance future budgets with debt; repeating the debt financing operation would require unanimous support among the member states. But it is true that a similar debt-financed initiative will be more easily repeated in the next economic crisis.

The rest of the paper is structured as follows. The next section explains how much money is made available through NGEU and how it will be spent, followed by the third section which discusses whether NGEU can be justified on economic grounds. The fourth section turns to the issue of conditionality. The fifth section discusses the implications for future debt financing of EU level public spending, and the final section concludes.

HOW MUCH MONEY WILL BE MADE AVAILABLE AND HOW WILL IT BE SPENT?

To understand the financial dimension and relevance of NGEU, it is helpful to consider it in the context of the EU's general budget. Ta-

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Table 1

MFF 2021-2027 and NGEU (Billion Euros)

	MFF	NGEU	Total
Single market, innovation and digital	132.8	10.6	143.4
Cohesion, resilience and values	377.8	721.9	1,099.7
Natural resources and environment	356.4	17.5	373.9
Migration and border management	22.7	-	22.7
Security and defense	13.2	-	13.2
Neighborhood and the world	98.4	-	98.4
European public administration	73.1	-	73.1
Total	1,074.4	750	1,824.4

Source: European Commission.

ble 1 provides an overview of the EU budget spending structure in the coming years as laid out in the Multiannual Financial Framework (MFF) for the period 2021-2027, as well as the spending planned for the new NGEU fund.

The overall volume of the budget and the recovery fund is significant, but the money will be spent over a period of seven years. Average yearly spending in the general EU budget amounts to roughly 1 percent of the EU's GDP, and the new recovery fund adds another 0.7 percent of GDP. Roughly half of the latter is dedicated to providing loans to member states. NGEU thus brings a significant extension of EU spending relative to the level before the coronavirus crisis. The overall level of public spending at the EU level is still limited if compared to budgets at the national level, but since it is spending on top of the national budgets, the question is warranted whether an extension of overall public spending in the EU, where the public sector is already much larger than in most countries outside Europe, is the right answer to the current crisis. What does NGEU mean for the level of public debt in Europe? In 2020, public debt in the EU will be equal to roughly 95 percent of GDP. The additional debt incurred to finance NGEU will raise the debt by 5.5 percentage points.

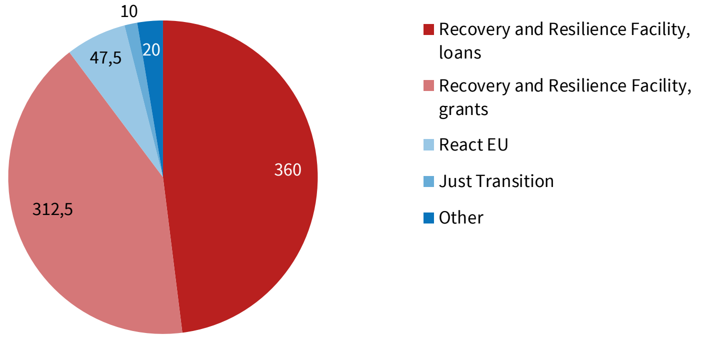
How about the spending structure? The "normal" EU budget continues to devote a significant share of its resources to agriculture, under the heading of natural resources and environment, although this share has been declining over the last decades. NGEU in contrast focuses on the support of cohesion as well as "resilience." What does this mean? Figure 1 illustrates the different spending programs that constitute NGEU.

The Recovery and Resilience Facility is the core of NGEU. The money will be spent as follows. Each member state is expected to submit national recovery plans describing how it intends to support its respective economic recovery and how it will make it more resilient. Particular emphasis will be given to the objectives of the Green New Deal, in particular climate change, and to the digitization of the economy. The role of national recovery plans will be discussed further below. REACT-EU stands for Recovery Assistance for Cohesion and the Territories of Europe. Funds from this program will be made available to support job maintenance and to create new jobs, in particular measures countering youth unemployment. The funds can also be used to support health care systems or to help finance investment in small- and medium-sized enterprises.

The Just Transition Mechanism (JTM) is a tool mostly financed through the general EU budget but reinforced by NGEU. Its objective is to ensure that distributional issues raised by the transition toward a climate-neutral economy are addressed. This includes the consequences of higher CO_2 prices for the rural population, which depends more on road transport than the population in cities does, or job losses due to structural change away from carbon-intensive industries.

Figure 1

Composition of Spending in the Fund NGEU (EUR bn)



Source: European Commission. © ifo Institute

IS THERE AN ECONOMIC JUSTIFICATION FOR NGEU?

It is evident that introducing the recovery fund is primarily a political move. Some see it as a signal for solidarity among EU countries in times of a severe crisis, an investment in the EU's cohesion and mutual trust. Others take a more critical view and see the fund as a result of pressure exerted by a majority of EU member states on the rest of the club. Of course, this pressure would probably have remained without effect, if Germany had not decided to support the initiative and agreed to a joint Franco-German proposal for the fund.

Irrespective of the political motives behind this step, is there an economic rationale for the recovery fund? To discuss this, it is helpful to consider the NGEU fund in the light of the Musgravian public sector functions of stabilization, allocation and distribution (Musgrave 1973). According to the European Commission (2020a), it is the objective of NGEU to boost the recovery and to achieve a "greener, more digital and more resilient EU."

The objective of "boosting the recovery" emphasizes that the fund has a macroeconomic stabilization function. While this is intuitive, given that the EU finds itself in the most severe recession of its history, the role of the NGEU for macroeconomic stabilization in the current crisis is probably limited. Spending from the recovery fund is unlikely to start before 2021. The peak of the crisis will hopefully be over by then. This means that fiscal stabilization during the crisis needs to come from other sources. Of course, funds made available in the near future affect expectations today; this stabilizes the economy while the crisis is still here.

In principle, individual member states are responsible for countercyclical fiscal policies in the EU. However, at least some of them may not be in the position to do so. In particular, member states with high levels of public debt may be reluctant to raise their debt levels further because they fear that investors in international capital markets may lose confidence. Currently, interest rates on government bonds are very low, so that the EU member states could finance stabilization policies themselves. To some extent, the low interest rates are certainly a consequence of the existence of the recovery fund. But even if financing conditions were a little more difficult for some countries, the ESM would be available to provide countries with credit, at least those who are members of the Eurozone. Some countries seem to find ESM loans politically unacceptable because the ESM is seen as an institution that is responsible for enforcing fiscal austerity, which is unpopular. ESM financial support to member states would indeed go along with conditionality, but the conditions would probably differ from what they were a decade ago. It should be noted, however, that the funds distributed by NGEU will also be conditional. These conditions will be discussed further below.

The objective of achieving a "greener, more digital and more resilient EU" suggests that the NGEU fund has an allocative function insofar as environmental protection and digitization are primarily about internalizing externalities and providing public infrastructures. From an economic perspective, a case can be made for more public goods provision, not just in environmental policy and digitization, but also in areas such as foreign policy and defense, research and development or foreign aid (Fuest and Pisani-Ferry 2019). However, this is not the focus of NGEU.

In terms of its contribution to allocative efficiency, it would be desirable for NGEU to draw a clearer line between areas where public spending may be justified or needed and areas where private investors should act. For instance, if the program REACT EU aims at preserving and creating jobs in sectors affected by the crisis, such as tourism or travel, the question arises what exactly can be achieved through public policies. Whether hotels or travel agents create jobs is primarily an entrepreneurial decision. It is not clear how government intervention can improve these decisions. For instance, the view is widespread that there will permanently be fewer business trips after the coronavirus crisis because more meetings will take place online. Given this, it may be better to support creating new jobs in other sectors. Using public funds efficiently requires that they be employed in areas where private markets do not work properly.

A key feature of NGEU is that it has a strong redistributive component. On the financing side, all member states will contribute to servicing the debt through the EU budget. Currently, the plan is to start paying down recently incurred debt in 2028 and to complete the repayment no later than in 2058. Precisely how the burden of repaying the debt will be distributed across member states is an open question. The EU intends to create new own resources to service the NGEU debt, but so far, nothing has been decided. If the GNI-based own resources are considered the marginal source of financing, the burden of financing will be distributed according to GNI.

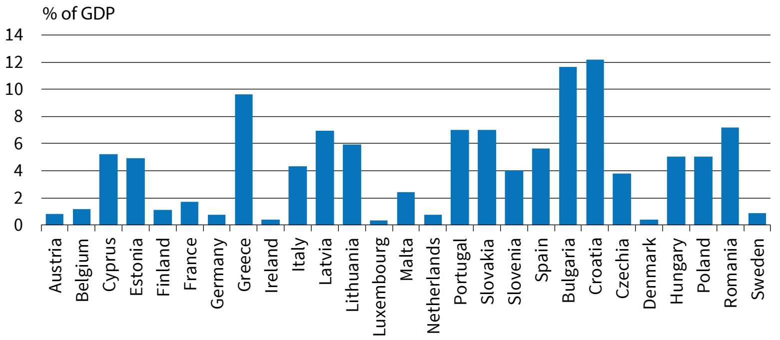
The redistributive component is driven by the spending side. The EUR 390 billion that will be spent as grants will be allocated quite unevenly across member states, as illustrated by Figure 2.

While NGEU grants are less than one percent of GDP in Ireland, Germany or the Netherlands, they amount to between 10 and 12 percent of GDP in countries such as Greece, Bulgaria and Croatia. In Spain and Italy, it is close to 5 percent of GDP.

What is the economic logic behind the redistributive side? If the EU is hit by an economic shock and if different countries are affected differently, a common fund may act as an insurance device. One obvious objection is that insurance normally requires an insur-

Figure 2

NGEU Spending (Grants) Allocation in % of GDP



Source: European Commission; author's calculation. © ifo Institute ance contract, which is signed before the damage happens. Such a contract did not exist. Introducing the fund can therefore be seen as a form of solidarity or aid based on an implicit insurance contract. Another issue is that an insurance device should redistribute monies based on the damage inflicted on each country, for instance, the decline in GDP caused by the crisis. This would lead to a situation where member states with lower per capita income might have to make payments to richer countries if their GDP loss is larger, which can easily happen. This is probably one of the reasons why distributing NGEU funds does not place much emphasis on the insurance principle. In allocating spending to countries, the political decision has been made that 30 percent of the funds are distributed according to the decline in GDP expected for 2020, whereas 70 percent of the funds follow other criteria, in particular, the level of per capita income. There is no deeper economic justification behind this allocation other than the fact that a much larger weight on the decline in GDP might have led to the problematic redistributive effects mentioned above. Ultimately, the redistributive effects are best measured by the net balances of each country with respect to the grant component of the fund. Assuming that servicing the debt will be proportional to GNI, the net balances would be as illustrated in Figure 3. Translating these net balances into euros per capita leads to the result that the largest per capita transfer goes to Croatia, with just under EUR 1,300 per capita, followed by Greece at roughly EUR 1,250. The largest net contributors per capita are Luxembourg at EUR 1,290 and Ireland at EUR 1,090. Germany at EUR 800 per capita and France at EUR 370 are also significant net contributors, while Italy at EUR 480 and Spain at EUR 810 receive transfers.

How are these net balances related to the loss in GDP during the crisis and the levels of per capita income? Figure 4 illustrates the relationship between the loss in GDP as measured by the difference between the growth of GDP in 2020 as forecasted by the IMF World Economic Outlook in October 2019 and the same forecast in October 2020.

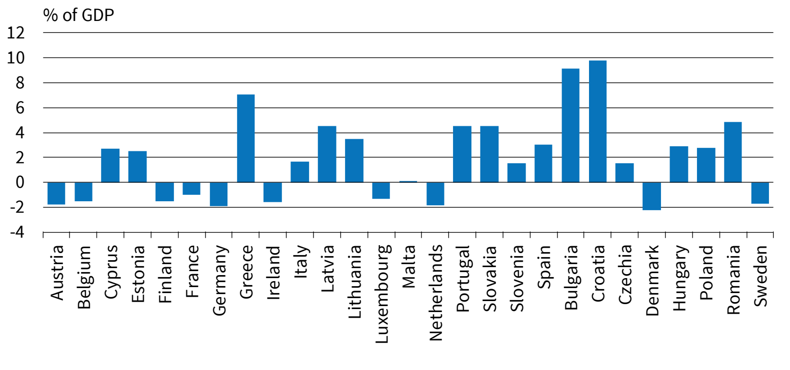
There is on average a negative correlation between the GDP loss and net balances, but the correlation is very weak (see also EEAG 2020). NGEU is not primarily geared toward redistributing in favor of those countries whose economy was most affected by the coronavirus crisis. The key factor determining the redistributive effects is the general level of prosperity. Figure 5 shows that there is a strong negative relationship between per capita income and the net balance with respect to NGEU.[1]

This implies that, as far as redistributive effects are concerned, NGEU is not really an insurance against the coronavirus shock but rather an extension of the EU's cohesion policies, which redistributes in favor of poorer EU countries.

To summarize, NGEU seems to have two major economic effects. First, it is a form of expansionary fiscal policy meant to stabilize the economy in the face of the shock caused by the coronavirus crisis. The money will probably not be spent before the crisis is mostly over. However, the prospect for the economically more vulnerable member states that they will receive these funds affects current expectations and extends their room for national debt-financed

Figure 3

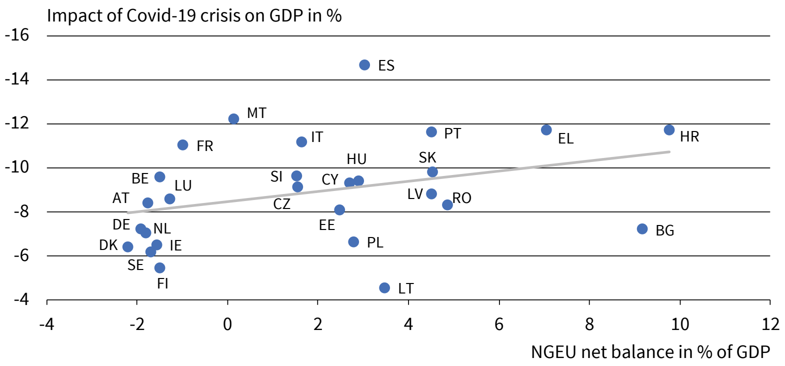
NGEU Net Balances



Source: European Commission; author's calculation. © ifo Institute

Figure 4

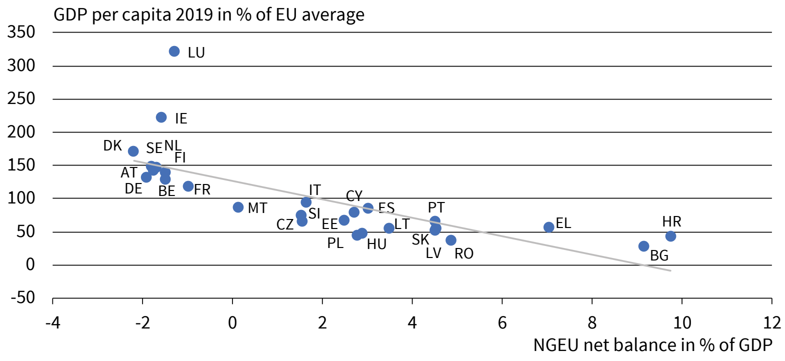
NGEU Net Balances and GDP Loss in 2020



Source: European Commission; IMF WEO; author's calculation. © ifo Institute

Figure 5

NGEU Net Balances per Capita Income



Source: European Commission; author's calculation. © ifo Institute

[1] A multivariate regression with the loss in GDP, the unemployment rate, the level of public debt and per capita GDP confirms the result that the latter is the only significant factor explaining the distributional effects.

stabilization policies. Second, the fund redistributes funds from countries with higher GDP per capita to the poorer member states, and to this extent, it may be considered an extension of the existing cohesion policies.

CONDITIONALITY AND EUROPEAN POLITICAL PRIORITIES

The European Commission has declared that it will consider NGEU not simply a device for increasing deficit spending in Europe and redistribute funds across countries, but also a way of steering public spending toward European political priorities, in particular, the Green New Deal and digitization. To achieve this, the European Commission has provided guidance to the member states regarding their national recovery plans, which are required for obtaining NGEU funds (European Commission 2020b). In their recovery plans, the member states are expected to focus on the following four objectives:

1. Promoting the Union's economic, social and territorial cohesion
2. Strengthening economic and social resilience
3. Mitigating the social and economic impact of the crisis
4. Supporting the green and digital transitions (European Commission 2020b)

These are rather general objectives, even if they are specified further in the guidelines. The member states will not find it difficult to relate a wide range of spending items to these objectives. The fact that member states will wield considerable discretion regarding the use of the funds is also reflected in the way the guidelines define investment:

> "Member States should consider an investment an expenditure on an activity, project, or other action within the scope of the proposal that is expected to bring beneficial results to society, the economy and/or the environment […] The proposal is therefore consistent with a broad concept of investment as capital formation in areas such as fixed capital, human capital and natural capital […] Human capital is accumulated by means of spending on health, social protection, education and training, etc." (European Commission 2020b, 13).

This implies that spending usually considered consumption, such as spending on health or social spending is defined as investment, confirming that member states will have a lot of discretion in using the NGEU funds.

The second challenge for those who think that NGEU can be used to steer national fiscal policies to favor European priorities is that money is fungible. For instance, member states can employ NGEU funds for public investments that would have been financed from national sources anyway. The guidance document does try to address this problem and make sure that NGEU funds give rise to additional investment. Member states are invited to report the average level of spending on items they include in their recovery plan in preceding years. The trouble is that the member states will be able to argue quite convincingly that the crisis has affected their ability to invest like they did before. It is practically impossible to ensure that spending financed via NGEU would not have happened without the fund.

Of course, the fact that countries can use NGEU money to replace national funds is not necessarily a disadvantage. It is far from clear that it would always be wise to use the resources countries receive from NGEU to increase public spending. It may be more desirable to reduce taxes or to cut public debt. There is of course a strong interest of the EU as a whole that member states make efforts to improve the resilience of their economies and to reduce their dependence on external help. But it is not clear that the best way to achieve this is to increase public spending, and it is certainly difficult to steer this process from the outside.

DEBT FINANCING OF EU LEVEL SPENDING — A ONE-OFF OR THE NEW NORMAL?

Normally public spending at the EU level is not supposed to be financed with debt. Art 310 (4) of the Treaty on the Functioning of the European Union (TFEU) states:

> "With a view to maintaining budgetary discipline, the Union shall not adopt any act which is likely to have appreciable implications for the budget without providing an assurance that the expenditure arising from such an act is capable of being financed within the limit of the Union's own resources […]"

While various forms of debt financing have been used in the past to fund European projects, the magnitude of debt incurred to finance NGEU is new for the EU. The EU member states have agreed that the debt financing in the context of NGEU is a singular event and the debt will be repaid within a defined period of time as mentioned above. But critics of NGEU argue that, by agreeing to incur massive amounts of common debt, the EU has taken a step toward debt financing of its spending which is irreversible, and a threat to solid public finances in Europe.

There is no doubt that the decision to finance NGEU via a common debt instrument has made it much more likely that the operation will be repeated in the next crisis. Whether this is considered to be good or bad depends on views regarding the desirability of additional debt financed spending at the

European level during or after severe recessions. But it should be taken into account that the debt that finances NGEU is based on guarantees provided by the member states. As long as the EU does not have the power to tax, its ability to use debt to finance its spending will be severely restricted.

Under the EU's existing institutional framework, future initiatives to repeat the current debt financing operation will require unanimous support among the member states. This is a high hurdle. Whether it can be overcome will probably depend, among other things, on the perceived success of NGEU spending. In particular, the net contributors to NGEU will be reluctant to repeat the exercise if it turns out that NGEU has not contributed to making the net recipients more resilient and less dependent on external support.

CONCLUSIONS

The EU has reacted to the coronavirus crisis by creating the NGEU fund to support the economic recovery in the EU. Although spending financed through the fund will probably not start before most of the crisis is behind us, it still contributes to fiscal stabilization during the crisis, mostly through its effect on expectations and in particular by extending room for fiscal policy of economically vulnerable member states.

The fund does not operate as a pure insurance device that would redistribute from countries with below-average economic losses to those that suffered above-average losses. Instead, it redistributes from member states with high levels of GDP per capita to less affluent countries. NGEU also attempts to steer national governments toward political priorities defined at the European level such as the Green New Deal of the green and digital transformation of the economy. However, since money is fungible, the member states may also replace national spending by money from NGEU and effectively use the funds for other types of spending, to cut taxes or to reduce their debt. This is not necessarily a disadvantage because it is far from clear whether the economic recovery works best if the net recipients use the support they receive via NGEU entirely for additional public spending. It may be more productive to cut taxes or reduce government debt. Too little emphasis is placed on border-crossing spillovers of national spending plans. During negotiations about national recovery plans, the European Commission should strongly encourage cooperation across member states and projects with European relevance and visibility such as border crossing infrastructure projects (see also Pisani-Ferry 2020).

The fact that NGEU is financed by the issuance of common debt has raised concerns that debt financing of EU-level spending may become more widespread, undermining fiscal discipline. One should take into account, however, that comparable financing operations in the future can only take place if all EU member states agree; NGEU is not equivalent to introducing the general right to use debt financing at the EU level; doing that would ultimately require giving the EU an independent power to tax. At the same time, it is likely that demand for repeating the current debt financing operation will come up during the next severe crisis. Whether in particular the net contributors will support this is likely to depend, among other things, on whether the NGEU funds are perceived to have been well spent. What that means is not easy to determine. It is clear that the fund should not start a regime that allows some countries two permanently live beyond their means at the expense of others. It may also be necessary that future funds created in crises place greater emphasis on the insurance aspect, that is, on losses countries have actually incurred as a result of the crisis. But if the main effect of the fund NGEU is to start a European tradition of helping neighboring countries in times of exceptional hardship, history will not judge it badly.

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