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Facts & Findings

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For a Stable Europe of Tomorrow

A Repayment Pact for the European Recovery Fund NGEU

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- In response to the Covid-19 crisis, the European Union (EU) established a large recovery fund (NGEU) of 750 billion Euro to put Member States' economies on a sustainable growth path out of the crisis. Given the exceptional nature of this pandemic, the NGEU is Europe's instrument of solidarity and subsidiarity. It is also in Germany's overall economic interest.

- To finance NGEU, the EU is for the first time taking on a large-scale debt of its own, which is to be repaid over 31 years, although there are no binding repayment targets. A "repayment pact" with binding repayment options is therefore needed. In addition to setting growth-oriented priorities in the EU budget and strengthening expenditure control, this repayment pact would lend the much-needed credibility to the unique character and thus the added value of the debt-financed NGEU.

- The repayment pact also requires a clear agreement on a sanction mechanism in the event that repayment obligations are not or only partially fulfilled despite given preconditions. The EU should stand by its commitment that the debt financed NGEU remains a one-off measure. A departure from this would jeopardise the trust of citizens and economic stakeholders in the EU.

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New Challenges Require New Measures

Suspension of the debt ban

The pandemic has led to a dramatic downturn in economic activity. For instance, the gross domestic product in the EU Member States slumped by 6.1 per cent in 2020.[1] In view of the symmetrical exogenous shock to all EU economies, the Member States had to act in this exceptional situation for economic and European policy reasons of solidarity. Above all, the EU and its Member States acted by pushing through extensive aid and support programmes for the economy and society.

EU recovery fund involving grants and loans

The EU went one step further and, in addition to the acute crisis response, set up the "NextGenerationEU" (NGEU) recovery programme. The NGEU aims to help structurally weak Member States to return to a sustainable path of growth out of the crisis. To cover the major financial aid, the European Council decided to take on an unprecedented amount of joint debt of up to 750 billion Euro.[2] These funds are available to the Reconstruction and Resilience Facility, where they are provided as grants of up to 312.5 billion Euro or as loans of up to 360 billion Euro to EU Member States.

NGEU not only unleashes growth potential, but also disincentives

For the instrument to have its desired effect on sustainable growth, its expenditure priorities must be consistently aligned with structural improvements in the economies. Consumption expenditure cannot be a component for NextGenerationEU.

In contrast, borrowing in the order of about three quarters of the regular EU budget causes covetousness. Therefore, there is a risk of a permanent mechanism.[3] The President of the Deutsche Bundesbank points out that "joint debt, as now envisaged in the recovery fund, [should be] limited in time and closely linked to the crisis"[4]. This is opposed by the EU Commissioner for Economic and Monetary Affairs, Paolo Gentiloni, who advocates a softening of the Maastricht criteria and calls for a differentiation between "good" and "bad" debt. That is, those that are growth-promoting and those that are not.[5]

Therefore, is a danger that the NGEU will create disincentives, especially for those Member States that hardly have any national debt leeway anymore. It is more important, in addition to controlling expenditure, to make clear and binding agreements now on the repayments of the debts taken on.

Contribution of European solidarity needs conditions for sustainable structural improvements.

The European Commission repays the 750 billion Euro to the investors through the EU budget. The public repayment service essentially relates to possible grants of up to 312.5 billion Euro. But the 360 billion Euro in loans can also become public repayment burdens for the EU budget in the event of debtor default.[6] It is important to ensure the quality and sustainability of the measures when allocating funds. This makes it important to ensure that these funds are also spent on projects that promote growth. The selection of these projects is managed by the European Commission based on the national recovery and resilience plans. These are based on three overall goals:

1. Compliance with the country-specific recommendations from the European Commission's European Semester for the relevant recipient country;

2. Strengthening competitiveness (growth potential, job creation and economic and social resilience);

3. Making an "effective" contribution to the digital and green transition.

Such conditionalisation represents, on the one hand, a political commitment as a sign of European solidarity.[7] On the other hand, it is also economically justified and must therefore be formally underpinned. The European Semester will play a prominent role here. The importance of the instrument was underestimated in the past and merely acknowledged as economic policy recommendations. In the future, however, the recovery and resilience plans, including the distribution of a large part of the NGEU funds, will be included in the European Semester. The structural improvements in the EU Member States highlighted in the European Semester thus become even more evident.[8] Enhancing national competitiveness strengthens the European Single Market as a whole and is a genuine European interest. Finally, Germany will benefit from this as an export nation.[9]

New EU own funds are uncertain.

To counter-finance the debt used for the NGEU, the heads of state and government agreed on the introduction of own resources. By July 2021, the European Commission is to present concrete proposals for the introduction of new EU own revenues. The new own resources envisage three sources of revenue: A revised EU Emissions Trading Scheme, possibly extended to transport and buildings, a CO2 border adjustment mechanism, and taxation of digital economy companies. In its first own resources proposals in May 2020, the European Commission had estimated potential revenues from these own resources of 16 to 25 billion Euro per year. This would, in terms of figures, cover the repayments for 312.5 billion Euro over 31 years. However, there are doubts as to whether the counter-financing of the NGEU debt can succeed in this way. The European Commission and the EU Member States must therefore agree on a procedure by which the capital market debt raised can also be repaid without new own resources.

Options for Action to Reduce Debt

Repayment rules urgently needed

Whereas the NGEU was launched quickly amid the pressure created by the Covid-19 pandemic, negotiations on repayment arrangements will be more difficult. In principle, the annual debt to be repaid for the grants from the NGEU of 312.5 billion Euro is a manageable amount; however, these sums may transpire to be even greater if there is a risk of payment defaults on a larger scale via the credit programme. So, there are several questions that need to be answered in the negotiations of the European institutions: How can it be ensured that loans are only granted to viable concepts? Are there sanction options in the event of a payment default? Are repayment amounts politically enforceable? What happens during phases of weak growth?

The following points are essential for the repayment of the EU debt:

Measure I: A Joint Repayment Pact

Credible commitments to debt repayments are needed: A repayment pact with fixed and flexible repayments.

The agreement already reached on a start date (2028) is not yet sufficient. The agreement that a separate budget item will be created in the EU budget for the loan payments of the respective country is also only a beginning. Rather, the negotiations should centre on how exactly the repayments are to be structured. This is not an end. By repaying their national debts, the Member States create scope again for investments that are as growth-promoting as possible. Both strengthen the national economies in Europe and ultimately the European Single Market.

A concrete repayment pact is therefore needed: This must of course be adaptable to current and individual circumstances, but still be rule-based. It would be possible to envisage that the repayment of principal would be based on the growth rate of the gross domestic product from the previous year of the respective Member State. In good times, part of the increased gross domestic product could be used for debt repayment; in bad years, the funds needed in the country itself. To be able to achieve a stable and automatically regulated repayment rate in the long term, a kind of basic amount that has to be reached every five years, for example, would be a possibility. Thus, any fluctuations within this period (e. g. due to periods of economic weakness) could be balanced out or tolerated. Similarly, this would constitute an automatic mechanism that would endure even in the event of alternating governments. These negotiations, which will not be easy, should begin immediately. The creation of an additional budget item is not sufficient for this. Thus, the background context of the states also plays a role, as not every country can use the same percentage of GDP for debt repayment. It is also necessary to define what exactly constitutes good and bad times. However, it is important to largely create an automatism to bind the policy for a sound repayment policy. A discretionary policy, where decisions would always be made from scratch with a veto right in reserve, is certainly the worse alternative.

This plan should also include clear agreements on what happens if repayment is not made or is only made in part – for example, despite a good economic situation and insistent requests by the Commission and the Council of Ministers. Financial penalties do not seem very appropriate here. Instead, project funds due to the country could be frozen up to a level of 30 per cent. This way, the EU would not run the risk of suspending entire projects and thus creating popular dissatisfaction among the population. On the other hand, however, the country concerned would lack considerable financial resources to pursue the necessary projects.

A discussion on the unresolved points mentioned is even more important, as debt repayment also entails certain risks. For example, to repay the EU bonds or the loans received, the individual countries could simply take on new national debt to repay the EU debt. There is also concern that not all additional revenues will be used for debt reduction, but for other programmes. In addition, for the period of the repayment service – until 2058 at the latest – the possibility was created for the own resources ceiling of 1.4 per cent of EU gross national income (GNI) to be increased by 0.6 percentage points.[10] Moreover, there is a risk that these additional own resources could be used to repay future debts. This would have made EU borrowing a common measure. However, since the EU is only allowed to take on debt once because of the Corona crisis, taking on new debt would be a serious breach of the political and legal commitments of the European Council. At best, the repayment pact is the commitment of each EU Member State to its European responsibility.

EU borrowing must be limited to the biggest economic crisis in its history so far. Moreover, it is uncertain whether previous highly indebted EU crisis countries will be able to repay their loan debts from the NGEU at all. In these cases, debt extension beyond 2058 would have to be agreed or other countries would have to step in. To prevent this as far as possible, thought should be given to a possible collateralisation of the loans from the NGEU. Even growth-promoting projects can fail, and thus the repayment of the loans that finance them may not materialise. The borrowing states should therefore secure the loans from state assets, from claims from EU subsidies or from a reserve to be formed nationally in the national budgets ("special assets"). This would avoid a "moral hazard" in the recipient countries.

Measure II: It's All in the Mix

Despite all the dangers, we can be optimistic in our outlook. Debt repayment should consist of a sustainable mix of spending:

A spending mix in the sense of a future-oriented, growth-promoting economic policy is necessary.

1. **Growth through far-sighted economic policy and wise investment**
   The best option is to grow out of debt. The forces for growth in the EU must be significantly strengthened. To this end, the EU budget must be consolidated in growth-promoting areas. In the long term, this will increase the gross national income in the EU Member States and thus the EU's revenues. However, this also means that expenditure that stands in the way of structural change should be cut back. On the one hand, this policy approach is about long-term expenditure in education and research. On the other hand, through the expenditures that create improved conditions for companies to produce new pioneering products and services. In addition, the further digitalisation of the economy is indispensable for reducing transaction costs and creating new business models. In Germany in recent years, wise spending policies can provide impetus for further growth and thus balance the budget.

   It is therefore important to be transparent about which investment measures Member States use NGEU funds for. This is not so much for mere control but should underline the importance of the investments to bring "European added value". This "European added value" results from the strengthening of national competitiveness. By positing a purely voluntary transparency requirement, there is a risk of funds not being used in a way that promotes growth. The European Commission and the European Council have already set targets for investment expenditure. However, these do not yet go far enough. A rough attribution to the core objectives of the European Commission (including sustainability and digitalisation) is too superficial. Therefore, a more concrete arrangement with greater conditionality for the investments in the national recovery and resilience plans is needed.

2. **Strengthening expenditure control**
   According to the European Court of Auditors, more than 4 billion Euro were spent incorrectly or uselessly in 2019. This accounted for 2.7 per cent of actual expenditure.[11] However, this only becomes apparent in retrospect. Therefore, expenditure frame-

works must be better drawn up by the Member States based on criteria such as growth promotion, feasibility, etc. The EU should better assess the necessity and sense of the measures and already monitor them during the use of funds. In this context, the use of the MSC own resources (Member States' contributions), which have been increased by up to 0.6 percentage points, must only be a "ultima ratio".

Conclusion

Repayment pact indispensable

In view of the major challenges facing the EU, there is a need for better funding of the EU. Especially in the event of a (further) crisis, this leads to more flexibility. However, this must not be secured with debt. The emphasis and regular repetition that this is a one-off measure is not sufficient. Credible action is needed – for example in the form of a "repayment pact" to renew the promise of a stability union. These include an early start on debt repayment and a determination of how this is to be done. A further postponement or respite of debt service must not be allowed. Otherwise, the problem would only be passed on to future generations, which would give the title "Next Generation EU" a bad aftertaste. The long duration of at least 31 years until the debt is finally paid off makes disciplined repayment over such a long period difficult. In fact, the crisis offers a great opportunity to reorganise the EU's financial architecture. This starts with the reactivation of the debt ban for the EU budget. Both the EU and the Member States must contribute credibly to debt settlement. A growth- and stability-oriented economic policy makes an important contribution to debt reduction. Strengthening expenditure control is also crucial. In principle, the Member States must live up to their national budgetary responsibility. On the one hand, this includes the corresponding consolidation and prioritisation of national budgets – with a particular focus on national and European areas of the future. On the other hand, the Member States must tackle the necessary and overdue structural reforms to be prepared for future crises. Therefore, the Stability and Growth Pact must be reinstated as soon as possible. This would not only help the individual states in a very concrete way, but also the EU as a whole. So that the EU does not have to intervene to this extent in the next crisis.

1 European Commission, Spring Forecast 2021, https://ec.europa.eu/commission/presscorner/api/files/attachment/868928/Tables-DE.pdf (last accessed on 8 June 2021).

2 More on the genesis: Hänsel, L. (Ed.), Einstellungen der EU-Mitgliedstaaten zum EU-Recovery Fund, https://www.kas.de/de/einzeltitel/-/content/einstellungen-der-eu-mitgliedsstaaten-zum-eu-recovery-fund or on the procedure for using the fund: Morwinsky, O., Erwacht das Europäische Semester aus seinem Dornrößchenschlaf?, https://www.kas.de/de/analysen-und-argumente/detail/-/content/erwacht-das-europaeische-semester-aus-seinem-dornroeschenschlaf (each last accessed on 12 April 2021).

3 Both the President of the European Central Bank, Christine Lagarde, and the President of the European Parliament, David Sassoli, have publicly advocated a permanent maintenance of the debt option: www.reuters.com/article/us-ecb-policy-lagarde/europe-mustnot-delay-cash-to-crisis-hit-economies-lagarde-tells-le-monde-idUSKBN2740GT and www.welt.de/politik/ausland/article220417820/EU-Parlamentspraesident-Sassoli-Die-Regierungen-im-Norden-werden-ihre-Meinung-aendern.html (each last accessed on 12 April 2021).

4 “A fiscal union must not be introduced through the back door”, ibid.

5 Mussler, W.: Italienischer EU-Kommissar rüttelt am Stabilitätspakt, https://www.faz.net/aktuell/wirtschaft/eu-kommissar-gentiloni-ruettelt-an-maastricht-regeln-17224336.html (last accessed on 27 May 2021).

6 The remaining expenditure (77.5 billion Euro) relates to various programmes: Horizon Europe, React-EU, InvestEU, rescEU, Rural Development or the Just Transition Fund.

7 s. a. Oliver Morwinsky: Konditionalität und europäische Verantwortung, https://www.kas.de/de/kurzum/detail/-/content/konditionalitaet-und-europaeische-verantwortung (last accessed on 12 April 2021).

8 Morwinsky, O., Erwacht das Europäische Semester aus seinem Dornrößchenschlaf?, https://www.kas.de/de/analysen-und-argumente/detail/-/content/erwacht-das-europaeische-semester-aus-seinem-dornroeschenschlaf (each last accessed on 12 April 2021).

9 About 60 per cent of all German exports go to the EU; Federal Statistical Office, November 2020.

10 Conclusions of the European Council of 20 July 2020, page 3, clause A9; https://www.consilium.europa.eu/media/45136/210720-euco-final-conclusions-de.pdf (last accessed on 12 April 2021).

11 Cf. Lehne, K.H. (2020): Speech on the ECA’s 2019 annual report, https://www.eca.europa.eu/Lists/ECADocuments/Speech-CONT-AR2019/Speech-CONT-AR2019_DE.pdf (last accessed on 12 April 2021).

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