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The Franco-German initiative, agreed between French President Emmanuel Macron and German Chancellor Angela Merkel on May 18,[1] has beaten Ursula von der Leyen to the punch. The European Commission president had announced to unveil her proposal for the Recovery Fund (RF) in the first days of May, but then postponed the presentation to the end of the month with the aim of reaching a pre-emptive compromise between the member states of the European Union (EU). The Franco-German initiative will significantly bind the Commission's strategy. However, the scope of Merkel and Macron is so positively disruptive that it apparently pushes the possible institutional friction between the two most important EU countries and one of the main EU institutions to the background. In fact, this friction, which is part of the recurring contrast between intergovernmental and 'EU community' approaches, could have an impact on the approval and implementation of the RF.

1. The main novelties

The debt aspect of the RF, designed by the leaders of France and Germany, rests on an idea shared by the EU officials and economists who have been committed to the issue: the European Commission, acting on behalf of the EU, would issue one-time debt bonds on financial markets guaranteed by a series of seven-year EU balance sheets (the so-called Multiannual Financial Frameworks: MFFs). Due to this joint guarantee from the EU countries, the new European debt binds member states to undertake commitments exceeding their actual contributions to the 2021-2027 MFF. However, the main novelties of Macron and Merkel's framework reside in the use of the financial resources thus collected. Unlike the European Commission's expected guidelines, the Franco-German initiative does not intend to allocate these resources to EU member states in the form of a minority share of "non-repayable" transfers and a majority share of long-term (perhaps thirty-year) interest-bearing loans. The two leaders suggest, instead, to use the entire amount of resources to make transfers ("gifts") to EU member states in proportion to the asymmetric intensity with which those states have been hit by the common exogenous shock (the coronavirus pandemic).

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[1] See "A French-German initiative for the European recovery from the coronavirus crisis", *Presse-und Informationsamt der Bundesregierung*, *Pressemitteilung*, n. 173/20, May 18, pp. 1-5.

This novelty introduces radical and positive innovations compared to the configuration of the RF informally outlined by the European Commission, and on different grounds. From the analytical point of view, the Franco-German proposal solves, at least, two complex problems. First, it eliminates at the root the trade-off between leverage and allocation of the financial resources among transfers and loans. It is well known that the amount of loans can become a multiple of the initial resources thanks to leverage-effects; by definition, these latter effects do not apply to transfers. Hence, in the Commission's expected version, two objectives (size and composition of the RF) would have to be pursued by means of a single tool; and, as the basics of the theory of economic policy show, this leads to suboptimal results. Second, in this same version, the Commission's market debts are guaranteed by the current MFF with a seven-year time horizon but, in the meantime, would have to allow a provision of loans with a much longer duration (thirty years). This timing mismatch would ask for the use of future and uncertain MFFs as guarantee, thus implying the writing of complex debt contracts (with roll-over and related renegotiations). On the contrary, in the Franco-German proposal the commitment is clear-cut: the debt is jointly guaranteed by EU member states through a series of MFFs.

However, Macron and Merkel's most disruptive innovations refer to the institutional structure of the proposed RF. First of all, the exclusive emphasis on transfers strengthens the redistributive and sharing function of the MFFs. Furthermore, unlike loans that commit the borrowing countries to only repaying the debt (interests and principals) at the due dates, the transfers require close cooperation between the lending institution and the beneficiary state, that is, they compel the European Commission to condition and verify the use of these transferred funds by the country that receives them. The latter has the task of transforming the transfers into effective and efficient investments and reforms previously agreed with the Commission and under its monitoring: the "recovery support [...] will be based on a clear commitment of member states to follow sound economic policies and an ambitious reform agenda" (p. 3). Finally, in the examples offered by Merkel and Macron, the RF would mainly have to be used in areas which produce "common goods" (in addition to healthcare and sectors largely affected by the pandemic, sustainable development and digital innovations) since these areas are essential for the progress of the whole EU and for the implementation of convergence, not divergence, processes between member states.

2. A slight digression

The foregoing considerations should clarify the groundbreaking importance of the political and institutional innovations characterizing this Franco-German initiative. The centralization of debt issuance at the EU level and the cooperation between the 'donor' (the European Commission) and the beneficiaries (the EU countries) in the utilization of the financial resources represent a crucial step towards the implementation of a European investment program. The financing of this program leads to the issue of European project bonds which - at least in Delors' original version - should have been the true form of the eurobond. The centralized allocation of resources, even if once, is the first step towards a single European fiscal policy.

To make these implications even more evident, a brief foray into the field of theory could be useful.

Conceptually, the Franco-German initiative refers to a nexus that has long been analyzed in the field of cultural anthropology (it is enough to refer to Lévi-Strauss or Godelier): in any society that possessed even rudimentary market forms, "gifts" were not incompatible with exchanges. The former can actually play a crucial role in allowing social and institutional interactions between individuals and, thus, in creating temporary and collective equilibria. However, any "gift" is complete only if it involves, at one time or another, some form of "reciprocity". This type of nexus is vital in Merkel and Macron's proposal: the European Commission makes a "gift" that requires reciprocity in the form of a partial and temporary transfer of national fiscal sovereignty from the beneficiary country to the EU institution.

At the end of March – beginning of April 2020, I published a *Policy Brief* which builds a conceptual scheme quite close to that adopted by the Franco-German initiative.[2] In my paper, the role of issuer of debt bonds and of donor towards member states is played by the European Stability Mechanism (ESM), while the European Commission continues to manage the cooperative relationships with the beneficiary countries to implement the investment and reform projects. There are at least three justifications for this setup. First, at the end of March, it was difficult to conceive a mutual utilization of the MFFs such as proposed by the Franco-German initiative. Second, the ESM refers to the euro area, which is more homogeneous than the larger EU, and its decision-making procedures do not require unanimity, something that is instead compulsory for any decision relating to MFFs. Third, the ESM can transfer resources under the guarantee of its funded capital, which, mainly at the end of March, was not fully utilized. In any case, these aspects do not contradict the similarity of the schemes. Hence, I can testify that an approach of this kind was judged unrealistic until a few days ago.

It is worth noting that this accusation has an obvious justification. The Merkel and Macron initiative is, in fact, characterized by a significant redistribution of resources between member states through a centralized (even if temporary) fiscal policy: the market debt, contracted by the European Commission on behalf of the EU, will be covered (in terms of interest rates and repayment of the principal upon maturity) by the member states in proportion to their direct or indirect contributions to the MFFs. As already mentioned, the resources obtained through this debt are instead allocated in proportion to the asymmetrical impact of the pandemic in the various member states. This initiative thus marks the possible start of a process, albeit gradual and bumpy, characterized by the European centralization of fiscal policies that incorporate risk sharing mechanisms.

3. The approval process

This conclusion underlines that it would be wrong to take both the approval and the adequate implementation of the Franco-German proposal for granted. The process is, in fact, just in its initial stage and the required steps are very complex and full of pitfalls.

[2] See M. Messori, "The current European debate on fiscal policy: Too much and too little", *SEP Policy Brief*, March, n. 10, pp. 1-5; enlarged version in: "Europe debate on fiscal policy: too much yet too little", *CEPS Policy Insights*, n. 2020-08, April, pp. 1-8.

Suffice it to recall that, as a preliminary step, it is necessary that the European Commission be ready to make this proposal its own, with minor adjustments, by the end of May. Any substantial change, especially if previously unarranged with France and Germany, could lead to disagreements and strengthen the group of countries opposing the launch of a strong RF. As a second step, the Commission must present its proposal to the European Council; and the other twenty-five member-states, which make up this Council (besides France and Germany), will have to unanimously approve the proposal. A number of member states from Northern and Eastern Europe have already raised fundamental objections to the Franco-German scheme by arguing that transfers cannot replace financing. Each of them can exert a veto power. Moreover, these countries will take time before making their decision since they have the right to subject their choice to prior approval by their national parliaments. In their proposal, Macron and Merkel state that they "will strive to make the budgetary effort related to Coronavirus-crisis available as soon as possible" (p. 3). In this respect, we should not be too optimistic.

There is another reason for being cautious. The fact that the initiative is devised by the two main EU countries does not automatically imply there will be a positive outcome. Although in a very different institutional context, we can recall a recent case in which a Franco-German initiative was not successful: the Meseberg Declaration (June 2018). In that statement, Macron and Merkel had made various proposals for major progress in the economic governance of the euro area. The Eurogroup, which met a few days later, and the subsequent Euro Summit (i.e. the European Council limited to the countries belonging to the euro area), limited themselves to accepting one of those proposals (the reform of the ESM statute, still incomplete), neglecting - de facto - all the others.

On the other hand, Merkel and Macron's proposal is not devoid of means for exerting pressure on the most opposing countries.

It is well known that the Netherlands (and partly Hungary) pursues distortionary tax competition inside the euro area and the EU.[3] This behavior is strengthened by the expansion of the digital economy. The Franco-German initiative states that "improving the framework for fair taxation in the EU remains a priority, in particular by introducing effective minimum taxation and fair taxation of the digital economy" (p. 3). Besides referring to a fundamental principle, this statement can also be read as a threat to the Dutch government and could become a 'bargaining chip' for the approval of Merkel and Macron's proposal on the RF. In fact, at least in the short term, the implementation of the RF does not require new European taxes. Moreover, it is well known that the Polish and Hungarian economies largely benefit from the inclusion of their firms in the value chains dominated by German companies also thanks to a compression of internal wages. Macron and Merkel state that they will "support the diversification of supply chains" as well as a "framework for minimum wages adapted to national situations" (pp. 4-5). Again, these two fully reasonable principles could become a 'bargaining chip' for the approval of the RF. In fact, diversification of supply chains and European constraints on national wage policies could be implemented in a very damaging way for the short-term competition of Polish and Hungarian economies.

[3] We disregard here the other EU 'free riding' countries in terms of tax competition since they do not explicitly oppose the Franco-German initiative

4. To conclude: some arithmetic

If the Franco-German initiative has the disruptive capacity described above and has to deal with a complex approval process, it would be really shortsighted to regret that its quantitative scope (500 billion euro) does not meet the expectations set by the hypothetical European Commission's proposal (1,000 or 1,500 billion euro). This is especially true for a country like Italy which, due to its pre-existing macroeconomic fragility and the intensity of the pandemic impact, could receive the greatest benefits in absolute terms (approximately 100 billion euro) from the implementation of Macron and Merkel's initiative and could enjoy a significant positive gap between the short-term transfers and its future contribution to the repayment of the joint European debt.

To argue that the Franco-German initiative represents a downsizing of the Recovery Fund as possibly conceived by the European Commission is not only a statement flawed by comparing a specific and concrete proposal with a hypothetical one. This argument is also conditioned by a far more serious economic misunderstanding. Suffice it to consider that the floated 1,500 billion euro should have been based on the issue of 300-billion-euro bonds to be allocated on the market by the European Commission. In principle, these 300 billion euro would have allowed for the disbursement of a minority share of transfers (say 100 billion euro) and a majority share of interest-bearing loans (say 1,400 billion) to member states for a total of 1,500 billion euro. Such a result would have been based on a supposed leverage of 7 for the disbursement of loans to member states. Conversely, the Franco-German proposal provides for a significant increase in the issuance of bonds by the European Commission: 500 billion instead of 300 billion. The transfers based on this increased European debt cannot, however, be multiplied since - by definition - "gifts" unlike loans cannot count on any leverage effect.

The implication is obvious: the comparison between the possible 1,400-billion-euro loans and the 100-billion-euro transfers, on the one hand, and the 500-billion-euro transfers, on the other, cannot be based on a simple quantitative sum of the first two components to be directly weighted with the third one. As is known, this operation requires a common unit of measurement (in general, it makes little sense to add apples and oranges). The comparison must therefore be more complex and involve two steps formulated here under the guise of simple questions. First: for a country with a very high public debt/GDP ratio such as Italy, is it not preferable to obtain a "gift" with "reciprocity" rather than a loan with a further increase in public debt? Second: since the transfer is asymmetrical - that is, it is based on the impact of the pandemic shock in individual countries - while the repartition of the European debt will be presumably based on the macroeconomic weight of each of the member states, is it not worthwhile for Italy to opt for the more redistributive alternative? The obvious answer to these questions highlights the groundbreaking novelties of the Franco-German initiative and the misuse of the abacus.