Luiss
School of European Political Economy

A permanent Recovery Fund requires a European Government

Carlo Bastasin

Policy Brief 35/2020

LUISS

September 25, 2020

A permanent Recovery Fund requires a European Government

Carlo Bastasin

On July 21, 2020, the European Council agreed on the Next Generation - EU (NG-EU). The new exceptional temporary recovery instrument was primarily meant to address the economic fallout from the pandemic through a debt based fiscal stimulus of around 1% of GDP on average in the euro area over the period from 2021 to 2024. In this context, the European Commission is authorized to raise up to €750 billion on the capital markets on behalf of the European Union. The funds can be used to provide loans of up to €360 billion and grants of up to €390 billion.

Provided it is deployed for productive spending and accompanied by growth-enhancing reforms, the NG-EU would not only help to underpin the recovery but also increase the resilience and the growth potential of Member State economies. The dichotomy between the Recovery and the Resilience aims of the initiative has profound political implications: while the Recovery initiative has a clear one-off character linked to the pandemic crisis, there is no reason why the Resilience component should not be maintained in place after the crisis.

To receive financial support, EU Member States need to prepare national recovery and resilience plans setting out their reform and investment agenda for the 2021-23 period. These plans are expected to feature coherent packages of reforms and public investment projects and address the challenges identified in the context of the European Semester. In substance, they should strengthen the growth potential, job creation and economic and social resilience of the recipient Member State. The clear goal is to avoid an uneven recovery in the euro area and the deriving risk of economic fragmentation.

None of these goals – enhancing the growth potential in the most fragile economies and preventing euro-area fragmentation – is necessarily temporary. On the contrary, both should be part of the permanent agenda of the European institutions. However, if the Recovery and Resilience Facility transforms into a permanent tool in European economic governance, political considerations should become much more relevant than they are today. A more transparent and accomplished system for economic governance should be designed, taking in due account the element of democracy. In simpler words, a permanent European fiscal capacity could not exist without democratic accountability and the full-fledged political dimension of a European economic government.

The lack of a permanent fiscal capacity at EU level has often been indicated as one of the main flaws of the architecture of European economic governance. Large shocks can have significantly different impacts on each Member State, as the pandemic crisis has shown. Sizeable asymmetric shocks are not infrequent in the euro area.

Business cycle fluctuations have remained significant since the inception of the monetary union. According to an economist at the EU Commission[1], almost half of the cyclical variations of euro-area Member States can be attributed to country-specific developments. Although Member-State economies have been integrating, national business cycles are still imperfectly correlated, and the effects of asymmetric shocks have remained substantial.

As the Coronavirus crisis has shown, the variations in public finances triggered by exogenous shocks can be far stronger than those normally factored in by the euro-area fiscal rules. Historical data show that even once a country has achieved the Medium-Term Objective, its fiscal space can be insufficient to accommodate for the size of changes in headline fiscal balances. This may require a common fiscal intervention to compensate for the lack of national fiscal space. Otherwise, procyclical fiscal austerity might be triggered at the wrong time under the pressure of financial markets. This is particularly relevant for countries that have accumulated a legacy of high debt.

Besides the issue of asymmetry stoking fragmentation, a common fiscal stance has become relevant with the diminished role of monetary policy. Asymmetric components of the business cycle cannot be addressed by monetary policy, by definition. However, given the exhaustion of conventional and non-conventional instruments, also the common component of the euro-area business cycle cannot be addressed by the European central bank. Against a backdrop of "lower for longer" interest rates, a permanent common fiscal capacity may be of vital importance for a correct governance of the European economy.

The fact that an asymmetric component in the business cycle remains strong leads financial institutions to maintain a certain degree of home bias. This is one of the main reasons why the full development of a banking union and of a capital market union may take longer than desired. This can prevent the private risk-sharing channel from taking on the task of smoothing asymmetric shocks across countries. Consequently, for the foreseeable time the role of a common fiscal capacity can barely be substituted even by the relaunch of financial integration in the euro area.

By compensating the lack of a common fiscal capacity, the EU's recovery and resilience package can represent a milestone in European economic policy integration, establishing a joint funding model to support government spending and reform in the EU. The NG-EU issuance will increase outstanding EU debt by a multiple of around 15, becoming the largest ever euro-denominated issuance at supranational level. While the loans will be repaid by the beneficiary Member States, the European Council agreed to reform the own resources system and ensure that grant repayments will be covered by gross national income-based contributions and new EU own resources. As recently suggested by the ECB, the review of the economic governance framework, which was launched by the Commission in February 2020 and postponed because of the pandemic, provides a good opportunity to incorporate the NG-EU package in the permanent framework of the European economic governance.

[1] Buti, Carnot: "The case for a central fiscal capacity in EMU" voxeu.org – December 2018

However, if the Recovery and Resilience Facility becomes a permanent feature of European governance, one should not overlook its huge political implications, which must be aligned with the quality of common EU institutions and the depth of democratic practices in the European Union.

In order to have an idea of the RRF's impact on government practices, one must consider the highly informative "guidance to member states" issued on September 17, 2020 by the EU Commission. The guidance instructs national governments on how to present their plans and request loans or grants. As is known, the financial support will be disbursed in instalments when milestones and targets identified in the national recovery and resilience plans are reached.

The guidance states that the plans should be composed of reforms and investments, grouped in coherent "components". "Each component should reflect related reform and investment priorities in a policy area or related policy areas, sectors, activities or themes, aiming at tackling specific challenges, forming a coherent package with mutually reinforcing measures." Moreover, the components should be of a sufficient granularity / specificity to show a direct link between the proposed measures therein. Several detailed examples are listed so as to identify desirable "components".

Each component should support one or more of the overarching principles indicated by the European Commission: 1) The proposed reforms and investments tackle one or more of the challenges outlined in the Member State's country-specific recommendations. 2) The proposed reforms and investments contribute to the digital or green transitions, going beyond the issues addressed in the country-specific recommendations. 3) The proposed reforms and investments contribute to effectively strengthening the sustainable growth potential, job creation, and economic and social resilience, and mitigating the economic and social impact of the crisis while fostering cohesion and convergence.

Member States can rely on different elements to indicate the estimated impacts of reforms and to substantiate their expected effectiveness. For instance, reforms can have a major positive impact by raising potential sustainable growth or by strengthening economic and social resilience, ensuring the long-term sustainability of public finances, improving the business environment (especially for SMEs,) or by accelerating the twin transitions. The document presents a list of examples of such types of reforms: pension reforms, labor market reforms, education and training reforms, reforms improving the business environment by addressing regulatory requirements and red tape or well-designed and comprehensive reform packages in the green and digital sectors.

The political impact of the plans is enhanced by the implementation and control practices indicated by the "guidance". Article 16(3)(g) of the Proposal for a Regulation on the Recovery and Resilience Facility prescribes that the arrangements proposed by the Member States concerned are expected to ensure an effective implementation of the Recovery and Resilience Plan, including the envisaged timetable, milestones and targets, and the related indicators. Overall, Member States should define milestones and targets with a high level of specificity to ensure that progress can be tracked effectively. Moreover, milestones and targets will be discussed bilaterally with the Member States based on their plans before agreeing on the ones to be included in the implementing decision.

The European Commission seems to be aware of the profound institutional implications of the interaction with the national governments. The guidance specifies that "Member States are invited to describe the institutional nature of the plan, as well as the role of their national/regional parliaments, other regional/local authorities, and national advisory bodies such as national fiscal boards and national productivity boards in the decision process leading up to the adoption/submission of the Recovery and Resilience Plans." Member States are also invited to describe any consultation and/or contribution from social partners, civil society and other relevant stakeholders, in the drafting and implementation of the Recovery and Resilience Plan. In fact, this may remain wishful thinking or a simple figurative exercise. The level of technicality and the need for progressive adjustments of the plans are not functional for constant interaction with many different interlocutors.

In fact, to ensure effective implementation, the "guidance" requests that clear responsibilities be established at the national level: "A lead ministry/authority should be nominated that has the overall responsibility for the recovery and resilience plans and is the single point of contact for the Commission ('coordinator'). The coordinator would be responsible for the implementation of the recovery and resilience plans, for ensuring coordination with other relevant ministries at national level (including ensuring coherence regarding the use of other EU funds), for monitoring of progress on milestones and targets, for overseeing and – if appropriate – implementing the control and audit measures and providing the reporting (Article 20 of the Proposal) and the requests for payments of the financial contribution and, where relevant, of the loan tranche (Article 19 of the Proposal). The Recovery and Resilience Plan needs to outline that the coordinator has the (i) administrative capacity in terms of human resources (staff numbers and profiles), institutional experience and expertise, and (ii) the mandate and authority to exercise all relevant tasks. If a responsible authority (i.e. ministry or agency) is defined at the level of a component, the respective information needs to be provided as well. In addition, the coordination structure as well as the reporting of responsibilities to the coordinator should be clearly described."

Overall, the Recovery and Resilience Facility represents a significant step towards more intense political cooperation between Member States and the EU institutions. The problems will arise if – as is necessary – the Facility becomes permanent. In that case, the multiannual commitments inherent to the structural policies funded through EU resources will put significant constraints on the functioning of a national consensus-based democracy. Reforms chosen, proposed and agreed by a national government may become contentious if the government changes. The concentration of powers in a national "coordinator", normally a minister, is functional to the interlocution with the European counterparts but can also be a source of political fragility. Other considerations highlight the importance of clearing the democratic endorsement of the plans and – if the Facility becomes permanent, as is desirable – of setting up transparent ways for conducting a constructive dialogue between national parliaments and the EU institutions.

If, as is necessary, the Recovery and Resilience Facility becomes a permanent pillar in the architecture of European economic governance, more than just little attention will have to be devoted to a proper democratic framework. At this stage, if any, political integration cannot advance by stealth. The Council of the European Union should not shy away from acknowledging that economic integration in the EU, and even more so in the EMU, requires a new level of political powers and democratic accountability. The Council may be reluctant to call this the bud of a European Government, but the sooner it does, the better it will be for the correct and transparent development of European cooperation and coexistence.