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European Union recovery funds: strings attached, but not tied up in knots

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Executive summary

- **THE EUROPEAN UNION'S PLAN** for aiding recovery in member states hit by the coronavirus crisis has been rightly hailed as a major breakthrough for the bloc. But there is much less clarity on the plan's economic aims, its priorities and the content of the contractual arrangements it should entail between the EU and member countries. The plan's main plank, the Recovery and Resilience Facility (RRF) is widely seen as a short-term Keynesian stimulus. Although the EU debt is expected to be repaid through contributions from member states, the resulting transfers are often seen, including by national governments, as money from heaven. There has also been controversy over the conditions attached to grants and loans
- **FUZZINESS OVER** objectives and overloaded procedures can derail the RRF. The EU needs to provide clarity from the outset and put the plan on the right track. It should acknowledge and emphasise that the main goal of the RRF is not to contribute to immediate relief or a Keynesian stimulus, but to foster structural transformation, especially in less-advanced and harder-hit member states.
- **THE EU SHOULD** hold back from trying to impose through overall policy conditionality its reform agenda on the member states. Support for digitalisation cannot be conditioned on pension reform. Instead, there should be a narrow-conditionality approach in which reforms that strongly complement intended investments should be identified and bundled with that investment. A grant aimed at encouraging decarbonisation in the transport sector, for example, would, be made conditional on the elimination of transport fuel subsidies. Therefore, in national recovery and resilience plans, each bundle of investments and reforms should be focused on the limited set of policy measures that need to be implemented to maximise the impact of EU-financed investment.
- **MEANWHILE, COMPLEMENTARITY ACROSS** objectives should be addressed through a dialogue with each member state on the sectoral allocation of EU funding and the overall architecture of their recovery and resilience plans. As the provider of the funds, the EU has the leverage and legitimacy to be demanding in this discussion.
- **THE EU SHOULD** emphasise where relevant the cross-border dimension of investment plans and should encourage member states, including financially, to cooperate on the design and implementation of their plans.

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Introduction

Because of its size, the way it will be financed and the fact that it involves outright cross-country transfers, the agreement reached by European Union leaders in July 2020 on the European Recovery and Resilience Facility (RRF) was rightly hailed as a major breakthrough for the EU, perhaps even a 'Hamiltonian moment' in the process of fiscal federalisation.

But there is much less clarity on the economic aims of the RRF, its priorities and the content of the contractual arrangements it should entail between the EU and the member states. Despite the planned disbursement schedule, which would span five years, the RRF is widely seen as a short-term Keynesian stimulus. And despite the fact that the EU debt is expected to be repaid through contributions from member states, the resulting transfers are seen, including by national governments, as money from heaven. There has also been controversy over the conditions attached to grants and loans, and the resulting political compromise has been interpreted in various ways by the protagonists.

Clarity is needed, therefore, first and foremost to ensure effectiveness, but also if the RRF is meant to provide a template for future budgetary initiatives at EU level. While its contours have been settled, in particular by guidance from the European Commission on the preparation of national plans[1], much could still be done to dispel ambiguities and to define precisely the nature of the policy dialogue that will take place within the framework under construction.

My intention here is to contribute to this clarification through (1) evaluating the significance of the RRF from a macroeconomic standpoint; (2) analysing its stated aims; (3) discussing conditionality; and (4) making proposals on tackling the crucial challenges of interdependence across objectives and EU countries[2].

1 Macroeconomic aims

There is by now growing agreement that the pandemic shock can be characterised as a combination of *lockdown shock* affecting simultaneously supply and demand in specific sectors, a resulting *demand shock* affecting other sectors not directly hit by the crisis, and a *reallocation shock* that will gradually trigger a transfer of resources across sectors, regions and possibly countries (Blanchard, 2020; Barrero and Bloom, 2020). Discussions continue on the significance of the demand shock or the permanent character of the reallocation shock, but there is broad consensus on the overall characterisation.

The question is then: where will the EU programme help?

Let us start from the perspective of a country that has normal access to capital markets and is neither on the giving nor on the receiving end of the transfers involved in the RRF (assume that the present value of the expected transfers from the EU budget is equal to the present value of expected additional contributions to the EU budget). For such a country, the loans component of the programme will be immaterial (because it can borrow on the market on exactly the same terms), and even the grants component would be of secondary importance (because they will not change the intertemporal budget constraint). Nominally, the country's deficit and debt will be lower in the short run, but its off-balance sheet liabilities will

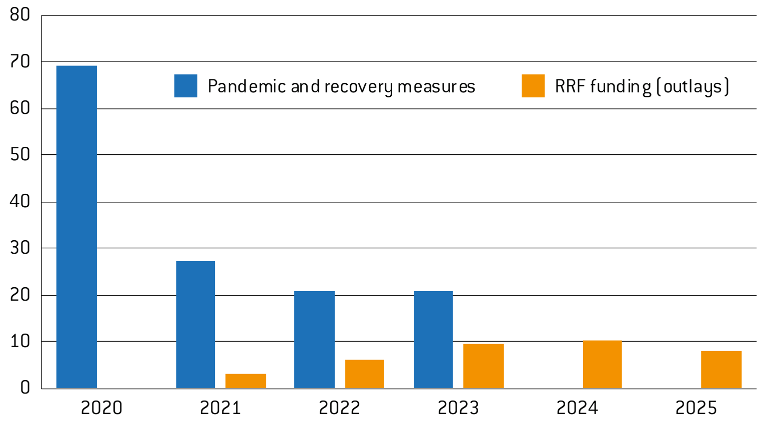
1 See https://ec.europa.eu/info/files/guidance-member-states-recovery-and-resilience-plans_en.

2 The EU initiative, dubbed Next Generation EU, consists of a series of programmes, the most important of which is the Recovery and Resilience Facility. My focus here is on the €312.5 billion grant component of that facility. Additional grants will be provided through other programmes, especially the bridge programme ReactEU (€47.5 billion), bringing the total to €390 billion.

be higher – certainly not a first-order impact. Although the Maastricht indicators for deficit and debt will improve, markets will certainly notice that the underlying situation remains the same.

There are only two cases in which the RRF will provide a net gain. This is firstly if the EU agrees to finance the repayment through new own resources that genuinely broaden the aggregate tax base by tapping into revenue sources unavailable to national governments. Such resources do exist. To assume that they will be of an order of magnitude commensurate with the €390 billion EU debt repayment burden (plus interest) is a long shot, however[3]. The second case is an inflation tax that would be a substitute for repayment if the European Central Bank were to monetise the debt – again, quite a long shot[4]. In practice, both possibilities exist, but are unlikely to materialise.

Figure 1: France, distribution over time of support measures and RRF funding, € billions, 2020-2025



Source: Bruegel based on the French government's RESF report (Direction générale du Trésor, 2020). For simplicity, it is assumed that the Plan de relance will be disbursed over three years (2021 to 2023). Faster disbursement, as planned by the government, would only strengthen the argument. It is assumed that the time profile of the RRF funding will follow that indicated in Giovannini et al (2020. Permanent tax cuts are excluded from the calculation.

France is a good approximation of this category of country: according to tentative ECB calculations (Giovannini *et al*, 2020), the grants it will receive, net of future repayments, should eventually amount to about minus 1 percent of GDP (meaning that it will be a net contributor)[5]. If cross-country spillovers are disregarded (more on this in section 4), France cannot expect the EU plan to make a positive medium-term contribution to its own economic performance, at least from a macroeconomic standpoint. It cannot expect much in the short term either. As apparent in Figure 1, which shows the distribution over time of the budgetary measures introduced in France and their partial funding by the RRF, the entirety of the short-term pandemic package and the bulk of the overall budgetary support will be financed by the national budget. The EU will finance only one-fourth of the total budgetary support (excluding permanent tax cuts) engineered in response to the shock.

3 See for details my recent report with Clemens Fuest to the informal Ecofin of September 2020 (Fuest and Pisani-Ferry, 2020). A new EU own resource will broaden the aggregate tax base if the source it taps into cannot be taxed individually by member states, either because it has a genuinely pan-European character or because tax competition prevents tax initiatives by individual countries.

4 A mere decision by the ECB to roll over its debt portfolio would not materially soften the government budget constraint. See Blanchard and Pisani-Ferry (2020).

5 This calculation assumes that repayments will be based on each country's share of the EU's Gross National Income. Net transfers may eventually differ if new meaningful new own resources are created. The ECB calculations are based on a number of assumptions and are therefore open to challenge.

However the same reasoning does not apply to the countries that are major beneficiaries of the RRF. Gross transfers are expected to reach 16 percent of GNI for Bulgaria, 13.5 percent for Greece, 8 percent for Poland and Portugal, and 5 percent for Italy (Darvas, 2020). For many countries in southern and central-eastern Europe, *transfers net of expected repayments* should exceed by far the aid worth 2.6 percent of recipient's GDP that the United States granted to Europe under the Marshall Plan (Steil, 2019). In addition, these countries will benefit from being able to borrow on more favourable terms through the loan component of the RRF and other liquidity lines, because the EU will pass on to them the very favourable conditions it is expected to benefit from when tapping the bond market[6].

It is through the combination of this structural transfer and this provision of liquidity on favourable terms that the RRF is expected to support a subset of EU countries in a significant way. Such amounts represent a major relief. If invested shrewdly, they could change the recipient countries' economic fates. They would also improve the overall outlook for the EU, indirectly benefitting countries that are net payers into the scheme.

The upshot is that a clear division of tasks is at work in the EU. States have shouldered most of the immediate response to the lockdown shock, with the help of the ECB's Pandemic Emergency Purchase Programme and, to some extent, of the EU's SURE facility[7]. They also remain in charge of coping with the ensuing demand shock, as the EU has not provided and will not provide meaningful Keynesian stimulus. But the RRF will contribute significantly to the response to the reallocation shock by supporting medium-term oriented measures in less-advanced and hard-hit countries. In these countries, it could be a major help in fostering economic transformation, addressing structural deficiencies, improving economic performance and preventing further divergence from the EU core[8]. For this to happen, the RRF must be designed appropriately.

2 Recovery and resilience: a multi-purpose plan

The mechanics of grant allocation under the RRF are by now clear. Amounts available to member states are (and, for the still-unallocated part, will be) determined on the basis of numerical criteria. Access will be conditional on approval of plans submitted by the member states, which should be consistent with general objectives set out by the EU. Implementation will be monitored by the EU and disbursements will be conditional on fulfilment of agreed milestones and targets.

As defined by the EU, the RRF pursues several objectives simultaneously. The European Council conclusions of July 2020 spelled out the goal to *"set the Union firmly on the path to a sustainable and resilient recovery, creating jobs and repairing the immediate damage caused by the COVID-19 pandemic whilst supporting the Union's green and digital priorities"* (European Council, 2020a, paragraph A2). They also indicated that for assessing the RRF, plans put forward by member states should demonstrate *"consistency with the country-specific recommendations …* [while] *strengthening the growth potential, job creation and economic and social resilience of the Member State shall need the highest score"*. Finally, it was added

6 Darvas (2020) puts the corresponding net present value benefit at 1.3 percent of GNI for Italy.

7 Support to mitigate Unemployment Risks in an Emergency; see https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/financial-assistance-eu/funding-mechanisms-and-facilities/sure_en.

8 From a political economy standpoint, the EU initiative may also serve as a coordination device and avoid that some member states free-ride on their neighbours' fiscal action. In a low interest rates environment where multipliers are high, such coordination could yield non-insignificant benefits.

that *"effective contribution to the green and digital transition shall also be a prerequisite for a positive assessment"*. This is a long list in which priorities are not clearly defined. A previous Commission proposal (European Commission, 2020a) and further Commission documents (the Annual Sustainable Growth Strategy 2021 (European Commission, 2020b) and the guidance to member states for the preparation of recovery and resilience plans (European Commission, 2020c)) list more or less the same objectives, although with variable categorisation and emphasis.

The 17 September guidance for the preparations of national recovery and resilience plans (European Commission, 2020c) lists four general objectives:

- Promoting the Union's economic, social and territorial cohesion;
- Strengthening economic and social resilience;
- Mitigating the social and economic impact of the crisis;
- Supporting the green and digital transitions.

In more concrete terms, the guidance document indicates that member states should present plans consisting of a series of *"coherent components"* composed of reforms and investments. Each bundle of investment and reform will be assessed separately against three main criteria:

- Whether it tackles the country's priority challenges as outlined in the EU's country-specific recommendations;
- Whether it is conducive to the digital and green transitions;
- Whether it contribute effectively to the RRF's overall goals[9].

The national plans should also meet the requirement that a minimum of 37 percent of expenditure is related to climate and 20 percent to the digital transition.

By adopting this scheme, the EU has aimed to find a compromise between conflicting aims, both vertically and horizontally. Vertically, it intends to leave the initiative to the member states, while ensuring that money is spent in accordance with what is regarded as priority challenges. Horizontally, it intends to make progress towards overall objectives such as the green transition and digitalisation, while addressing country-specific challenges of high unemployment and dismal growth. It has also tried to balance the conflicting objectives of structural transformation and disbursement speed.

These are commendable goals. The question, however, is if the procedures in place give a good chance of reaching them. Clearly, the risk is that the whole process becomes a box-ticking exercise. Having negotiated the total amount of support they are entitled to receive, countries may well regard the EU template as a pointless bureaucratic hassle deprived of substantive content, and either paint their projects with the required colours, or pick and choose those of their existing programmes that have the best chance of meeting the EU criteria. By the same token, trade-offs between objectives may be overlooked and the pan-European dimension may end up being ignored.

9 Box on "*overarching principles underpinning a component*" in Section 1 of Part 2 (European Commission, 2020c).

3 Addressing the controversy over conditionality

In large part because of the legacy of the Troika programmes implemented in 2010-2012 in the context of the euro crisis, conditionality has been a contentious issue in discussions on the design of the RRF. The established EU philosophy, as enshrined in the European Stability Mechanism treaty, was that *"strict conditionality"* goes hand in hand with financial assistance. But potential beneficiaries such as Italy have argued vocally that the pandemic crisis has had an exogenous character and that solidarity cannot be conditioned on structural reforms. In the end, the political compromise has left the initiative to member states but to spell out criteria for the assessment of their plans.

It should be clear that conditionality is indispensable. Whereas immediate relief provided to hard-hit member states on solidarity grounds or temporary transfers aiming at pure macroeconomic stabilisation should not be subject to the fulfilment of economic policy conditions, new structural transfers worth several percentage points of GDP that aim at improving economic performance, strengthening resilience or fostering the transition towards a digitalised, greener economy cannot be handed out unconditionally. This would be a recipe for political capture – if not, as argued by Wolff (2020), outright corruption.

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The question therefore is not the principle of conditionality but its purpose and design. This is the challenge the European institutions have tried to tackle, and this is still the challenge the EU faces.

Conceptually, there are two types of solution to the problem. The first is to devise a broad set of policy actions that are deemed critical with respect to priority objectives, and to condition the financing of the whole programme on these actions. This top-down approach is the philosophy underlying International Monetary Fund conditional lending: the granting of assistance is conditional on an overall programme and actual disbursements are conditional on the fulfilment of pre-agreed milestones. The same approach can easily be applied to medium term-oriented programmes aiming at lifting potential output, alleviating structural unemployment, reducing inequality or fostering decarbonisation.

The difficulty with this approach – quite apart from the question of its political acceptability – is the selection of the priority actions. As emphasised by Hausmann *et al* (2005), priorities should not be chosen from a laundry list of desirable reforms, but by prioritising policy initiatives that help to allocate scarce political capital to the lifting of the most binding constraints on economic activity (or any other objective, be it social justice or a low environment footprint)[10].

According to this approach – let us call it *broad conditionality* – reforms should therefore not be looked at one by one, but rather as a system, and the choice of a reform strategy should be dictated by the ranking of the marginal efficiency of individual measures (and the complementarity between them). An effective recovery programme should therefore make overall financial support conditional on a critical set of priority reforms.

The second, more bottom-up solution is to start instead from the specific aims of sectoral grants – be they for innovation, employment, education, digitalisation or the greening of the economy – and to determine for each what immediately adjacent conditions are required to improve the effectiveness of the money spent. With this approach, the question is not what the most binding constraint on the aggregate outcome is, but what reforms that strongly complement the intended investment and should therefore be bundled with it. A grant aimed at encouraging decarbonisation in a certain sector, say transport, would, for example, be made conditional on the elimination of transport fuel subsidies. Similarly, a grant targeting

10 The corresponding IMF notion is *"macro-critical conditionality"*. It is far from being always implemented in practice.

digitalisation would be conditional on the introduction of coding courses in high school programmes. Let us call this approach *narrow conditionality*[11].

This type of conditionality does not start from a superior knowledge of what is good for a given country, but from the conditions that must be met so that money spent with certain goals actually achieves these goals. In this case, the legitimacy of setting conditions is simply that grants are means to aim for certain goals, and that the grant-giver has a responsibility for ensuring that these goals have a good chance of achievement.

The EU has apparently chosen to blend these two solutions. The bundling of EU-financed investments and flanking reforms goes in the direction of narrow conditionality, while the reference to the often very macro country-specific recommendations and the requirement that each of the components be assessed against the whole list of EU objectives suggests that a much broader approach will prevail.

There is nothing wrong in trying to combine the two approaches, but this should be done on the basis of an unambiguous definition of where each of them applies. By not choosing between them, the EU is running the risk of relying on an ill-defined method that will complicate serious discussion on national reform plans and increase the risk of content-free box-ticking.

Moreover, the EU should not avoid hard choices. At this stage, because broad conditionality is a political non-starter, and because aggregate monetary entitlements have been defined already, the EU would be well-advised to embrace narrow conditionality explicitly. This would imply inviting member states to structure the components of their recovery and resilience plans around key investments and a parsimonious selection of complementary reforms. Policy dialogue between the EU and the member state would then focus on the composition of these components, that is, on the matching of reforms and investments.

As developed in the next section, such an approach should still leave room for dialogue between the EU and the member states on the overall architecture of the national recovery and resilience programme. But it would avoid overarching controversies over the conditions attached to financial support. To be clear, it would leave no room for making support for digitalisation conditional on a reform of the pension system.

4 Interdependence across objectives and member states

The downside of narrow conditionality is, however, that it risks leaving aside two issues. First, it could fail to address interdependence across objectives. It would not take cross derivatives into account and could therefore result in a suboptimal allocation of means. Concretely, investment and reform in a certain field, say product-market competition, may have significant effects on labour markets that will not be accounted for in an excessively granular approach that focuses on specific objectives and flanking conditions[12]. This could result in significant shortcomings and a less effective programme.

Second, narrow conditionality would equally miss interdependence across countries. It is well known that the existence of cross-country spillovers results in the suboptimality of

11 The United States has a certain tradition in this respect that goes back at least to the New Deal: the federal government manages an array of *categorical grants* with the aim of encouraging state and local governments to move into new policy areas and expand efforts identified as national priorities (Congressional Research Service, 2019).

12 The example is borrowed from Blanchard and Giavazzi (2003).

a country-by-country approach to policy reform. Such spillovers may not be significant for standard growth-enhancing reforms (Tabellini and Wyplosz, 2006), but they are much more important for the digital and green agendas. In both cases, research, standardisation and network externalities make the results of initiatives in one country dependent on initiatives in the EU as a whole.

Hence, whereas the neglect of cross-country spillovers can be regarded as a second-order issue for, say, labour-market reforms, this does not apply to significant part of the recovery and resilience agenda. Moreover, although the Commission's initial proposals included a strong European public goods aspect, the political economy of the negotiation led unfortunately to their almost complete neglect in the final agreement reached by the European Council in July 2020 (European Council, 2020a). By itself, narrow conditionality is unlikely to bring them back to the fore.

These are significant problems. Interdependence across objectives is a major issue for the RRF, because its various aims are not necessarily coherent. To take the most obvious example, the greening of the economy and the enhancement of growth potential will be hard to reconcile, at least in the medium term. Because it implies an accelerated discarding of significant parts of the existing capital stock (and even more so if the transition is intended to be fast), greening can in fact be regarded as a negative supply shock that will adversely affect potential output in the short run. The same applies to a great extent to some aspects of the resilience requirement, which may lead to trade-off efficiency for security of supplies, even if this lowers potential output. The design of an appropriate plan therefore requires that strategic complementarities and strategic substitutabilities between objectives are both taken into account.

Cross-country spillovers are also a major concern. Beyond the green and digital agendas, they can also be found wherever the single market is involved. For example strategic autonomy, which was recently promoted as a key objective of the EU, must be regarded as a property of the EU system as a whole, rather than of its national components taken in isolation[13]. Achieving such autonomy – for whatever it means concretely – will require coordination between member states.

These challenges can be addressed, however, because the EU retains strong leverage: it is ultimately the provider of funding and therefore must have a say in the allocation of money between, say, infrastructure investment, incentives for R&D and vocational training. In this capacity, it has undisputable legitimacy for discussing with each member state what components its recovery and resilience plan should include and how much funding will be allocated to each of them. In other words, it is hard to deny the EU a strong voice in the determination of the overall architecture of recovery and resilience plans, and the relative funding of the associated investment packages.

The EU has undisputable legitimacy for discussing with each member state what components its recovery and resilience plan should include and how much funding will be allocated to each

Instead of drawing up a long list of desirable reforms for every EU country, the EU should therefore prepare for a two-level dialogue with each: first on the major priorities of their recovery and resilience plans and the corresponding allocation of funds, and second on the reforms to be included in each component. The Commission should, for example, first take a view on whether broadband access, business innovation or skills should be part of the recovery and resilience plan of a recipient country, and in a second stage, discuss with the national government which reforms of telecom regulation, incentives for private R&D or vocational training are required to maximise the impact of the EU grant.

Cross-country coordination issues could similarly be addressed within the framework of the discussion on the recovery and resilience plans. The very fact that there are minimal requirements for the proportion of funding to be allocated to the digital agenda and the green agenda already goes in this direction. The Commission should go one step further by assessing the coherence of national plans in fields that correspond to EU priorities and incentivising member states to engage in cross-border projects. To this end, it could make use

13 See the European Council Conclusions of 2 October 2020 (European Council, 2020b).

of EU budget funds to top up support given within the framework of the RRF to projects that have an explicit cross-border dimension. For example, the EU should encourage governments that have indicated an intention to foster the development of hydrogen to devise coordinated strategies, and should provide extra support to member states that engage in joint projects.

Both the cross-sectoral and cross-country aspects should be emphasised by the Commission in the discussion about recovery and resilience plans. These are not domains where the Commission should be afraid of issuing directions. In particular, the Commission has a legitimate role in taking care of the cross-border spillovers that member states naturally fail to consider.

5 Conclusions

Ensuring the success of the RRF is a high-stakes challenge for the EU. Success is by no means guaranteed and the cost of failure would be very high. If the plan succeeds, it will surely pave the way to further initiatives, and perhaps ultimately to a fiscal union alongside the monetary union established two decades ago. But if the RRF fails to deliver on stated goals, if political interests prevail over economic necessity, if the money is wasted, the very legitimacy of EU initiatives will be affected and, for sure, federal aspirations will be dashed for a generation.

Fuzziness over objectives and overloaded procedures can derail the process. But the EU still has time and the means to put things straight. It should:

- Acknowledge and emphasise that the main goal of the RRF is not to contribute to immediate relief or a Keynesian stimulus, but to foster structural transformation, especially in less-advanced and hard-hit member states;
- Abstain from trying to impose through overall policy conditionality its reform agenda on the member states;
- Endorse a narrow-conditionality approach to the design of national recovery and resilience plans and focus for each bundle of investments and reforms on the limited set of policy measures that need to be implemented to maximise the impact of EU-financed investments;
- Address complementarity across objectives through a dialogue with each member state on the sectoral allocation of EU funding and the overall architecture of their recovery and resilience plans;
- Emphasise when relevant the cross-border dimension of investment plans and encourage member states, including through financial incentives, to cooperate on the design and the implementation of their plans

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