28 May 2020

The EU Recovery Plan - New Generation EU

Summary

On 27 May, the European Commission put forward its proposal for a stimulus plan, ‘New Generation EU’, financially helping member states recover following the Covid-19 pandemic. The plan is in line with our analysis in previous notes:

- Support package: The new measures amount to EUR 750 bn – EUR 500 bn in grants and EUR 250 bn in loans. Additionally, the EU has announced loans that could bring the overall fiscal boost to over EUR 1trn - a figure earlier announced by the European Commission President Ursula Von der Leyen.
- Distribution: Both grants and loans will be frontloaded and distributed to the member states and sectors hardest hit by the crisis, particularly to projects that promote the three main EU objectives (Green Deal, Digital agenda, and health-sector resilience). This additional expenditure will form part of the EU’s budget but will be placed in a separate chapter, which will expire once the recovery plan is concluded. The rescue package is in addition to the EUR 1.1 trn Multiannual Financial Framework (MFF) budget for 2021-2027 proposed by the European Council President Charles Michel in February.
- Financing: The additional EUR 750 bn will be borrowed on financial markets by the European Commission, acting as an independent financial agent on behalf of the EU. The amount will have to be paid back between 2028-2058 from EU direct taxation (EU’s own resources). To boost the EU’s loan capacity, the EU’s tax ceiling (the amount the EU can claim from member states) has been temporarily raised from 1.2 percent to 1.8 percent of member states’ GDP. To make funding available as soon as possible for the most urgent needs, the European Commission has also proposed to increase the 2020 budget by EUR 11.5 bn.

Size of the recovery fund

The EUR 750 bn package exceeds the 18 May French-German proposal to provide EUR 500 bn worth of grants. The new proposal includes EUR 250 bn worth of loans, as a concession to the ‘frugal four’ (Netherlands, Austria, Denmark, and Sweden) which prefer loans to grants. The EUR 250 bn loan component also increases the overall impact of the rescue package to an estimated EUR 1-1.5trn, as the money will be used as seed money to raise large sums in financial markets – a technique successfully used in previous EU financing initiatives. The European Commission’s AAA credit rating makes these types of bonds attractive to investors and the sums involved are not expected to change this credit rating.

Distribution between member states and spending priorities

The support measures will mainly be spent on member states and sectors that have been hardest hit since the health and economic consequences of Covid-19 have impacted member states differently. The precise amount allocated to each member state will not be known until there is greater clarity on the damage caused by the pandemic and the levels of unemployment within member states.

The majority of the support should be given to projects that also promote the EU's three main priorities: the Green Deal, the Digital Agenda and making the EU more resilient to future crises.

The European Commission also proposed to deploy additional funds to reinforce existing programs including:

- Horizon Europe (research and innovation investment programme),
- The EU Cohesion spending (combatting youth unemployment),
- The Just Transition Fund (helping member states in their green transitions),
- Rural Development,
- Support for developing countries and countries in the EU periphery.

Finally, the European Commission will launch a EUR 300 bn solvency-support mechanism this year for businesses with liquidity and solvency problems. This mechanism is an addition to the European Investment Bank's recently adopted support mechanism for SMEs.

The European Commission's only condition to access the various measures is the respect of fundamental rights, which was already proposed as conditions for budget support, and the endorsement of the EU's 2050 climate neutrality goal by all member states, including Poland.

Financing

For the first time in EU history, the European Commission will finance EU spending through bonds sourced from financial markets. Unlike earlier loans, including the EU EUR 540 bn financial package agreed in April, the recovery loans are not guaranteed by member states but by the EU as a separate entity. The recovery plan will, therefore, not increase the member states' national debt.

The loans in the package, which will be floated incrementally as the need arises, will have to be paid back by the EU starting from the next financial term in 2028, and repayments could stretch over 30 years (2028-2058). The debt will be serviced by the EU's own resources. For the moment, these consist of direct contributions by member states based on their GDI, 1 percent of EU VAT receipts and customs duties on imports.

The EU is now considering additional options to raise its revenues, including a potential new EU-wide tax on plastic waste, extending the EU's Emission Trading Scheme (ETS) to Shipping and Air transport, a digital tax and a Carbon border tax. The coronavirus rescue package also suggests introducing a new tax on large corporations (0.1 percent on companies with a worldwide turnover of more than EUR 750m). EU states are under pressure now to agree to new EU tax instruments, to avoid having to repay the EU loans from national coffers, but only the plastic tax and possibly the ETS-tax are likely to be agreed now. Decisions on the other will be postponed.

Next steps

The European Commission’s package marks the start of difficult negotiations. It needs to be agreed by July to enter into force on 1 January 2021. The negotiations will start at a European Council Summit on 19 June.

The ‘frugal four’ will likely oppose the proposal, but their opposition will be weakened by an offer to extend the rebate on their EU budget contributions. They will likely push for a smaller grant component in the rescue package, maintain their current demands to keep the main budget framework as small as possible and defend their rebate.

Central European Countries could also put up resistance but won’t have a unified position. To keep them onside, the European Commission has proposed additional funding for economically disadvantaged areas, flexibility in the use of this funding in the coming two years, and support for the Green transition.

The remaining member states support the European Commission’s proposal and appear ready to approve a deal.