EU Recovery Plan: emerging agreement and tax proposals

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Overview

The European Commission is moving forward quickly with its Recovery Plan. The overall financial framework including EUR 500 bn in grants and EUR 250 bn in loans, and most of the underlying legal texts are already on the table. The plan also proposes a slightly amended version of the 2021-27 framework of the normal EU budget (MFF), amounting to EUR 1,100 bn, and an addition of EUR 13 bn to this year's budget. Despite divergences in approach, no delegation seems to reject the overall approach and they agree on the need to move rapidly. The negotiations will start at a European Council Summit on 19 June. The German Presidency of the Council of the EU, with Chancellor Angela Merkel leading, is determined to move forward at full speed from 1 July (the start of the six-month German EU presidency) and reach an agreement on the whole expenditure program (MFF and recovery budget) already in July, with the aim to finalise and adopt the necessary legal texts in the early fall. This will be necessary to ensure that the hardest-hit countries can receive the money from late fall. However, the Germans are in no hurry to discuss how to pay back the EUR 750 bn loan and the possibility to raise new EU taxes (own resources) in this context. However, Germany will need to reach an agreement on the ceiling for own resources to be raised to two percent (0.2 percent to compensate for Brexit, and 0.6 percent to repay the loans in the rescue package), and possibly a tax on plastic waste.

Potential obstacles towards reaching an agreement

As explained in our previous note on the EU Recovery Plan, the so-called 'frugal four' (Netherlands, Denmark, Sweden, and Austria) 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 and maintain their current demands to keep the main budget framework as small as possible. They are, however, unlikely to obtain significant cutbacks on the grant element. Instead, they are likely to obtain the continuation of their present rebate - since the Commission has already opened this door in its new proposal and Germany has similar claims - and minor cuts on individual budget items.

We expect intense discussions around the methodologies that the Commission has proposed for the indicative division of funding from the biggest part of the Recovery Plan, namely the EUR 560 bn Recovery and Resilience Facility. Methodologies for the allocation of EU funding are typically based on GDP per capita and unemployment rates, which does not reflect the needs created by the fallout from COVID-19. Belgium and Ireland are also asking for the economic consequences of Brexit to be taken into consideration. The Southern European countries have expressed their satisfaction with the proposal. Indeed, Italy, Spain, Portugal and Greece will receive more than 50 percent of the grant, according to the Commission's proposal. The Central and Eastern European countries initially expressed scepticisms but seem now quite satisfied. In relative terms, the Commission is even more generous to Poland than to Italy, which might comfort the sceptics in their objection to the parameters chosen by the Commission.

Unlike the Commission's proposal (30-year period starting in 2028), some member states (including Germany) will want a quicker repayment of the Commission's loans, starting already in the 2021-2027 budget period. This is unlikely to happen since this would involve further cuts to the 2021-27 MFF.

Despite the various difficulties, odds are that an agreement on the expenditure (budget and Recovery Plan) will be achieved in July. The German Presidency will fully exploit the present headwind and highlight the economic and political problems that the EU could face if it fails in its ambition to reach an agreement. Should negotiations break down, the present positive mood on the financial markets would not only disappear but turn sour.

Agreement on the expenditure side

An agreement by EU leaders in July will allow negotiations with the European Parliament to start in September on both the 2021-27 MFF and the corresponding 2021 Budget. In addition, the European Parliament will deal with the Recovery Plan - where an important point of controversy is expected on the question of additional own resources (see below) - and with the many sectoral regulations that determine criteria and procedure for spending the money. The European Parliament will also need to approve the revised MFF for the current period and a revised budget for 2021. The legislative procedure will be unprecedented in scope and will take place during a period, where the good functioning of the institution is being hindered by the COVID-19 crisis conditions. An agreement by the Heads of State in July should ensure unanimity in the ministerial negotiations on the necessary legislation. It could, however, be a frustrating period for many members of the European Parliament, since they could be blamed for delays.

Agreement on the income side

Under the Recovery Plan, the Commission will be authorized to borrow funds on behalf of the Union itself, up to an amount of EUR 750 bn on the capital market. The proceeds will be transferred to the various EU spending programs. Repayments of the funds should start in 2028 and the loans should be fully repaid in 2058.

As explained in our previous note on the EU Recovery Plan, to obtain low interests in the market and retain the EU's present triple-A rating, the EU must have the necessary capacity to pay back, which is why the own-resources ceiling needs to be increased for the Commission to source loans from financial markets with its credit rating intact. This capacity is based on its claims on member states (EU 'own resources'), which presently consist of direct contributions by member states based on their Growth Domestic Income (GDI), 1 percent of EU VAT receipts and customs duties on imports. To boost the EU's loan capacity, the EU's tax ceiling has been temporarily raised from 1.2 percent to 1.8 percent of member states' GDP, until the recovery fund loan is fully paid back. In addition, Brexit and the present fall in the EU GDP will require an extra 0.2 percent addition to the ceiling. The two percent ceiling will remain in place until the loans have been paid back.

A decision to change the EU's own resources (including adding new types of own resources) requires unanimity in by Member States, but the European Parliament is only consulted. Entry into force of the decision requires the ratification of all national parliaments, however, which could take more than a year. Member states will, this time around, try to convince their national parliaments to move forward much more rapidly.

Repaying the national stimulus packages will draw on classical tax resources such as income tax, VAT, and other sales taxes and property taxes. We expect to see the trend of lowering general corporate taxation coming to an end in most EU countries, which does not necessarily mean increasing corporate income taxation. However, with direct taxation falling under the competence of member states, national governments have their hands free to initiate new taxes instead. For example, Poland is planning to introduce a new tax on sugar.

New tax proposals

The EU is now also 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.

The current drive for new types of tax revenue at the EU level could lead to a significant change in how the EU is funded, paving the way for a system where it has more of its own resources rather than being almost exclusively dependent on the contributions it receives from the member states. Some of the new tax proposals (see below for more details), which have been put forward don't have any chances of being adopted as they do not have the support from national governments.

For now, the only additional tax that could be adopted is the tax on non-recycled plastic packaging waste, which is the only one included in the Commission's new proposal. The other proposals on the table will likely be examined at a later by the Commission. Most of these do not primarily aim for the collection of revenue but for obtaining other policy goals (ETS, Carbon Tax). In addition, an agreement on a tax by member states does not necessarily imply a decision to transfer the revenue to the EU.

The European Parliament will want the European Commission to have control over its tax-raising and spending decisions. Otherwise, the fear is that member states will reduce EU spending to pay back the loans included in the package. However, it remains to be seen whether the parliament is willing to delay the whole rescue plan to get what it wants on the EU's own resources. The challenge here is that the European Parliament has no voting rights on own resources, only on the MFF, 2021 budget and regulations linked to expenditure.

Proposed taxes and fees: features and outlook

Digital tax

State of play: The EU has been trying for years to create a pan-regional digital tax, targeted primarily at Silicon Valley "tech giants" that have large footprints across Europe. This was blocked last year by several EU countries including Ireland, Sweden and Denmark, thus forcing the EU to focus instead on ongoing discussions at the OECD-level for a new global tax. However, the EU reminded in its recovery plan that it stands ready to move ahead with plans for a digital tax that could bring in EUR 1.3 bn for the EU's budget if the OECD fails to deliver a plan. It is currently uncertain who will collect the revenue – the member states or the EU, or both. So far, countries like France, the Netherlands, Poland and Czechia have already put forward non-uniform proposals for new national digital services tax (DST) mechanisms.

Chances of success and timeline: It is very unlikely in the short-term, until there is clarity on the OECD negotiations - which are expected to materialize in early 2021. An EU digital tax would require unanimity among EU countries, including Ireland - which has previously blocked a pan-EU digital tax from being adopted. The Irish — and other smaller countries — may however potentially make the calculated decision of allowing some form of digital taxation through, as long as they get something major in return. If the member states do reach an agreement, the tax is, however, unlikely to be operational before 2022 at the very earliest.

New corporate or “single market” tax

State of play: This is a completely new proposal from the European Commission envisaging a levy of 0.1 percent of turnover on large companies with a global turnover above EUR 750 mn. The Commission does not elaborate on how businesses would be assessed but says “it could yield around EUR 10 bn annually” and would target large companies benefiting from the EU single market to make them contribute to rebuilding the economy.

Chances of success and timeline: This tax has small chances of being adopted since corporate tax and harmonizing tax rates across the EU are hugely sensitive issues for countries such as Ireland, Denmark, Luxembourg and the Netherlands. A new tax on big corporates could also spark another race to the bottom if companies see more sense in moving their headquarters to countries that are willing to offer better tax regimes. This is also completely new, meaning that if discussions were to move forward, it would be a 3+ year timeframe before such a tax could be agreed and implemented.

Tax on non-recycled plastic packaging waste

State of play: This proposal has also been on the table for two years and was initially designed to fill the gap in the EU budget caused by Brexit. It is aligned on the 2018 European Strategy for Plastics in a Circular Economy to reduce plastic waste. The idea is to charge national governments a fee of 80 cents on each kilogram of non-recycled plastic packaging, which the European Commission calculates would generate EUR 6.6 bn a year. The modalities of such a tax are still to be clarified – it is to be paid by governments but would possibly be levied back to the industry.

Chances of success and timeline: Discussion in member states around ways to reduce plastic waste have been intensifying over the course of the past year and there is general support for it. This is the likeliest new revenue stream to be agreed on as part of the Recovery Plan now discussed in the EU and would be operational in 2021 if agreed.

Extension of EU Emissions Trading Scheme

State of play: The European Commission is proposing to redirect a share of revenues from the EU’s Emissions Trading Scheme to the overall EU budget. It is also considering a possible extension of the ETS to the maritime and aviation sectors.

Chances of success and timeline: There is a reasonable probability this will go through, given the economic context post-crisis. Indeed, the economic crisis might help to revive the plan as it could generate revenues for the EU budget of about EUR 10 bn, depending on the evolution of the carbon price and the extension of the system to other sectors.

Carbon border tax

State of play: The carbon border tax plan, or carbon border adjustment mechanism should apply to selected sectors, focusing on energy-intensive industries (such as steel, aluminium etc.), to reduce the risk of carbon leakage (i.e. production and investment relocating abroad with no reduction in global emissions) and ensuring a level playing field for European producers against imports from non-EU countries that have more lenient climate rules. The main objective here is not to secure extra revenue, but to avoid carbon leakage.

Chance of success and timeline: The chances are very low, as the proposal has been criticized for generating more risks than proven benefits. Empirical evidence suggests that the EU should instead focus on implementing measures to trigger the development of a competitive low-carbon industry rather than applying a charge on imported goods based on the emissions emitted during their production. The European Commission plans to introduce a proposal for a border adjustment mechanism in 2021.