Teneo

16 July 2020

EU summit 17-18 July

Make or break moment for the EU pandemic recovery

Summary

In the first face-to-face EU summit since the pandemic hit Europe, on 17-18 July, leaders will face several challenges to effectively respond to economic downturn that has been created by COVID-19. It could be a decisive moment in European history with an ambitious recovery and economic stimulus on the top of the agenda and high political and economic stakes. Leaders will negotiate the Multi-Annual Financial Framework (MFF) and the "Next Generation EU" stimulus package, and finding a consensus on either of those will likely prove difficult. It remains uncertain if leaders will be able to reach a political agreement on 18 July, to allow the Commission to increase its capacity to raise new own resources and ensure prompt implementation of the recovery package. Leaders are under high pressure to agree, since postponing the recovery measures would harm the economy, particularly for countries that have already suffered from the pandemic.

The challenge

EU leaders will meet for a European Council in Brussels on 17-18 July in person for the first time since the outbreak of the pandemic. According to the Commission's recent economic forecast, the EU economy is heading for a 9 percent annual drop. A return to pre-2020 levels is unlikely to happen until the end of 2022. This forecast assumes that Europe is not hit by a second wave of the pandemic, which would lower the estimates further.

The weakest member states (Italy, Spain, Portugal and Greece) have suffered the most and can expect falls of 11 percent or more. For technical reasons, the negative effects of Brexit are not included in the forecast but will add to the negative trend – whether a long-term agreement with the UK is reached or not.

Only a collective fiscal boost to the European economy of an unprecedented size can change this somber outlook. All member states have implemented national stimulus measures but with great variations in size depending on each country's economic capacity. More than half of the expansion has taken place in Germany. This has positive spill-over effects on the other countries but, at the same time, can distort the internal market. The European Central Bank (ECB) has until now been able to avoid excessive differences in borrowing rates

between member states through aggressive monetary interventions, but ECB president Christine Lagarde has repeatedly warned that the Bank might not be able to maintain the cap unless it is supported by a major EU-wide effort on fiscal policy.

The revised proposal

Late in May, the Commission presented an ambitious recovery and stimulus package (called Next Generation European Union – NGEU) of EUR750bn (4 per cent of EU GDP), composed of EUR500bn in grants and the rest in loans to be spent over the next 3-4 years. For the first time in EU history, the proposal would be financed through floating long loans sourced from the market (EU-bonds). The recovery package comes on top of a EUR1.100bn framework for regular EU expenditure over the next seven years.

Since the announcement of the package, intensive preparation has taken place at technical level in Brussels. Leaders have had a first collective exchange of view via videoconference and have all been consulted bilaterally on the main elements of the package by European Council president Charles Michel. German Chancellor Angela Merkel has followed up with political consultations on the need for solidarity in the present crisis with the weakest countries being the worst hit, and the need for speed. Merkel is firmly determined to reach a political agreement before the end of July so that action can be taken as soon as possible. She will let Charles Michel take the frontline battle in the European Council but will play a strong supporting role, as it is her habit.

Negotiation basis and the hardest nuts to crack

Last week, Charles Michel circulated his proposal for an overall agreement covering both the framework for the normal EU Budget (MFF) and the Recovery Fund.

MFF Proposal: Charles Michel's MFF proposal of 1.074€ was slightly lower than the Commission's one, including minor cuts in programs like REACH (Research) and ERASMUS (higher education). He also scrapped the money set aside for a euro-budget – a brainchild of French President Emmanuel Macron – and reserved the funds for interest payments and other costs linked to the loans that will finance the recovery plan. This might not please the French President but aligns with the main objective of NGEU to ensure the survival of the euro currency. To please the "frugal four" (Netherlands, Austria, Denmark, and Sweden), Michel has proposed

to extend the four countries' rebates on payments to the EU budget, an advantage also extended to Germany. In addition, he added smaller "gifts" like increased flexibility in use of structural funds and higher advance payments, special support to Islands (Cyprus, Malta and the French Oversees Departments) and a EUR5bn support scheme to help regions that will be particularly hit by Brexit.

Finally, the President proposed two elements of conditionality which should apply to both the MFF and NGEU:

- An increase from 25 to 30 percent in spending that supports the EU's climate objectives.
- A "soft" rule of law mechanism. The Commission originally proposed a mechanism that would allow it to cut funding to countries that infringed their rule of law obligations, unless a qualified majority of member states **voted against.** Michel changed the voting rule to require **positive support** from a qualified majority, and limited interventions to cases where the implementation of the budget is under threat. Additional financial support was offered to the newly created Public Prosecutor's office (from which Poland and Hungary have opted out).

There will be plenty of complaints from member states in the European Council to various aspects of Charles Michel's package, but it is unlikely that they will derail the negotiations. The exception might be the rule of law provision, where many member states will call for a more robust set of safeguards, while Hungary's Prime Minister Viktor Orbán has announced that he will veto any human rights clause.

Next Generation EU: Charles Michel has retained the amount in the Commission's proposal. The overall amount and the division between loans and grants is likely to be the last pieces of the puzzle to fall into place. Most member states seem to be prepared to accept the proposed financial framework and it is hoped that the rest can be persuaded by concessions offered elsewhere in the package like the following:

- **Greater political insight in allocating support:**
  The main instrument "the Recovery and Resilience Facility– RRF" (EUR310bn in grants and EUR250bn in loans), which will support the main priorities identified in the European Semester – the process of identifying important reforms that are needed in each member state. During the 2020 cycle, European objectives linked to the "Green deal" and the digital agenda were promoted. The Commission proposed a procedure involving a committee of member state representatives that would be able to question the reform plans. by a simple majority. Charles Michel proposes to raise the political level for these decisions to ministerial level and a qualified majority would be needed. The Netherlands wants to go further and asks for a unanimous decision. In the opposite direction, Italy rejects any political interference in the decision making, having observed what happened to Greece in the aftermath of the 2009 financial crisis. This could become a complicated issue in the negotiations.

- **Allocation of support under the RRF related to the macroeconomic damage from COVID-19:** According to the Commission, the funds will be allocated to member states according pre-Corona growth rates and unemployment, while ignoring any pandemic-related effects. Michel proposes to maintain this method for the first two years (70 percent of the total) but to include the "COVID-years" 2020-2021 when determining the allocation for the third year of support. It is doubtful whether this proposal goes far enough for most leaders. They will be happy to accept a formula that ensures that more than half of the overall support benefits Italy, Spain, Portugal and Greece, but object to a distribution where Poland - only mildly affected by the pandemic – will end up being the third-biggest recipient.

- **Greater frontloading and earlier repayment of the loan:** The Commission foresees a 4-year period of operation for NGEU and repayment of the underlying loan to start after 2028. In his proposal, Charles Michel responded to a widespread wish to see the implementation period shortened, reducing it by one year. In addition, repayment could start already in 2026 if there are funds left over from interest payments or if revenue starts flowing from EU taxes.

New own resources

Michel's proposal mirrors Commission's proposal to raise the Own Resources Ceiling (the upper limit on EU direct taxation) from 1.2 percent of GDP to 2.0 percent. Most of this increase (0.6 percent) is time-limited to the period of repayment for the loan that finances the NGEU expenditures. The proposal also adds potential new resources allocated to the EU. None of the proposed new taxes will go directly into the EU treasury. Rather, they will be collected by member states and the EU will share part of the revenue. The following measures are included:

- A levy on non-recycled plastic packing waste to be introduced on 1 January 2021.
- A carbon border adjustment mechanism and a digital levy. The Commission will bring forward proposals in the first semester 2021, and the levies will be introduced at the latest by 1 January 2023.
- A revised ETS scheme will possibly be extended to aviation and maritime. No deadline is stipulated.
- Other own resources which "may include a Financial Transaction tax".

The plastic levy seems to be generally accepted. The timeline and mandate for other taxes fall below the ambitions of several member states. France is likely to insist that the ETS revision and the digital tax should be included in the first batch of the new own resources.

Conclusion

Under normal circumstances, negotiations to reach an agreement will take months if not years. But the situation is not normal, and the European Council has previously been able to produce miracles when needed.

The aim is to reach a political agreement in the evening on 18 July. This will allow an immediate start of the large legislative work that needs to be finalized to make the agreement operational. Agreement by the European Parliament will also be necessary on various points. All national parliaments need to give their approval for the decision on additional EU taxes.

An outcome on the 18 July short of a full political agreement is possible. A situation could arise where European leaders need to return to capitals to seek political backing by coalition partners or national parliament before they can sign up. In this case, a new European Council will be held later in July. A longer delay can't be excluded but could prove dangerous. It would not necessarily make an agreement easier and, in the meantime, the financial market could react negatively and add exacerbate the economic crisis. Once more, it would be the weakest member states that will suffer the most.