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Barriers to EU fiscal policy cohesion remain high despite progress on EU recovery fund

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In Europe, where the spread of COVID-19 has pushed the economy to the brink of a financial crisis, both the EU and individual countries have introduced large-scale fiscal policies. After discussions of an EU recovery fund stalled over issues such as financing, Germany's Angela Merkel and France's Emmanuel Macron submitted a joint proposal on 18 May to the EU for a 500 billion euro grant fund. This was followed up on 27 May by the European Commission's announcement of a 750 billion euro fund, including 250 billion euro in additional budget for loans (Table 1).

The proposal is for funding to be released over a number of years, meaning that it could be called a relatively modest crisis response, but would nevertheless be significant if implemented. The current proposal is to fund the rescue package by issuing joint EU bonds, but these would be repaid out of the EU budget, which essentially amounts to fiscal transfers between member states. That Germany agreed to the proposal is unprecedented: in the past it has repeatedly refused fiscal transfers to aid countries suffering from individual crises. This change of heart seems to be the result of Germany prioritising EU harmony over its own national interests.

Objections from fiscally sound countries like the Netherlands meant that the proposal wasn't approved at the EU Summit conducted via video conference on 18-19 June. That said, given that Germany takes over the rotating presidency of the European Council in July, and the numerous past examples of EU member states reaching a compromise on controversial policies, it seems likely that an agreement will be reached eventually, even if this involves some compromises over sticking points such as grant allocation or generous funding for Southern European countries.

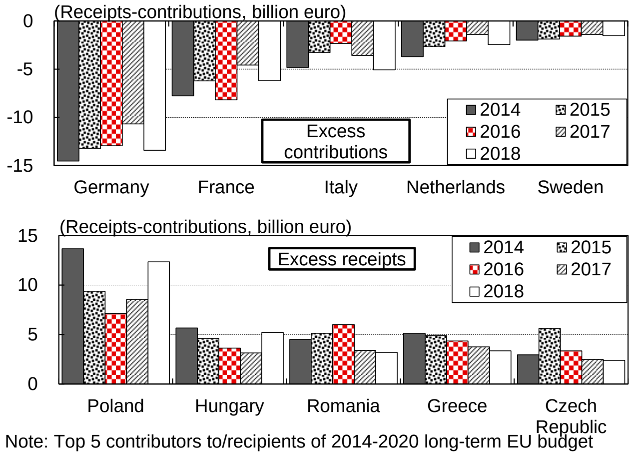
However, it remains to be seen whether the creation of this joint fund will lead to increased cohesion in terms of future EU fiscal policy. The EU budget is allocated to member states based on each country's contributions, but major countries like Germany as well as other fiscally sound countries that objected to the recovery fund have been making excess contributions for some time now (Chart 1). The barriers to achieving fiscal policy cohesion are extremely high: it would require net budget contributor countries to agree to permanent, large scale fiscal transfers. Germany's current attitude to the idea of a recovery fund is motivated by the unprecedented nature of the COVID-19 crisis, and it is worth noting that there is still strong domestic opposition to the idea of fiscal transfers. Whether or not discussions on the recovery fund turn out to be the first step towards future cohesion in terms of EU fiscal policy will hinge upon the extent to which confidence in the EU and solidarity between member states is built up by the fiscal response to the COVID-19 crisis.

Chart 1: European Commission EU Recovery Fund Proposal Details and Objections

Total cost	€750bn
Content	€500bn in grants, €250bn in loans
Timeline	To be delivered over several years from 2021 to 2024
Funding	Funded via the financial market by joint EU bonds
Repayment	Capital to be repaid over 30 years from 2027 to 2058 (raised via new taxes on big companies, e.g. digital tax)
Funding allocation	■€560bn 'Recovery and Resilience facility' to provide financial support for member states, including:
	€310bn in grants to member states
	€250bn in loans to member states
	■ €43.8bn to strengthen private investment, including:
	€30.3bn to upgrade strategic investment (Invest EU)
	€13.5bn to fund research (Horizon Europe)
	■€7.7bn to upgrade health security (EU4Health)
Objections	Objections from Netherlands, Austria, Sweden, Denmark, Finland

Source: European Commission, MUFG Bank Economic Research Office

Chart 1: EU Member States' Budget Balances



Note: Top 5 contributors to/recipients of 2014-2020 long-term EU budget
Source: European Commission, MUFG Bank Economic Research Office

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