European Daily: The Recovery Fund—Transitory Tool or Hamiltonian Moment? (Stehn)

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- The Recovery Fund—which will start disbursements to member states soon—was agreed as a one-off package to support the recovery from the covid crisis. Following the disbursement of grants over the next five years, repayment is planned for 2027-58, through a combination of member state contributions and new EU-wide revenue sources.
- A number of commentators, however, have argued that the Recovery Fund is more than a one-off tool and provides a breakthrough in financial integration. Visions for the Recovery Fund range from a permanent loan facility, to a "rainy day" fund, to a central fiscal authority with tax and spending powers.
- Given the political difficulty of agreeing on a large, central fiscal capacity, we expect the Recovery Fund to advance European fiscal integration more incrementally but along a number of important dimensions. We see a low bar for a continuation of the Recovery Fund loan facility, expect the new EU-wide revenue sources to allow for a permanently larger EU budget and, most importantly, regard the Recovery Fund as a precedent for a Europe-wide fiscal tool that can be utilised again during a future crisis.
- In sum, the Recovery Fund is unlikely to be either temporary or Hamiltonian, but an important step down the road of European integration.

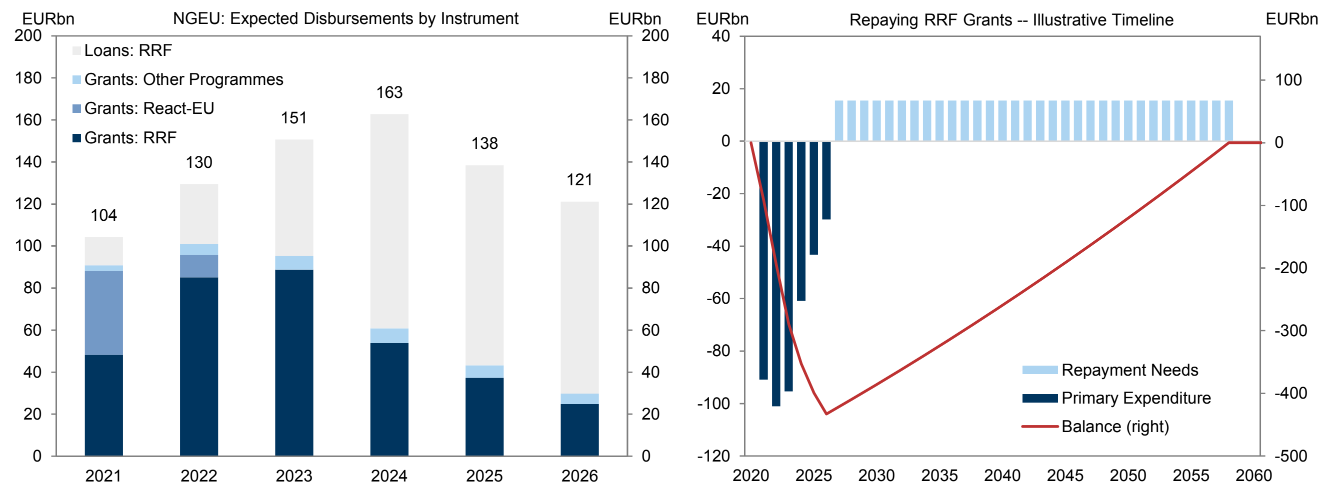
The Recovery Fund—Transitory Tool or Hamiltonian Moment?

Following last week's EU Council meeting, the Recovery Fund—a key component of NextGenerationEU, or NGEU—will disburse funds to member states soon. Debt issuance has already started, and we expect the Recovery Fund to disburse money to member states in July. We estimate that the Recovery Fund will have large effects on the Southern European economies, boosting activity by 5% of GDP in Italy and Spain by 2026. The future of the Recovery Fund beyond the next five years, however, remains unclear yet very important for Europe's longer-term institutional outlook. In this *Daily*, we chart its planned trajectory, visions of further integration and our views on the most likely outcomes.

The Plan

The Recovery Fund was agreed as a temporary vehicle last July, designed as a one-off package to support the recovery from the covid crisis. Setting aside loans—the repayment of which will be fully borne by the recipient Member States—EUR 420bn worth of grants are to be disbursed over the 2021-26 period (Exhibit 1, left). The repayment is due to start in 2027, and the political agreement struck last year states that the funds "*shall be fully repaid at the latest [end-]2058.*"[1] At the current funding cost implied by market expectations, the EU will need to set aside on average EUR 15bn per year to meet the repayment deadline (Exhibit 1, right).[2]

Exhibit 1: A Temporary Plan



Source: Goldman Sachs Global Investment Research

Turning to the funding of the repayment needs, the legislation calls for the introduction of new sources of revenues and for Member States' contributions to complete the shortfall. This provision both softened the Fund's redistributional implications—which allowed the most reticent Member States to buy in—and pre-empted the Fund's lasting footprint on the EU budget.

The legislation sets out a roadmap for the introduction of these new levies. In two main legislative cycles, the European Commission will make proposals to expand the scope of the EU Emission Trading Scheme (ETS), introduce a Carbon Border Adjustment Mechanism (CBAM), and more tentatively, levy revenues via a digital tax, a tax on financial transactions (FFT) and a corporate tax (CCCTB, Exhibit 2, left).

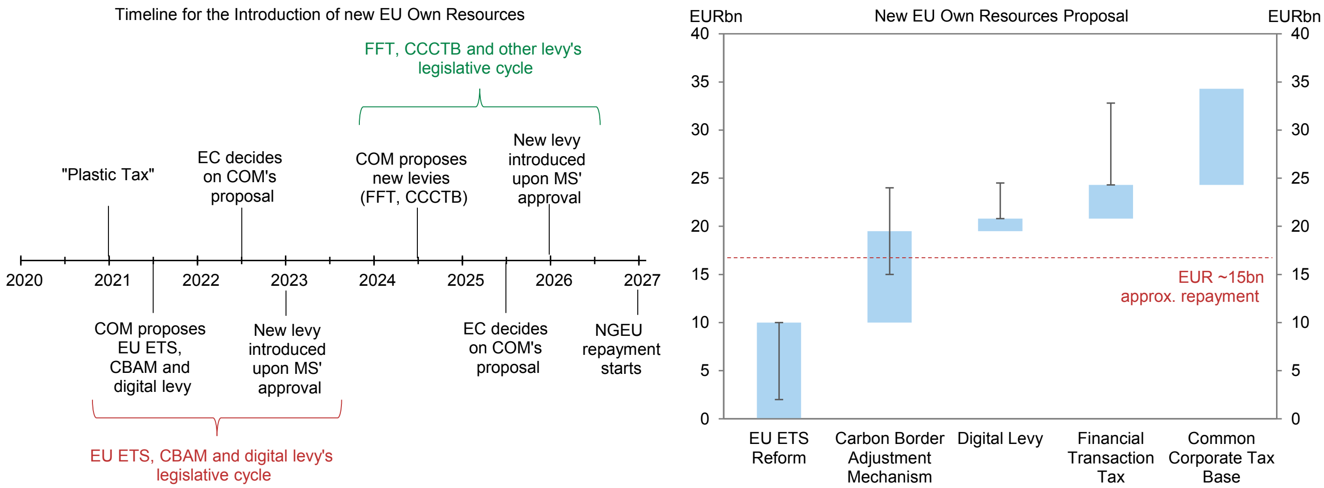
The Commission estimates that these new tax sources bear significant revenue potential of around EUR 35bn per year.[3] While our own work on climate policies highlights the rationale and political capital for rising carbon prices, reaching agreement on higher corporate taxes seems difficult, not least due to the recent G7 development. Nevertheless, the Commission's estimates—in line with the broader literature—suggest that locking in an ETS reform and related CBAM could already cover the Recovery Fund's annual repayment effort (Exhibit 2, right).

1 See Council Decision 10046/20.

2 We use an average of Bund and OAT 15y forward rates from 2021 to 2027.

3 See Schwarcz (2021) for an overview of the Commission's proposals.

Exhibit 2: How to Repay



Error bands on the right-hand side show mininum and maximum estimates across studies.

Source: European Commission, European Parliament, Goldman Sachs Global Investment Research

The Vision

A number of commentators, however, have argued that the Recovery Fund is more than a one-off tool and provides a breakthrough in financial integration. The German finance minister Scholz famously called the NGEU Europe's "Hamiltonian" moment. We can group the visions for the Recovery Fund into a few broad categories (Exhibit 3).

At the lower end of ambitions, academics and policy-makers alike have argued that the Euro Area needs a fiscal re-insurance mechanism, that backstops a sovereign's access to cheap funding.[4] The European Stability Mechanism (ESM) has historically played that role, but can come with political stigma, which has at times discouraged Member States from seeking assistance. A number of commentators have thus suggested retaining the Recovery Fund's loans on a permanent basis, with the recovery plans acting as a light conditionality device.

[4] See Vandenbroucke and co-authors (2020).

Exhibit 3: Big Dreams

Proposal	Key Features
Fiscal Re-Insurance	• Requires issuance of loans, and can work under back-to-back issuance. • Backstops a sovereign's funding cost. • Conditionality can vary, but the funds are ideally targeted (e.g. automatic stabilisers).
Insurance with Deductible	• Requires redistribution towards the affected Member State. • Censors the left tail of the shocks' distribution. • The deductible is the threshold past which the insurance is triggered.
Rainy-day Fund	• Requires Member States' transfers in good time and draw-downs in bad times, while allowing for asymmetries in Member States' balances towards the fund. • Squeezes the distribution of shocks from both sides. • Calibration of the fund can prevent permanent transfers, and could function without debt depending on the initialisation.
Fiscal Treasury	• Devolves significant taxation power and debt issuance in greater discretion to a central authority. • Allows for a somewhat discretionary fiscal policy at a centralised level. • Political oversight can range from a consensus amongst the 27, to a fully independent counterpart to the monetary authority.

Source: Goldman Sachs Global Investment Research

Moving past funding provision to actual redistribution, parts of the Recovery Fund could be retained as a fiscal shock absorber, or an output insurance scheme with a threshold past which shocks to output or unemployment are compensated. That is, the Union would commit to censoring the left tail of a Member State's distribution of economic output shocks.[5]

A more ambitious proposal would aim to lower the variance of shocks, by squeezing their distribution from both ends. That is, the Recovery Fund could be turned into a "rainy-day fund," where Member States contribute in good times and draw from it in bad times.[6]

Finally, going even further, Member States could devolve their fiscal power to a central fiscal authority, which would have discretion over tax levying and debt issuance. Only this last step can legitimately bear the name of "Hamiltonian moment," in the strict sense.[7]

The Reality

Although the economic arguments for a permanent Recovery Fund are compelling—as it would pair the single monetary authority with a more centralised fiscal capacity—the politics of such agreement are very difficult, given worries of a permanent North-South transfer union. We therefore expect the Recovery Fund to advance European fiscal integration more incrementally, but along three important dimensions.

First, we see a low bar for a continuation of the Recovery Fund loan facility, with the recovery plans acting as a light conditionality mechanism. This in, turn, would require a portion of the new EU debt to be rolled over beyond the planned horizon.

Second, we expect the new EU-wide revenue sources to allow for a permanently larger

5 For a short discussion, see Gros (2014).

6 As for instance, in Lenarčič and Korhonen (2018).

7 Alexander Hamilton was the first Secretary of the US Treasury and is widely recognised as having spearheaded the mutualisation of the 13 American colonies' debts during the War of Independence while carving out designated sources of revenues.

EU budget. A bigger EU budget could allow for grants as a conditionality-enforcing device in addition to the loans if the Recovery Fund proves to be an effective tool for policy coordination.

Third, and most importantly, the Recovery Fund provides a precedent for a Europe-wide fiscal response that can be utilised again during a future crisis. This is because the Recovery Fund has set a legal precedent for using Article 122 of the Treaty on the Functioning of the European Union to issue debt for redistributive (that is, grant) purposes. Although the hurdle needed to trigger a European response through Article 122 looks high, the Recovery Fund thus sets a clear path for further EU integration in response to another crisis.

In sum, the Recovery Fund is unlikely to be either temporary or Hamiltonian, but an important step down the road of European integration.

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