



Special purpose report

on the potential impact of joint borrowing of the
member states of the European Union on the
federal budget (Recovery Fund)

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0 Executive Summary

As a response to the COVID-19 pandemic, the member states of the European Union (EU) have decided to set up a Recovery Fund. The Fund will have a volume of €750 billion and be financed via bonds issued by the EU, i.e. Union debt. Union programmes will be used to allocate the money to the member states. Rather than as loans, most of the money (€390 billion) will be disbursed as non-repayable grants to the member states.

Preliminary calculations suggest that Germany will be the largest net contributor to the Recovery Fund with a net contribution of €65 billion. Germany may likely face further liability risks in the magnitude of several billions.

Therefore, the German Supreme Audit Institution reports to German parliament, the government and the general public on any adverse impacts potentially arising from the Recovery Fund and on the risks posed for the federal budget. In this version of our report, we have also given consideration to the comments made by the Federal Ministry of Finance (finance ministry) on our draft report.

Our key findings are set out below:

0.1 For the first time in its history, the Union will issue EU bonds to borrow substantial funds on the capital market and pass these on as grants to its member states. These bonds will not be repaid directly by the recipient member states but from the overall Union budget. Therefore, the Recovery Fund actually implements debt-financed transfers among the member states. In addition, the Union budget is liable for all debts of the Recovery Fund. We know from experience that instruments launched in times of crisis usually become permanent. However, this often ignores the fact that the costs and risks associated with such instruments may be justified to overcome a severe crisis, but not in normal times. The Recovery Fund might thus be an additional, permanent step towards a stronger fiscal integration in the Union, which would have major impacts on the stability of the Economic and Monetary Union.

The finance ministry described the Recovery Fund as an "exceptional response to temporary but extreme circumstances." The finance ministry also stated that the focus on the current crisis and the temporary nature of the instrument were explicitly regulated in the legislation. These regulations could only be permanently implemented if the Own Resources Decision were amended. This amendment would require a unanimous vote of the EU Council and the approval of the member states.

In this respect, the finance ministry rightly points out that any decision to permanently implement the Recovery Fund would be subject to the approval of the member states. In doing so, however, the finance ministry confirms our concerns that such crisis-related instruments may become permanent. In fact, member states eventually always agreed to turn such temporary instruments into permanent instruments in the past. In the light of the risks related to the joint issuing of debt, a more

convenient and transparent alternative would have been to allocate grants from the EU budget to the member states directly. It would have not been necessary to issue EU bonds for that purpose. (Nos. 3 and 4)

- 0.2 The Union budget is designed to serve as a guarantee for the debt of the Recovery Fund. This means that all member states will be held jointly liable for the debt via their future contributions to the EU budget. If a member state is either unable or unwilling to meet its debt repayment obligations, the other member states must step in to cover any pending repayments, without renewed consent. Such a liability mechanism sets wrong incentives and weakens the Economic and Monetary Union.

The finance ministry stated that the member states would not need to step in for pending repayment obligations of other member states directly. In case of non-compliance with repayment obligations, the European Commission (the Commission) would first have to identify liquidity options within the Union budget. In a next step, the Commission could reschedule maturing EU bonds at short notice. Only once these initial steps would not solve the liquidity problems, the Commission could demand the other member states to cover the pending balances.

As a result, the finance ministry confirms that the Commission will always use money from other member states if a member state defaults. Once a member state fails to meet its payment obligations, the other states eventually step in without renewed consent on their part. (No. 5)

- 0.3 The member states have adopted binding fiscal rules to limit public deficits and debt levels. No such rules are in place for Union debt. The Recovery Fund thus enables member states to circumvent the fiscal rules and incur debt at the Union level. To prevent this, all liabilities of the Recovery Fund should be added to the national public debt levels of the member states. In this way, the fiscal rules will actually apply and can have a disciplining effect.

The finance ministry stated that the EU bonds were Union debt. As such, debt arising from EU bonds was not to be added to the national debt levels of the member states. The finance ministry noted that the independent Statistical Office of the European Union had also opted for this categorisation.

This is not a matter of financial statistics, but rather of who will finally be liable for this debt. Since the member states will ultimately have to cover liabilities via their future contributions to the EU budget, it would be logical to add such debt to the national debt levels. This approach would also be expedient, since it serves to prevent member states from circumventing the fiscal rules and from violating basic principles of the Economic and Monetary Union. This would have a major adverse impact on the Union. (Nos. 4 and 6)

- 0.4 The EU bonds are intended to be repaid from the Union budget in the 2028-2058 period. However, how exactly debt repayment obligations will be split among the

member states is yet to be determined. This will be discussed during future negotiations on the Union budget. The Union budget will also guarantee for the entire debt of the Recovery Fund. For this purpose, the own resources ceiling will be raised. As a result, the Union will have access to an enormous guarantee volume of a least €4,000 billion. This exceeds the amount needed by far. This lends credence to the idea that the way for expanding Union debt has already been paved. Therefore, the ceiling should be significantly reduced. In addition, the member states' expected repayment obligations should be fixed in a mandatory redemption schedule.

The finance ministry stated that the own resources ceiling would be raised as a precaution to enable the Union to meet its payment obligations at any and all times and conditions. The calculations of the Commission were based on the hypothetical scenario that the maximum possible annual amount of repayment was due in every year and both, interest rates and economic growth, would decrease. The finance ministry also stated that the amount of loans and grants that would be allocated via the Recovery Fund had not yet been determined. Therefore, it was not possible to provide a mandatory redemption schedule yet.

The Commission's calculations are based on flawed assumptions. The question as to whether the Union can meet its debt repayment obligations at any time does not depend on the maximum possible annual amount of repayment but on the annual repayment that is required. In fact, the Commission may not exceed the "maximum annual repayment", but repaying less is possible. In addition, a scenario that assumes that all risks manifest in one year is not careful but rather unreasonable, especially if the risks are negatively correlated as in this case. However, the finance ministry rightly points out that at this point of time, no information is available as to the actual funding needs and payment streams for those funds that will be disbursed as loans. This does not apply, however, to the funds that will be disbursed as grants. (Nos. 3, 5 and 6)

- 0.5 Solidarity is premised on compliance with common rules, shouldering the burden arising from one's own failures and using all ways and means to address one's own shortcomings. It is at least doubtful whether, against this background, the Recovery Fund is justified. For example, several member states have, for years, not complied with the fiscal rules and thus effectively weakened themselves. The Recovery Fund does not ensure that the member states must exhaust all reasonable possibilities to address shortcomings from their own effort first. For example, more domestic actors could share the burdens of the pandemic.

The finance ministry stressed the principle of member states' national ownership of fiscal policy. The finance ministry added that the Recovery Fund was an instrument of active European solidarity. The aim was to mitigate the impacts of the pandemic at an early stage to avert lasting structural damage, particularly in hard-hit economies. All member states would also undertake considerable efforts on their own to cope with the pandemic and fund their programmes largely from their own pockets. The Recovery Fund would support and complement such programmes.

The finance ministry rightly points out that responsibility for fiscal policy lies with the member states. It would be logical to rely on this responsibility also when dealing with the impact of the pandemic. It should also be ensured that member states build up adequate financial reserves to enable them to adopt economic policy programmes and pursue a national stabilisation policy in a future crisis. Against this background, we advise reflecting on compliance with the fiscal rules to ensure resilience and long-term sustainability of the member states' domestic budgets. The goal should be to strengthen resilience and the scope of action of the Union as a whole to enable it to better withstand future crises. (Nos. 4, 7 and 8)

- 0.6 The resources of the Recovery Fund will be allocated to the member states via various Union programmes. The idea is to achieve higher economic growth, to strengthen economic and social resilience and to create jobs. The member states must report on the progress made in implementing their reforms in the European Semester for economic policy coordination. The efficiency and effectiveness of funding through Union programmes has not yet been substantiated with convincing evidence. In addition, the member states have largely failed to fully or properly implement country-specific recommendations made by the European Semester.

The finance ministry stated that it considered monitoring the use of funds to be a high priority. The Recovery Fund offered the opportunity to increase the number of programmes successfully implemented under the European Semester. The finance ministry urged for country-specific recommendations being attributed a "great binding force" and would regularly assume an active role in discussions on the further development of the European Semester. The aim was to strengthen the member states' responsibility for implementing structural reforms.

Even though the finance ministry seeks to ensure that the Recovery Fund is used effectively and contributes to the further development of the European Semester, we have reservations about this due to past experience with prior support programmes. (No. 8)

- 0.7 As a result of the COVID-19 pandemic, government structures, businesses, health and social systems and citizens all over the world face enormous burdens. The pandemic also poses unprecedented challenges to the economies and societies in the EU. Although the pandemic has hit all member states, some of them have neither sustainable public finances nor resilient government structures to implement the economic policy measures required from their point of view. The call for a joint response of the European Union is therefore understandable.

However, it is doubtful whether the Recovery Fund can meet the expectations placed on it and be a part of this response mechanism. The negative experiences with earlier EU programmes raise considerable doubts on the effectiveness and efficiency of the use of funds and therefore also on whether the targets of the Recovery Fund can be reached.

In a few years, the member states may be reluctant to cover open bills once they realise that although hundreds of billions of euros have been spent, structural weaknesses have still not been addressed – especially because the member states that currently have more financial reserves may by then have to cope themselves with the costs of their national recovery programmes. If the economic upswing even fails to materialise, this could have a lasting impact on the cohesion of the European Union. This is another reason why the debt repayment obligations should have been fixed before disbursing the funds.

The long-term risks associated with the Recovery Fund are of even greater concern because the Recovery Fund undermines the principle of ownership. In addition, the enormous guarantee volume provided by the member states enables them to borrow at the Union level, to effectively circumvent the fiscal rules and then to allocate these funds to them as grants via Union programmes. Furthermore, the liability mechanism may promote selfish national behaviour. Overall, the Recovery Fund may weaken the Union as a community based on the rule of law and solidarity and may put at risk the essence and stability of the Economic and Monetary Union.

We are aware that the Recovery Fund is a policy project already decided upon. However, given the considerable risks involved, the federal government should ensure that borrowing at the EU level and a circumvention of the fiscal rules does not become a permanent solution. (No. 9)

1 Preface

On 11 March 2020, the World Health Organization declared the outbreak of the global COVID-19 pandemic. At that time, the European Union (EU) had already been hit hard by the pandemic. All EU member states imposed far-reaching restrictions on public life to avert the threat of an exponential increase in the number of people at risk of severe illness and of health systems' ability to cope. The pandemic brought about a massive shrinking of the economy which is still continuing and has not been overcome yet. The pandemic-related economic impacts were and still are the result of the restrictions on public life rather than of the number of infected people varying across the regions.

High-debt member states of the period before the pandemic are limited in their capacity to tackle current economic challenges. Such member states may be less capable to implement domestic programmes to safeguard economic structures for example, since new borrowing is usually needed to fund any such increased expenditures. The limitation of government's leeway to act ultimately reflects pre-pandemic weaknesses and shortcomings.

Currently, some member states are facing even more severe challenges regarding debt sustainability and economic competitiveness because of the pandemic and its aftermath. Several actors therefore urged for European solidarity. Against this backdrop, the European Commission developed a proposal which provides for sizeable debt-funded transfers among member states.¹

In July 2020, at the EU summit, the European Council² agreed on a package aiming to link the next multiannual financial framework of the EU (MFF) to specific pandemic-related programmes.³ In response to the pandemic, the EU adopted the establishment of a Recovery Fund⁴. The Commission's power to borrowing was supposed to be clearly limited in terms of size, duration and scope.

On 17 December 2020, following the European Parliament's approval, the Council of the European Union (the Council) adopted the regulation laying down the MFF for the years 2021 to 2027. Pursuant to this regulation, the Union budget is to amount to €1,074.3 billion for the entire period and provide for an additional amount of €750 billion that will be earmarked for the Recovery Fund.

¹ Proposal for a Council Regulation establishing a European Union Recovery Instrument to support the recovery in the aftermath of the COVID-19 pandemic of 28 May 2020, COM(2020) 441 final.

² Members of the European Council are the heads of states and governments of the 27 member states of the European Union, the President of the European Council and the President of the European Commission.

³ Special meeting of the European Council (17, 18, 19, 20 and 21 July 2020) – Conclusions of 21 July 2020, EUCO 10/20

⁴ The Recovery Fund paves the way for debt-financed spending, which shall complement the regular EU budget for the period 2021-2027. The Commission calls it "recovery effort" or "Next Generation EU (NGEU)".

In a next step, the EU's Own Resources Decision needs to be ratified by all member states in accordance with the respective provisions of national constitutions.⁵

2 Premises and purpose of the report

According to the ruling of the Federal Constitutional Court, federal parliament must remain the body that has the final say on federal revenues and expenditures especially seen against the background of international or European obligations.⁶ Our audit reports on these obligations and inherent federal budget risks are designed to enhance transparency and to strengthen parliament's power over the budget. The purpose of parliamentary budget oversight is to safeguard Germany's autonomy as a constitutional democracy and to represent the popular will expressed in the citizens' democratic right to vote.

Our report is based on the agreement made at the EU summit held on 21 July 2020. In December 2020, this agreement was transposed into various legal documents⁷. We acknowledge that several aspects related to the Recovery Fund, such as the allocation of funds to the member states, have still not been settled. However, the major features seem to be quite clear.

Our report serves to provide information to parliament, the government and the general public about any adverse impacts potentially arising from the Recovery Fund. Based on the decision to put solidarity first in the EU, the report particularly focuses on potential risks posed for the federal budget emerging from joint EU borrowing and makes recommendations that may inform future deliberations and negotiations. Our reporting efforts mainly aim to strengthen the EU as a community of law and solidarity and, in the long run, to safeguard the stability of the Economic and Monetary Union. The report also focuses on potentially adverse trends and misdirected incentives that may jeopardise this goal.

We have given consideration to the comments made by the Federal Ministry of Finance on our draft report.

⁵ In Germany: Bill on the Council Decision of 14 December 2020 on the system of own resources of the European Union and repealing decision 2014/335/EU, Euratom (Law ratifying the Own Resources Decision), Parliamentary records 19/26821 of 19 February 2021.

⁶ See judgment of the Federal Constitutional Court of 7 September 2011 - 2 BvR 987/10, BVerfGE 129, 124 (178) (on aid for Greece euro rescue package, EFSF).

⁷ Council Decision (EU, Euratom) 2020/2053 of 14 December 2020 on the system of own resources of the European Union and repealing decision 2014/335/EU, Euratom and Council Regulation (EU) 2020/2094 establishing a European Union Recovery Instrument to support the recovery in the aftermath of the COVID-19 crisis.

3 Recovery Fund and its terms and conditions

For the first time in its history, the European Union has been empowered to issue bonds to borrow substantial funds on the capital market and pass these on as non-repayable grants to the member states. These bonds will be repaid from the EU budget. As the grant amount usually does not equal the repayment amount for the individual member states, the Recovery Fund actually implements debt-financed transfers.

3.1 Recovery Fund will result in debt-financed transfers

The total volume of the Recovery Fund will be €750 billion. This total will be financed via EU bonds. For the first time in its history, the EU is empowered to incur borrowing in order to increase the EU budget. The EU may also pass on such funds to the member states as non-repayable grants. Rather than as loans, a portion of the money will be disbursed as non-repayable grants to the member states.

In order to shore up EU bonds, the ceiling for own resources⁸ is to be raised by 0.6 per cent of EU gross national income. Such additional headroom⁹ is to serve as a guarantee and stay in place until all EU bonds have been repaid, but no later than 2058. Repayment is scheduled to begin in 2028¹⁰ and be completed in 2058.

The Recovery Fund is to make available to the member states €390 billion of its total funding as grants and €360 billion as loans (cf. figure 1).¹¹ The funds are to be allocated to various EU programmes.

Loans need to be repaid by the respective recipient member states. Up to the total loan amount, these member states are in fact responsible for repaying the EU bonds. In the case of the grants, the EU bonds are repaid from the EU budget. However, at this point of time it has not yet been settled which share is to be borne by the individual member states. This is a topic for the upcoming deliberations on EU finance as from 2028.

⁸ The own resources ceiling determines the maximum amount of own resources the European Union requests from member states to finance EU expenditure. The ceiling is established as percentage of the EU Gross National Income in the Own Resources Decision for the validity of the respective MFF.

⁹ Headroom is the difference between the own resources ceiling and the volume of expenditure which is covered directly by own resources in the EU budget.

¹⁰ In the 2021-2027 period, unspent funds earmarked for interest payments and additional revenue from new EU own resources can be used for repayments under certain conditions before 2028.

¹¹ In general, amounts relating to the Recovery Fund are stated in constant prices of the year 2018 in this report.

Figure 1

More than half of Fund resources to be allocated as grants

The Recovery Fund's total resources amount to €750 billion, of which €390 billion are earmarked for grants and €360 billion for loans.

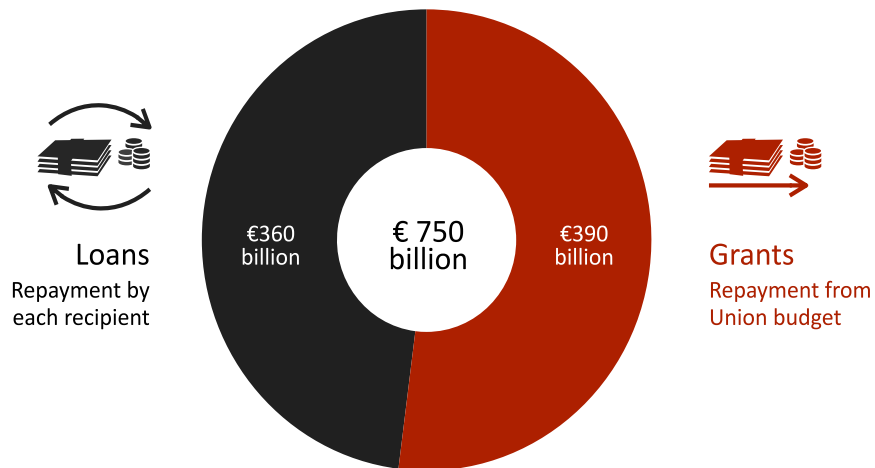


Figure: Bundesrechnungshof.

Source: EU Council, Commission.

The Commission intends to raise additional revenue for the EU budget and to use the receipts to repay the EU bonds. In a first step, the Commission adopted the national plastic contribution (known as “EU Plastic Tax”) effective from 1 January 2021. Plans also provide for a carbon border adjustment mechanism as part of the European Green Deal, a digital levy and ETS revenue.

In its first column, table 1 below shows the projected grants by member state. The second column shows the estimated EU bond repayment obligations. The third column illustrates the net position of each member state: If grants exceed repayment obligations, the member state is a net recipient, otherwise a net contributor. From today's view, Germany's net position is €65.9 billion, which makes Germany the largest net contributor.

The table illustrates the magnitude of debt mutualisation under the Recovery Fund as debt-financed transfers from net contributors to net recipients. Since all member states are to receive grants and to make contributions as a function of their respective EU budget share, the net effect only amounts to €144.9 billion. In other words, while total grants amount to €390 billion, the effective benefits accruing to all net recipients (net benefit) is less than €145 billion.

Table 1

Allocation of grants and repayment obligations (in absolute figures^c)

	Grant ^a	Repayment ^b	Net position	
	€ billions			
Spain	73.8	36.2	37.6	Net recipients
Italy	81.7	49.1	32.6	
Greece	20.3	5.2	15.1	
Poland	28.8	16.0	12.8	
Romania	17.2	6.8	10.4	
Portugal	16.4	6.2	10.2	
Croatia	7.4	1.5	5.9	
Bulgaria	7.5	1.8	5.7	
Slovak Rep.	7.3	2.7	4.6	
Hungary	7.8	4.4	3.4	
Czech Rep.	8.4	6.0	2.4	
Lithuania	3.0	1.5	1.5	
Latvia	2.3	0.9	1.4	
Cyprus	1.2	0.6	0.6	
Estonia	1.3	0.9	0.4	
Slovenia	1.9	1.6	0.3	
Malta	0.3	0.4	-0.1	Net contributors
Luxembourg	0.1	1.4	-1.3	
Finland	2.9	6.7	-3.8	
Austria	3.7	9.6	-5.9	
Ireland	1.6	7.9	-6.3	
Sweden	4.6	11.0	-6.4	
Denmark	1.9	8.4	-6.5	
Belgium	6.4	17.4	-11.0	
Netherlands	7.0	22.0	-15.0	
France	46.7	69.4	-22.7	
Germany	28.4	94.3	-65.9	
Net effect			+/- 144.9	
Total	390.0	390.0	0	

Notes:

- a Own calculation based on the assumption that the allocation scheme for all grants is in line with the scheme applicable to the Recovery and Resilience Facility¹².
- b Calculation based on estimated contributions to the 2021-2027 EU budgets.
- c Any differences due to rounding.

Source: Commission, finance ministry, adapted by German SAI.

¹² The Recovery and Resilience Facility is the centrepiece of the Recovery Fund. With €672.5 billion, nearly 90 per cent of the resources are earmarked for this instrument.

3.2 Comments made by the Federal Ministry of Finance

The finance ministry stated that the Recovery Fund's financial resources were not passed on to the member states by way of transfers. The finance ministry added that it was borrowing to the benefit of EU programmes. Furthermore, the rules governing the allocation of grants and repayment obligations were not yet definite. The finance ministry also stated that the member states' ranking within the group of net recipients or net contributors would be a different one if the respective amounts were correlated to a member state's gross domestic product or number of the population.

3.3 Concluding audit findings

The finance ministry's line of reasoning on transfers is not convincing. The Recovery Fund allocates grants of varying amounts to the member states along with varying repayment obligations which ultimately leads to a mutualisation of the member states debt. Channelling these funds via EU programmes does not make a difference to this transfer nature. The technical term of "transfer" is also common usage in other EU programmes in place to describe the passing on of income without any consideration – which is the definition of transfer as defined in technical literature¹³ and used by the Commission¹⁴.

We acknowledge that the allocation of grants will eventually be determined in 2022, i.e. only once the magnitude of the COVID-19 related drop in economic output becomes clear. In addition, negotiations on repayment obligations will be initiated in a couple of years only. As a matter of fact, the figures shown in table 1 are only projections on the basis of the current status. Nevertheless, we consider these figures to be realistic.

We concur with the finance ministry's view that the member state ranking in the table would change if the respective amounts were considered relative to the member states' gross domestic product or number of the population. But even then, Germany would be one of the largest net contributors. A member state that is a net contributor in absolute terms would continue to be a net contributor in relative terms. The same is true for net recipients.

¹³ See for example Berthold Busch (2018), Cohesion Policy in the European Union- Review and reorientation, IW-Analyse Nr. 121 (Analysis No. 121 of the German Economic Institute).

¹⁴ The cohesion policy of the EU contributing to employment and growth in Europe, Joint paper from the Directorates-General for Regional & Urban Policy and Employment, Social Affairs & Inclusion, July 2013.

4 Stability of the Economic and Monetary Union

We know from experience that instruments launched in times of crisis usually become permanent. However, this often ignores the fact that the costs and risks associated with such instruments may be justified to overcome a severe crisis, but not in normal times. The Recovery Fund might thus be an additional, permanent step towards a stronger fiscal integration in the Union, which would have major impacts on the stability of the Economic and Monetary Union.

4.1 Principles laid down in European Treaties

The economic and finance policy falls within the exclusive remit of the member states (principle of ownership)¹⁵. Rules governing the coordination of their economic policies and the Stability and Growth Pact¹⁶ are to ensure that the member states have robust national public budgets. The two elements set out below have been implemented to mitigate the risk that other member states are adversely impacted by a member state's unsound fiscal policy and to protect the stability of the Economic and Monetary Union:

- Member states' compliance with the reference values for government deficit and debt are designed to ensure sustainable public finances.
- The "no bail-out" clause¹⁷ serves to bar member states from the euro area from assuming debt liabilities of a fellow member state and thus to avert misdirected incentives.

If all member states fully comply with the no bail-out clause, each member state must know that it is responsible for the consequences of its past actions. It is thus in all member states' interest to ensure sound public finances at national level. If, in times of crisis, a member state may count on the assistance of other member states, it may be tempted to significantly expand the scope of debt and to rely on the community instead ("moral hazard"¹⁸).

¹⁵ Competences not conferred upon the Union in the Treaties remain with the Member States (Article 5 of the Treaty on European Union (TEU) in the version of the Treaty of Lisbon), i.e. the Member States are responsible for the consequences of their decisions in areas which fall within their competences.

¹⁶ Resolution of the European Council on the Stability and Growth Pact Amsterdam, 17 June 1997, Official Journal C 236, 02/08/1997.

¹⁷ Article 125 (1) of the Treaty on the Functioning of the European Union (TFEU).

¹⁸ Moral hazard is a situation in which one party gets involved in a risky event knowing that it is protected against the risk and the other party will incur the cost.

4.2 Gradual modification of the fiscal and financial architecture

In the past, EU and euro area crises gave rise to new instruments. One of these is the asset purchase programme launched by the Eurosystem¹⁹ in July 2009 for the first time to support crisis-ridden financial markets. In subsequent years, new asset purchase programmes were initiated, existing ones were ramped up several times and the total volume hit ever new highs – as again in the course of the COVID-19 pandemic. The total assets held by the Eurosystem under the purchase programmes are projected to reach €4.3 trillion by mid-2021.²⁰

In addition, in 2010, the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stabilisation Facility (EFSF) were created as temporary arrangements for safeguarding financial stability. The EFSM provides for the member states to hold liability for any defaults, at least indirectly through their respective share in the EU budget. The EFSF arranges for a direct liability under national guarantees. The aid schemes have also been re-financed through the capital market via bonds.

In 2012, the euro area member states launched the European Stability Mechanism (ESM), a permanent bailout package. In times of crisis, the ESM grants financial support to its members provided such support is vital for the financial stability of the entire euro area. The ESM borrows funds in the capital market via bonds and passes on such funds as stability support to crisis-ridden member states. ESM support is, however, only granted if member states meet strict requirements.

The ESM capital stock amounts to €705 billion. Each member state is held liable for ESM losses of up to its share in the capital stock. The ESM has a €500 billion lending capacity. Up to this total amount, the ESM may grant stability support to its members. The 40 per cent excess coverage²¹ is to ensure a high credit rating and access to funding in the capital market at favourable terms.

The member states of the EU and the euro area have repeatedly issued bonds after the financial crisis that provided for a joint liability of all members. However, the funds borrowed and given to the member states have so far always taken the form of a loan. Financial liability for debt repayment always rested with the recipient.

In the case of the Recovery Fund, most of the funds borrowed in the capital markets are to be passed on as grants. The rationale behind this decision is that sovereign debt levels of some member states are rather high and that further borrowing could push refinancing

¹⁹ The European Central Bank and the national central banks of the member states which have adopted the euro, constitute the Eurosystem.

²⁰ German Institute for Economic Research (DIW): DIW Weekly Report No. 24/2020, p. 452.

²¹ The ESM shows an excess coverage, as the liable equity of the member states (the capital stock) is higher than the maximum stability support in form of loans (lending capacity).

costs incurred by such member states to extreme highs. This could place at risk access to capital markets.

There is no provision for member states issuing repayment guarantees. EU bonds are issued by the Union which means that the Union budget serves as a guarantee. Member states' contributions to the EU budget and new EU own resources are options considered for repaying borrowed funds.

Experience shows that instruments launched in times of crisis are not of a temporary nature but tend to perpetuate over time. In addition, proposed reliance on new EU own resources for repaying EU bonds also suggest that the Recovery Fund may go hand in hand with a more permanent fiscal integration.

4.3 Member states might rely on capital markets for refinancing their government debt

Commission and Council already stated in March 2020 that the member states, in a bid to address the economic fallout of the pandemic, should fully use the flexibility granted by the Stability and Growth Pact and activated the general escape clause (escape clause).²² The escape clause gives free rein to member states to depart from budgetary requirements usually applicable. This gives member states the leeway to take fiscal action needed to respond to the situation as appropriate.

In March 2020, the European Central Bank (ECB) launched the Pandemic Emergency Purchase Programme (PEPP).^{23 24} PEPP has a total volume of €1,850 billion and will formally expire in March 2022. In a bid to preserve the ECB's monetary goals, PEPP is to pave the way for a flexible response to this severe and unprecedented crisis. In addition to other purchase programmes in place, PEPP will significantly enhance the liquidity available in capital markets.

Nevertheless, Commission and Council felt the need to establish the Recovery Fund and make available €750 billion of more grant and loan funding to the member states. The member states are supposed to receive grants totalling 0.5 to 13.6 per cent of their respective 2019 GDP. The overall total grant amount is less than 3 per cent of the EU's GDP.

²² Communication from the Commission to the Council on the activation of the general escape clause of the Stability and Growth Pact COM(2020) 123 final of 20 March 2020. The ECOFIN Council agreed with the assessment of the Commission on 23 March 2020.

²³ Pandemic Emergency Purchase Programme.

²⁴ Decision (EU) 2020/440 of the European Central Bank of 24 March 2020 on a temporary pandemic emergency purchase programme (ECB/2020/17).

4.4 Comments made by the Federal Ministry of Finance

The finance ministry concurred with our audit findings and stressed that the fiscal set of rules was a keystone of the Economic and Monetary Union. The finance ministry considered it vital to avert the risk of contagion of non-sustainable fiscal policy in individual member states.

As to the bailout packages, the finance ministry stated that the liability mechanisms had been enhanced with transitioning from the EFSF to the ESM. The finance ministry added that in contrast to the EFSF, potential losses suffered by the ESM did no longer result in a capital lender's direct claim against the member states. Another benefit was that the maximum liability risk to be shouldered by a member state was strictly limited to its respective ESM share.

The finance ministry also pointed out that the conclusions of the EU summit held in July 2020 had called the Recovery Fund "an exceptional response to those temporary but extreme circumstances". The relevant legal documents expressly stated that the Fund had a temporary character and that the funds were to be made available only to respond to the crisis. On top of that, the basis of authorisation also suggested that the Recovery Fund was a crisis management instrument for responding to exceptional circumstances.

According to the finance ministry, these requirements and rules could only be changed by amending the Own Resources Decision. This step was subject to a unanimous vote of the Council and the consent of the member states within the limits set by their respective national constitutions.

4.5 Concluding audit findings

We are aware of the fact that the EFSF and the ESM provide for different liability mechanisms. However, this is not the point. Rather the point is that temporary instruments and mechanisms adopted in times of crisis may perpetuate over time to become a permanent feature of the European fiscal architecture, which has repeatedly been the case in the past. If such crisis response mechanisms become permanent, this may lead to costs and risks that are acceptable in times of crisis, but unwarranted in the long run, such as transfers, mutualisation of liability risks or misdirected incentives. This aspect is often neglected.

The finance ministry rightly referred to an argument often cited which was the exceptional nature of the Recovery Fund. We also concur with the ministry's view that the trend initiated with the Recovery Fund was subject to the approval of the member states. By raising this argument, however, the finance ministry confirms the existence of the risk we highlighted. In fact, member states eventually always agreed to turn such temporary instruments into permanent instruments in the past.

The escape clause allows member states to cover their domestic funding needs for COVID-19 related programmes they deem necessary by means of new borrowing. As a matter of fact, at this point of time, member states seem not to lose access to capital markets, which may also be due to PEPP. As to the member states' ownership liability, this would have been the more preferable path to take.

In addition, the grant totals given to each individual member state are rather low against GDP. This fact becomes even more obvious by looking at the net figures. Actually, net benefit from the grants allocated to all member states totals less than €145 billion. As the funds are to flow over a period of up to six years, the annual amount available is significantly lower.

If transfers were the preferred option, it would have been more expedient and surely more transparent – particularly due to the risks coming along with joint EU borrowing – to give grants to the member states directly via the EU budget. This would have dispensed from the need to rely on EU bonds.

5 Mitigation of liability risks

If a member state is unable or unwilling to meet its payment obligation under the Recovery Fund, all other member states are held liable without requiring a renewed consent on their part. Such a liability mechanism sets wrong incentives and weakens the Economic and Monetary Union as it encourages unsafe and unsound management practices to the detriment of the Union.

5.1 Member states are jointly held liable for repaying EU bonds

No amendment of primary law has been provided for establishing the Recovery Fund. This presupposes that the EU's authorisation to establish the Fund and to incur debts for its funding can be derived from applicable primary law. The Commission and the finance ministry consider Articles 310(1) and 311 of the Treaty on the Functioning of the European Union (TFEU) taken together with Article 122 TFEU as a basis for authorisation.

In accordance with Article 310(1) TFEU, all revenue and expenditure shown in the annual budget shall be in balance. Article 311 TFEU stipulates that, without prejudice to other revenue, the EU budget shall be fully financed from own resources. According to the interpretation of the Council Legal Service, borrowing funds for the Recovery Fund does not affect the balance between revenue and expenditure since the funds are allocated to different Union

programmes as external assigned revenue. Such revenue is not made available “within the framework of the budget”.²⁵

According to this legal opinion, borrowing is budgetarily neutral also in the long term as during the entire repayment term the Union is able to ensure debt service in full from its own resources. The Council Legal Service argues that, as a result, debt is fully counter-balanced by the asset consisting of the commitments of the Member States. The member states have the duty to repay such debt by 2058 via their EU budget contributions. Ratifying the Own Resources Decision, means giving an “irrevocable, definitive and enforceable guarantee of payment”.²⁶

The burden for the member states resulting from this cannot yet be specified in detail. This issue will be discussed at the negotiations on the Multiannual Financial Framework starting in 2028. Repayment will not start before 2028.²⁷

5.2 Audit findings and recommendations

Issuing joint bonds for the Recovery Fund will entail a fundamental change in the European budgetary and financial architecture. The reason is that so far, primary law has been understood, also by the Commission²⁸, that to achieve a balanced budget in accordance with Article 310(1) TFEU, the Union must not incur debt at Union level or increase its budget in this manner.

To us, this realignment is an overinterpretation of applicable primary law. We do not want to study the question as to whether this overinterpretation is inadmissible. The way of how this bond instrument has been established factually rescinds applicable basic rules. Given the scope of this reorientation, a definite and intentional expansion of primary law based on the expressed will and approval of all member states would have been a more transparent and legally sound way of introducing a new instrument.

For the Recovery Fund does not only indirectly enable transfers between individual member states (cf. table 1), but also establishes a general liability mechanism which obliges the member states to take on debt liabilities for others without the need to give their consent when the case actually arises. The member states are held liable for debt of the Recovery Fund

²⁵ Council of the European Union, Opinion of the legal service of 24 June 2020, Proposals on Next Generation EU, 9062/20, No. 30 et seq., <https://data.consilium.europa.eu/doc/document/ST-9062-2020-INIT/en/pdf>.

²⁶ Council of the European Union, Opinion of the legal service of 24 June 2020, Proposals on Next Generation EU, 9062/20, No. 38 et seq.

²⁷ Unspent amounts planned for interest payments for the period 2021-2027 and additional revenue from new EU own resources can be used for repayments under certain conditions before 2028.

²⁸ “(...) as regards the obligation to balance the EU budget, the consistent interpretation over time of Article 310 AEUV is that the EU budget cannot be balanced by issuing public debt”, quoted from Council of the European Union, Opinion of the legal service of 24 June 2020, Proposals on Next Generation EU, 9062/20, No. 21.

through their future EU budget contributions, i.e. not only for the grants but also for the loans passed on under the Fund. In addition, the liability mechanism will remain effective until all EU bonds issued under the Fund have been repaid, which is by 2058.

If a member state is no longer able or willing to repay its debt, the other member states are liable for repaying this member state's share. Theoretically, they may be held liable for the Fund's entire debt. Factually, this is a mutualisation of debt.

In accordance with Article 125 TFEU as a rule, such a liability mechanism – i.e. the duty to take on the obligations of other member states – is to be avoided. For it could tempt the member states to neglect budgetary discipline pursue and thus provide wrong incentives. This may result in a potentially less robust Economic and Monetary Union that is less resilient in times of crisis.

In the upcoming negotiations at Union level, the federal government should urge for

- providing for a binding redemption plan of EU bonds from the Recovery Fund which also comprises rules on the use of the new Union own resources, and
- rules governing the consequences of a payment delay or default of individual member states, e.g. by stopping payments from the Union budget to these member states and using these to repay the member state's portion in EU bonds.

5.3 Comments made by the Federal Ministry of Finance

The finance ministry stated that the scope of loans or grants given by the Recovery Fund was not yet settled nor was the need to issue bonds in the capital market for this purpose. The finance ministry added that it was therefore impossible to prepare a final redemption plan. Pursuant to the Own Resources Decision, the Commission was obliged to develop a plan for the issuance of EU bonds, including repayment and payment of interest. This plan was to be communicated to the European Parliament and the Council and to be regularly updated.

In the finance ministry's view, setting up the Recovery Fund did not overstretch provisions of primary law. Nor would the member states be directly held liable for pending repayment obligations of other member states. In case of non-compliance with repayment obligations, the Commission would first have to explore liquidity options within the Union budget. In a next step, the Commission could reschedule maturing EU bonds at short notice. Only if these initial steps did not solve the liquidity problems, the Commission could demand the other member states to cover the pending balances in line with their respective portion in the EU budget. The finance ministry concluded that the financial obligations of the non-paying member state would remain unchanged.

5.4 Concluding audit findings

We acknowledge that the amount of loan funding cannot reliably be projected since actual funding requirements and cash flows are subject to the loan conditions agreed with the respective member state. This is, however, not the case for the grants. In this case, it can reasonably be expected that the total of some €390 billion will be used in full. In addition, rules stipulate that the EU bonds need to be repaid between 2028 and 2058.

Therefore, we reiterate our recommendation to act promptly and incorporate the repayment rules of EU bonds in a mandatory repayment plan. Such rules need to specify beforehand how the grant burdens are allocated among the various member states and spread over the individual years. Otherwise, this matter could overshadow the negotiations on future EU budgets, which poses the risk of shifting the financial burdens to some time in the future or even blocking other major EU projects. The repayment plan to be submitted by the Commission does not meet these requirements. For it is not mandatory and primarily serves to provide information to the European Parliament and the Council. The repayment plan provides no safeguard to the above risks.

We do not concur with the finance ministry's comments on liability ranking (cf. figure 2). In the case of a member state's default, the Commission ultimately relies on the other member states' financial resources. If, for example, a member state exits the Union, it does no longer meet its payment obligations nor contribute to the EU budget. Identifying liquidity options within the Union budget eventually means that the Commission relies on funds contributed by the member states. Solely issuing EU bonds with short maturities means to restructure debt which provides the Commission more time. Again, the remaining member states would be held liable for debt and interest payments.

Figure 2

Liability mechanism of the Recovery Fund leads to a mutualisation of debt

If a member state fails to meet its payment obligations from the Recovery Fund, the Commission directly or indirectly taps the financial resources of the other member states in accordance with a given liability procedure.

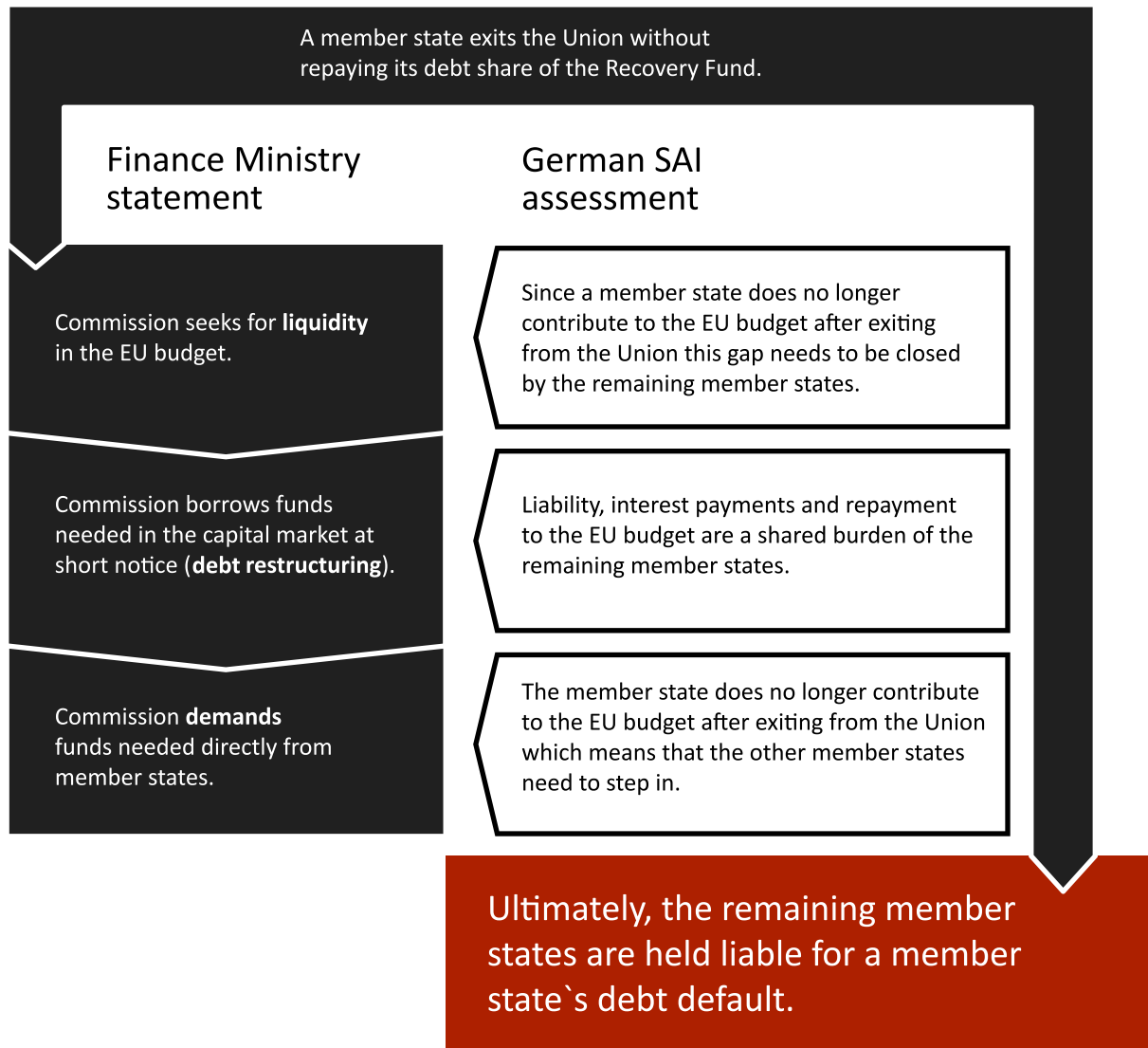


Figure: German SAI.

Source: Commission, finance ministry.

To put it in a nutshell: If a member state is unable to meet its financial obligations, the other member states are held liable pro rata, without the need to reaffirm their consent at that point in time.

6 Apply fiscal rules to the Recovery Fund

The fiscal rules do neither apply to the EU budget nor to the EU bonds of the Recovery Fund. The Fund thus gives free rein to the member states to borrow funds at Union level – theoretically without limitation – and to receive such funds as grants. The overstated guarantee volume of at least €4,000 billion could spark speculation about sharply rising debt and desire for even more support.

6.1 No fiscal rules for EU bonds

The EU member states adopted mandatory fiscal rules to reduce government deficit and debt. Article 126 TFEU is the primary legal authority governing this matter. Pursuant to this Article, the Commission and the Council monitor member states' compliance with fiscal discipline against two reference values known as Maastricht criteria:

- Government debt (debt-to-GDP ratio) shall not exceed 60 per cent of GDP.
- Government deficit (deficit ratio) shall not exceed 3 per cent of GDP.

The Stability and Growth Pact requires the member states to make every effort to meet the mid-term objective of a close to net zero budget or surplus budget.

As a rule, the constitutional debt rule stipulates that federal and state governments must not incur any borrowing to finance their annual budgets. They are not allowed, with some exceptions²⁹, to take on debt in order to balance revenue and expenditure.

No set of rules comparable to the fiscal rules governing compliance with budgetary discipline is in place either for the EU budget nor the Recovery Fund. Currently, there are no plans for requiring member states to credit debt incurred by the Fund against the national debt levels of the member states and to thus take them into account in the fiscal rules. According to the finance ministry, such debt may not be allocated to the federal government level and therefore cannot be reflected in the national debt rule.

The EU recognises funds borrowed through EU bonds to finance the Recovery Fund as budget-neutral since relevant debt is matched by an asset: According to the Council Legal Service, the member states provide a payment guarantee by increasing the own resources

²⁹ In cases of natural catastrophes or unusual emergency situations beyond governmental control and substantially harmful to the state's financial capacity, these credit limits may be exceeded (Article 115 para. 2 sentence 6 of the Basic Law (German Constitution) In view of the COVID-19 pandemic, the German parliament made use of this exemption.

ceilings. As a result, the EU has an irrevocable, definitive and enforceable guarantee of payment given upfront by the member states.³⁰

The German central bank (Deutsche Bundesbank) also commented on this issue. In view of Union level debt, the central bank made the point that, ultimately, the member states would have to cater for the liabilities. The bank added that such debt should be taken into account for analytical purposes. Depending on the issue analysed, it would also make sense to allocate debt proportionally to the individual member states. The central bank suggests a country's share of financing in the EU budget as a distribution key. This share was likely to remain broadly the same as a country's share of EU gross national income (GNI). According to this, around one-quarter of European debt would be allocated to Germany.³¹

In order to mutualise the Recovery Fund's debt, the own resources ceilings are to be raised by 0.6 per cent of EU-GNI. In a conservative scenario³², the Union's guarantee volume would thus hit €4,000 billion by 2058.³³ Given the total volume of the Recovery Fund, this would mean an excess coverage of 430 per cent. As only the grants that amount to €390 billion are supposed to be repaid from the EU budget, excess coverage makes up 930 per cent. In other words: To be able to repay €390 billion in the 2028-2058 period, the Union has access – in a conservative scenario – to repayment guarantees equivalent to ten times the volume of repayment.

³⁰ Council of the European Union, Opinion of the legal service of 24 June 2020, Proposals on Next Generation EU, No. 43.

³¹ Bundesbank, "The informative value of national fiscal indicators in respect of debt at the European level"; in: Monthly Report December 2020, p. 39 et seq.

³² This scenario is based on a real zero growth for the member states. The growth rate of the GDP would then correspond to the 2 per cent target of the inflation rate set by the ECB. This is economically unrealistic.

³³ Committee on the Affairs of the European Union – Parliamentary records 19(21)112 of 26 October 2020 (Public hearing, statement of Prof. Dr. Heinemann), p. 10 et seq.

Figure 3

Excess coverage through member states' guarantees

The guarantee volume covers an amount equivalent to ten times the EU bonds for grants and more than five times all EU bonds. The actual guarantee volume is not necessary and could give rise to desire for even more support.

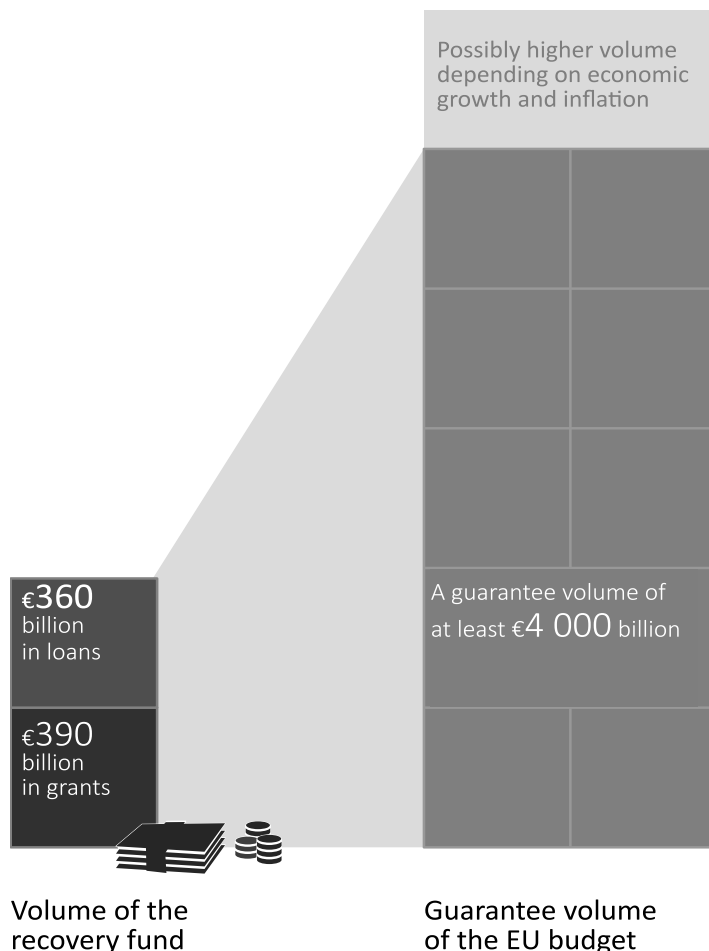


Figure: German SAI.

Source: Commission, finance ministry.

6.2 Audit findings and recommendations

We consider it a matter of concern that in implementing the Recovery Fund the EU and its member states opened the way for borrowing outside the budgetary discipline rules. It is true that so far, the Commission's powers to borrow funds have been limited. If, however, the Commission and the finance ministry are right in their assessment that applicable primary law may cover such borrowing, in the future, it can never be ruled out that the member states may wish to meet possible funding needs at Union level by issuing EU bonds. In theory, they could then incur unlimited borrowing, provided that national parliaments give their consent and investors stand to buy EU bonds and thus practically undermine the fiscal rules.

As to compliance with the fiscal rules, it would therefore be appropriate to add the respective member states' repayment obligations from the Recovery Fund's borrowings to their respective national debt levels. This view is shared by the Council Legal Service which argues that the member states give irrevocable, definitive and enforceable guarantees to repay debt through their EU budget contributions. This would also mean that the fiscal rules would apply automatically and have a disciplinary effect. Otherwise, this formula would result in undermining the fiscal rules.

In addition, we consider the amount of the planned guarantee volume a matter of concern. While in the case of the ESM a high creditworthiness was ensured by having an excess coverage of 40 per cent, the excess coverage envisaged for the Recovery Fund is many times higher. This lends credence to the idea that the way for expanding Union debt has already been paved and sets the wrong incentives. Furthermore, excess coverage could also foster postponement of the repayment deadline.

Against this backdrop, the federal government should ensure in upcoming negotiations at Union level that

- the Recovery Fund serves as a one-time, extraordinary response mechanism to the crisis and that an expansion of debt or the use of similar instruments are precluded by contract;
- as to the fiscal rules, the various member states' repayment obligations from the Recovery Fund's debts are added to national debt levels; and
- the increasing size of the own resources ceiling and also of the guarantee volume are capped significantly.

6.3 Comments made by the Federal Ministry of Finance

The finance ministry stated that the exceptional nature of the Recovery Fund was clearly and sufficiently highlighted in applicable legal provisions. The finance ministry did not concur with our view and stated that increasing the ceiling for the own resources was not an excess coverage but prudent planning. The increase was supposed to ensure that the EU would be able to meet payment obligations vis-à-vis third parties at any time and under all circumstances.

The finance ministry referred to the Commission's comments. According to the Commission, the increased own resources ceiling covers expected maximum repayment amounts for all EU bonds (i.e. also for funds that are passed on as loans), for potential defaults regarding the loans passed on to member states and for risks arising from trends in economic growth and interest rates.

The finance ministry added that the Commission's calculations were based on the hypothesis that each year liabilities amounting to the maximum repayment amount needed to be covered and that both the economy and the interest rates showed a negative trend. The finance ministry considered this to be "an extraordinary worst-case scenario" that the Union wished to cater for. Given these assumptions, the Commission presumed that it needed to repay €62.5 billion each year. Furthermore, the Commission planned to have another €20 billion each year as a risk buffer. The finance ministry concluded that as a result the Commission believed the annual repayment to amount to €82.5 billion.

In addition, the finance ministry stated that comparing the collateral for the ESM with those of the Recovery Fund was a misleading exercise. For in the case of the ESM, the entire liability amount was available at any given time, whereas the increased own resources ceiling constituted an annual maximum amount to be called up by the member states. This was another reason why the Commission had to make more cautious provisions.

The finance ministry fully rejected any speculation on a possible future expansion of debt at Union level. For the Own Resources Decision expressly stipulated that the increased own resources ceiling might only be relied on to cover debt from the Recovery Fund. An amendment of the Own Resources Decision was subject to a unanimous vote of the Council and the ratification by the member states.

As to crediting any debt level of the Fund against the debt levels of the member states, the finance ministry stated that the European statistical agency (Eurostat) also categorised the EU bonds as Union debt and not as member state debt. In doing so, the finance ministry made the point for Eurostat's independent status.

6.4 Concluding audit findings

We take note of the financial ministry's comments, particularly on the calculations made by the Commission. We hold the view that such calculations are based on false assumptions. The question as to whether the EU is able to meet its payment obligations from EU bonds at any given time does not boil down to the question as to how much money it is allowed to repay in one year³⁴, but how much money it probably must repay.

This means that the key issue is the maturity date of EU bonds. The Commission may play a significant part in determining this date – also due to its high creditworthiness. For the Commission is free to determine the volume, maturity and date of issuance of EU bonds in its portfolio strategy. In addition, it is the Commission that decides when to restructure or repay EU bonds. These decisions are the basis for determining the annual repayment amounts that may in the individual case be much lower than the permissible maximum amount laid

³⁴ According to the conclusions of the EU summit of July 2020, repayments shall **not exceed** 7.5 per cent of the maximum amount of €390 billion (**grants**) in one year. There is **no** limit or provision in the conclusions for the repayment of the **loans**.

down in the conclusions adopted by the EU summit in July 2020. For this reason, raising the own resources ceiling to reflect permissible annual maximum repayments leads to a structurally overstated guarantee volume.

Furthermore, a calculation that assumes that each year all potential risks may materialise is not prudent but unreasonable, all the more so since the risks adversely correlate. For example, in an economic downturn, interest rates would rather go down, not up.

The Commission's calculations can thus not serve as a justification for raising the own resources ceiling in the scope proposed. The following may illustrate this:

The Commission wishes to draw on an extra annual amount of own resources of €82.5 billion³⁵ over a period of 30 years in order to repay the EU bonds issued by the Recovery Fund. This annual amount would be high enough to repay the EU bonds for all grants within less than 5 years. Even if, on top of that, all loans – contrary to agreements – were repaid through the EU budget, repayment would be possible within less than 10 years. Therefore, it remains open as to why the Commission wishes to have and will be granted such a high guarantee volume.

We do not concur with the finance ministry's view about the apparent differences between the ESM and Recovery Fund making it impossible to compare them. For in both cases, excess coverage is designed as an obvious signal to the financial markets that debt repayment is ensured since the member states may jointly be held liable for even higher debt levels. In essence, the aim is to ensure a high creditworthiness for the two instruments and to have favourable refinancing conditions – i.e. low interest expenses. Therefore, a comparison even suggests itself.

Nor do we concur with the finance ministry's comments on the allocation of the Fund's debt. This matter falls neither exclusively nor primarily in the domain of financial statistics. In essence, those who are allocated such debt will ultimately have to shoulder the burden of repayment. The German Central Bank also believes that the member states will have to step in.

We also have concerns about the fact that in this way, member states may be tempted to circumvent the fiscal rules and thus principles that are fundamental to the stability of the Economic and Monetary Union. For this would be linked to misdirected incentives which, in the long term, could have a significant adverse impact for the entire Union.

To put it in a nutshell: The repayment obligations resulting from the Recovery Fund's debt should be added to the respective member state's debt level. For these member states are in charge of covering debt service from their national public budget and step in through

³⁵ The actual amount may be much higher, as we have to assume that in a period of more than 30 years at least the nominal GDP will grow due to inflation. That means that even in case of a real zero growth – an overly pessimistic projection – the guarantee volume would increase considerably in this period.

future contributions to the EU budget. This would ensure at the same time that the fiscal rules are effective. In addition, the overstated own resources ceiling should be significantly reduced. A guarantee volume of this level is not required. An amendment of the Own Resources Decision would free up these guarantee funds for other good causes possibly linked to new instruments. Precautionary reduction measures seem appropriate, particularly in order not to give rise to self-service strategies.

7 Urge for compliance and own efforts

Pursuant to the subsidiarity principle, the member states need to rely on own resources first and for example share burdens with more domestic stakeholders, before claiming financial assistance from the EU. As a rule, the member states also have to ensure that sufficient resources are available to take economic policy action in times of crisis and to stabilise the national economy. The key purpose of the fiscal rules is to ensure this ownership. So far, however, member states have frequently failed to comply with the fiscal rules, often for several years.

7.1 Sustainability of public budgets was at risk already before the pandemic

The conclusions adopted by the EU summit of 21 July 2020 stipulate that the member states develop recovery and resilience plans (reform plans) in which they specify their reform and investment agenda. The Commission shall assess the member states' reform plans and submit these plans to the Council for approval. On this basis, the grants and loans of the Recovery Fund shall be paid out. The member states are not supposed to exhaust all national resources to rebuild financial headroom, for example by selling assets³⁶ or raising taxes and fees.

A heavy argument for the proposed implementation of the Recovery Fund is that some member states urgently need financial assistance due to high public debt and the unprecedented crisis. Accordingly, the group of major net recipients is composed of high-debt countries. Such countries have a debt-to-GDP ratio considerably above 60 per cent of GDP stipulated by the fiscal rules (cf. figure 4). Often, these countries have failed to comply with the fiscal rules for a number of years.³⁷

³⁶ Particularly such assets that are not absolutely necessary for the performing public core functions, such as gold reserves.

³⁷ Bundesbank, "Design and implementation of the European fiscal rules"; in: Monthly Report June 2017, p. 29 et seq.

We repeatedly stated that the member states have failed to comply with the fiscal rules many times since the introduction of the euro in 1999. We highlighted

- non-compliance with debt-to-GDP ratio requirements in more than half of the cases (59 per cent), and
- a budget deficit ratio in 109 cases (40 per cent) including 13 cases of non-compliance in three or more consecutive years.³⁸

Still, the Council has not imposed sanctions in any of the cases.

³⁸ German SAI, Special purpose report pursuant to Article 99 Federal Budget Code on the intended implementation of harmonised European Public Sector Accounting Standards (EPSAS) in the Member States of the European Union, Parliamentary records 19/60 of 15 November 2017, p. 14 et seq. and Special purpose report pursuant to Article 99 Federal Budget Code on the risks for the federal budget posed by the establishment of a European Monetary Fund (EMF), Parliamentary records 19/5330 of 2 November 2018, p. 10 et seq.

Figure 4

Some member states had high public debt already by year-end 2019

Pursuant to the fiscal rules, national debt shall not exceed 60 per cent of GDP. 11 of the 27 EU member states³⁹ failed to meet this requirement even pre-pandemic.

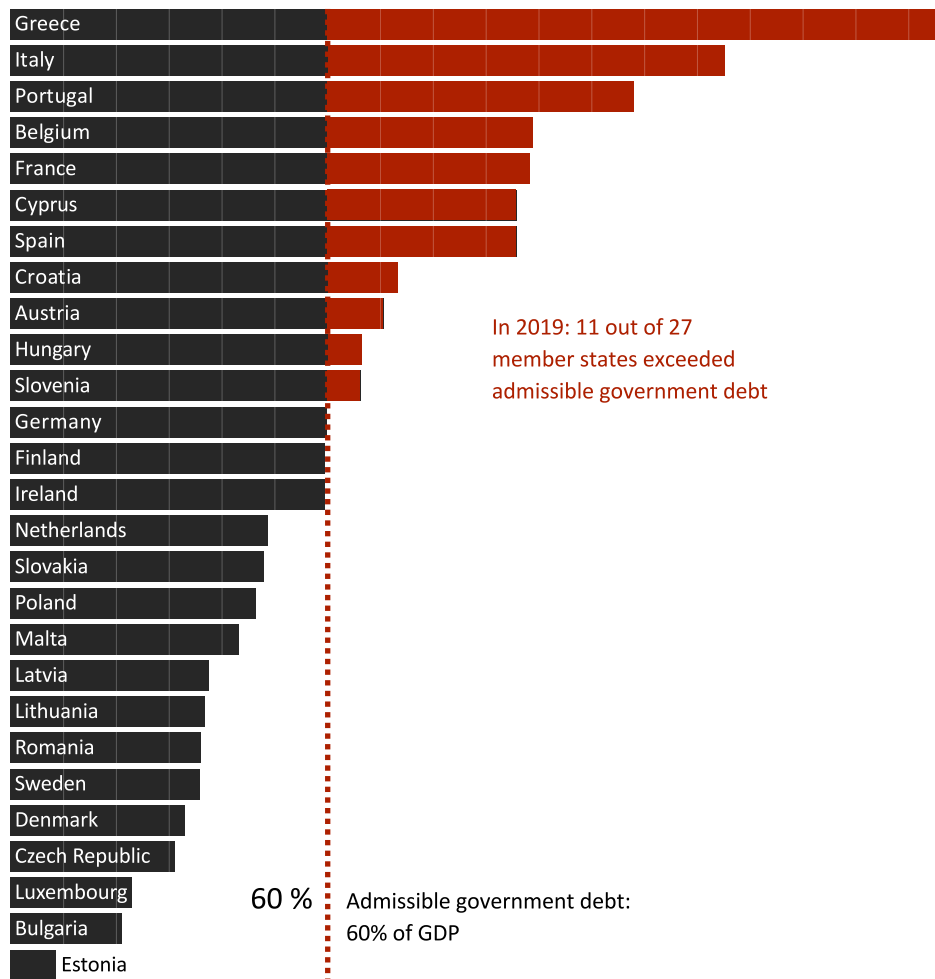


Chart: Bundesrechnungshof.

Source: Destatis, national accounts, debt-to-GDP ratio of member states, gross debt (consolidated) in per cent of GDP.

The debt-to-GDP ratio taken alone does not provide reliable information on domestic economic performance or even living conditions in a member state. Various other factors play a role in this field such as economic productivity or the financial situation of businesses and private households.

³⁹ The United Kingdom left the European Union on 31 January 2020. As a result, the United Kingdom is not represented in this figure.

Figure 5

Economic performance may vary significantly by region

In 2018, per-capita GDP adjusted for purchasing power⁴⁰ varied significantly among regions within member states⁴¹ – also in Germany.

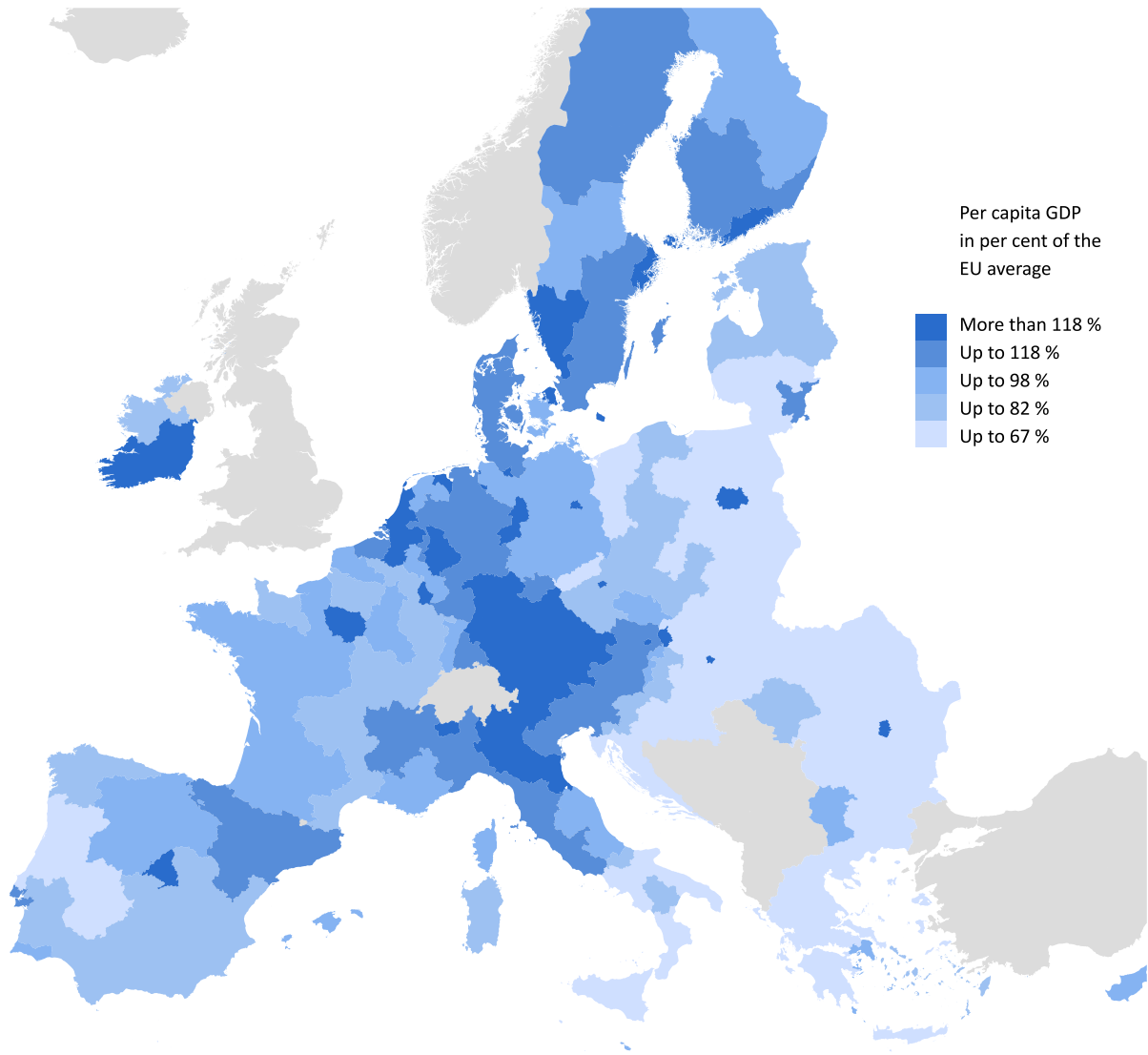


Chart: Bundesrechnungshof.

Source: Eurostat, regional accounts, gross domestic product in purchasing power standards per capita in per cent of EU average.

⁴⁰ For meaningful comparisons between regions and member states, per-capita GDP is expressed in purchasing power standards. This evens out price differences among the member states. An index of 100 is assigned to the average GDP per capita of the Union. Is the index of a region/member state higher than 100, the GDP per capita of this region/member state is higher than Union average (and vice versa).

⁴¹ The United Kingdom left the European Union on 31 January 2020. As a consequence, the United Kingdom is not represented in this figure.

As to the economic performance, per-capita GDP adjusted for purchasing power vary widely among regions even within member states (cf. figure 5). The median assets held by households in the various member states also vary widely (cf. figure 6). For example, in 2017, German private households owned €70,800 in median net assets, which was low compared to other member states of the euro area.

Figure 6

The median assets of private households vary widely

In 2017, German private households owned €70,800 in median net assets, which is low compared to other member states of the euro area.

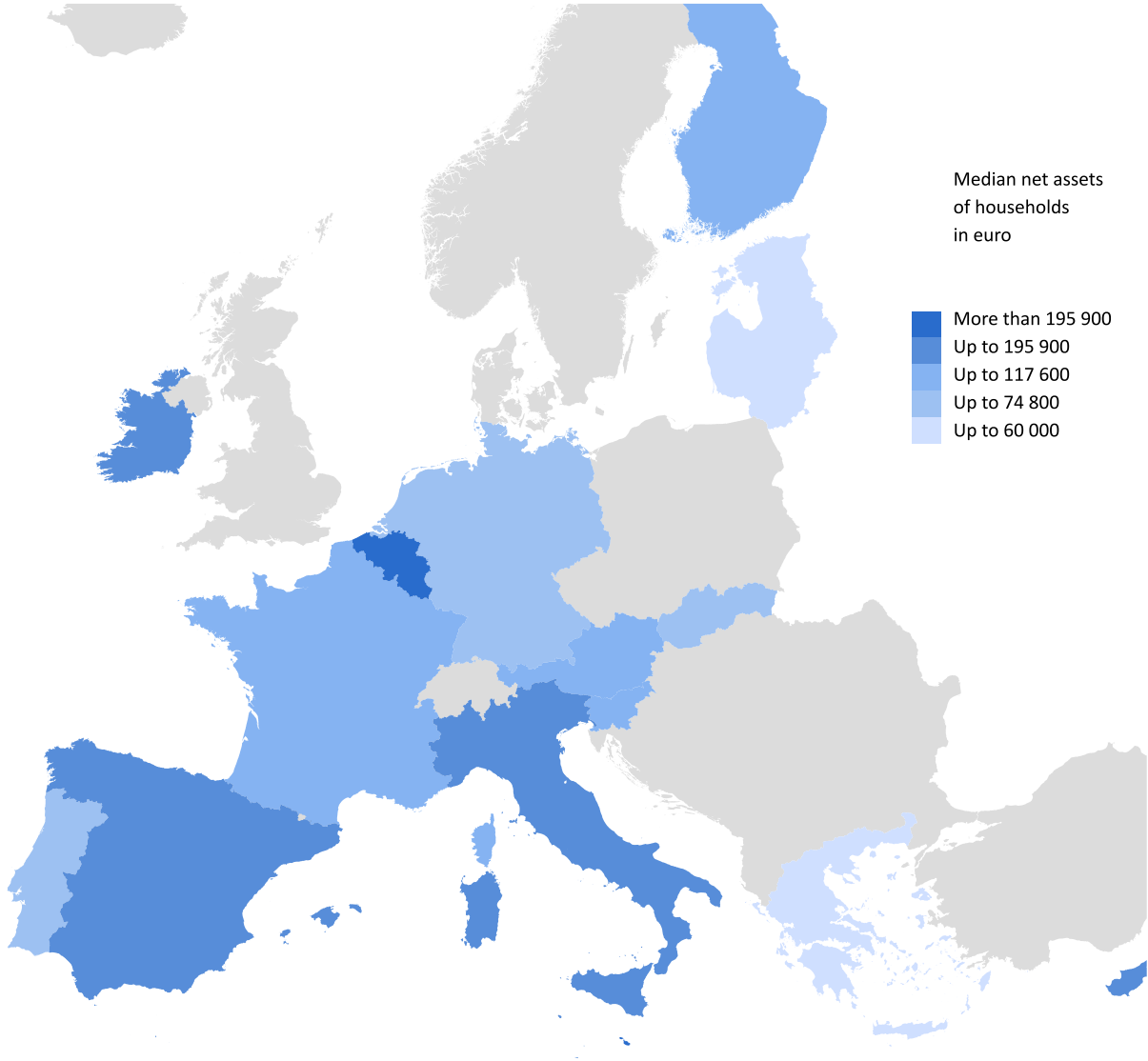


Figure: Bundesrechnungshof.

Source: ECB, Household Finance and Consumption Survey, median net assets of private households.

7.2 Audit findings and recommendations

The Recovery Fund has been designed as the European answer reflecting the spirit of solidarity among the member states. Solidarity, however, is premised on compliance with common rules, shouldering the burden arising from one's own failures and using all ways and means to address one's own shortcomings. Against this background, the Recovery Fund and its terms and conditions has to be seen in a critical light.

Pursuant to applicable law, the economic and finance policy falls within the exclusive remit of the member states of the European Union. If debt sustainability and competitiveness in a member state are under pressure, this is a foremost domestic responsibility of the individual member state. As a rule, each member state must build up adequate financial reserves to be able to adopt economic policy programmes and pursue a national stabilisation policy in a crisis. Ensuring this ownership function was the key purpose of all mandatory fiscal rules adopted jointly by the Union and its member states.

If a member state fails to comply with the fiscal rules for years, this state silently accepts an erosion of the basis for European corporate identity and solidarity and the willingness to stand in for each other in times of crisis. Such a behaviour signals a lack in solidarity in a rules-based community such as the European Union. If in an acute crisis, grants and loans are given without imposing reform requirements at the same time, this may lead, in the long run, to policies driven largely by domestic interests and thus put at risk the stability of the Economic and Monetary Union.

All member states have been affected by the pandemic and have to raise considerable funds to cushion burdens at national level and ease the drop in economic performance. A helicopter view of data available suggests that also in member states with a high government debt ratio, private households can be affluent and economic performance can be high in some regions. For reasons of subsidiarity, these national potentials have to be exploited before relying on help provided by the community of member states.

In the further negotiations at Union level, the federal government should urge for

- member states providing all ways and means they can reasonably be expected to cushion burdens at domestic level and ease the drop in economic performance,
- the Commission and the member states returning to their stability consensus as soon as the pandemic belongs to the past,
- strengthening the fiscal rules, in their function as a key element for the stability of the Economic and Monetary Union.

7.3 Comments made by the Federal Ministry of Finance

The finance ministry stated that the German SAI was right in stressing the principle of ownership of the member states. The finance ministry added that the Recovery Fund was an instrument of active European solidarity. The aim was to mitigate the impacts of the pandemic at an early stage to avert lasting structural damage, particularly in hard-hit economies. All member states would also undertake considerable efforts on their own to cope with the pandemic and fund their programmes largely from their own pockets. The Recovery Fund would support and complement such programmes.

The finance ministry also pointed out that responsibility for fiscal policy laid within the remit of the member states. The member states had the duty to decide on the taxation structure in their respective state.

7.4 Concluding audit findings

We concur with the finance ministry's acknowledgement of the ownership principle and the member states' need to make efforts of their own to overcome the pandemic. However, we wish to make the point that the member states need to exhaust all ways and means available before they can rely on solidarity and support of the Union.

The prerequisite for building strong member states and a strong Europe is to use the potentials offered by the national economies of the Union in line with the legal framework of the Union in order to ensure resilient and high-performing national public budgets and the functioning and resilience of government structures. Although the Union may encourage these efforts, it has no legal ways and means to actually replace them.

8 Ensure efficient and effective use of funds

Union programmes shall be used to allocate the money of the Recovery Fund to the member states. At this point of time, the success of such an approach has not yet convincingly been demonstrated. We have doubts that the funds are used effectively and that the long-term targets set for the Fund can be achieved.

8.1 Monitoring of measures in the European Semester

The loans and grants of the Recovery Fund shall be allocated via EU programmes under the Multi-Annual Financial Framework. The idea is to achieve higher economic growth, to strengthen economic and social resilience and to create jobs. In addition, the capital expenditure is designed to furnish a contribution to the green and digital transformation. More than €322 billion alone are planned for investments in employment and growth in order to

strengthen the cohesion policy⁴² of the Union. To this end, the member states have to develop reform plans.

By the end of the year 2023, the legal commitments for Union programmes expanded under the Recovery Fund need to be finalised. The funds may be disbursed until the end of the year 2026. It is possible to use grants only. The member states do not have the duty to co-fund projects from their own resources nor by loans issued by the Recovery Fund.

The requirements governing the use of funds are subject to the provisions of the respective Union programme. To ensure compliance with the requirements set, the member states must report quarterly on the progress made in implementing their reforms in the European Semester⁴³.

Recently, the European Court of Auditors stated in a Special Report⁴⁴ that the member states fully or substantially implemented merely each fourth country-specific recommendation (26 per cent) of the European Semester in the years 2011-2018. In less than half of the cases (44 per cent), at least some progress has been made. There was limited progress or no progress on implementing the remaining 30 per cent of country-specific recommendations. Overall, member states have not or not fully implemented three quarters of the country-specific recommendations.

This is in line with various analyses indicating that a varied result has been achieved in terms of the effectiveness of the cohesion policy⁴⁵ and the success of the EU funding policy monitored by the European Semester. Some findings suggest that financial assistance of the Union has a beneficial effect especially in those member states that have in place adequate institutional structures.⁴⁶

⁴² The cohesion policy of the European Union aims to reduce economic, social and territorial disparities in the level of development between regions in strengthening growth and employment in rural regions. Approx. a third of EU budget funds is allocated to financial instruments which support cohesion policy.

⁴³ In the course of the annual cycle of the European Semester, the Commission and the Council coordinate economic and budgetary policy within the Union in order to improve economic and social sustainability.

⁴⁴ European Court of Auditors, Special Report 16/2020, The European Semester – Country Specific Recommendations address important issues but need better implementation.

⁴⁵ Darvas and Leandro (2015), <https://www.econstor.eu/handle/10419/126693>, Bruegel Policy Contribution, Issue 19. Darvas, Collin, Mazza and Midoes (2019), Effectiveness of cohesion policy: Learning from the project characteristics that produce the best results, European parliament research report, forthcoming.

⁴⁶ Becker, Egger and von Ehrlich (2013). Absorptive Capacity and the Growth and Investment Effects of Regional Transfers: A Regression Discontinuity Design with Heterogeneous Treatment Effects, American Economic Journal: Economic Policy, 5(4), pp. 29-77.

8.2 Audit findings and recommendations

The key problem is not lacking liquidity in times of crises but lacking soundness of public budgets in some member states (cf. 7.2). This problem will not be attended to by the Recovery Fund. On the contrary, the Recovery Fund opens up a way to net recipients to make each state of the community share some portion of national cost burden arising from the COVID-19 pandemic. In addition, some member states may take the Fund as a precedence to pave the way for borrowing to strengthen future Union budgets as needed (cf. 6.2). This would give rise to disincentive effects and thus puts at risk the stability of the Economic and Monetary Union in the long run. The efficiency and effectiveness of funding through Union programmes has not yet been substantiated with convincing evidence.

On top of that, differing from the ESM, financial assistance of the Recovery Fund is granted without member states meeting strict requirements for reform (cf. 4.2) nor co-funding of the funded projects from own resources. As a result, member states can draw rather easily from the grants and loans of the Recovery Fund. If such a practice perpetuates, this may undermine any progress made especially on the ESM front. It seems likely for the member states to opt for the Recovery Fund and decide against stability assistance offered by the ESM, because this would impose on them rather rigorous reform requirements in return for funding.

Against this background, we advise reflecting on compliance with the fiscal rules to ensure long-term sustainability of the member states' domestic budgets. The goal should be to strengthen resilience and the scope of action of the Union as a whole to enable it to better withstand future crises.

We are aware that the Recovery Fund is a policy project already decided upon. If cash transfers are considered to be the response to meeting the challenges of the pandemic, the Recovery Fund should build on the time-tested ownership principle and ensure efficient and effective use of the funding made available. Seen against lessons learned from the cohesion policy and the European Semester, the appropriate framework conditions would have to be established.

The federal government should urge for

- linking grants and loans of the Recovery Fund to reform requirements that aim at addressing structural shortcomings,
- member states co-funding their projects from national own resources or loans to increase the scope of the Fund and strengthen economic and efficient use of funds,
- ensuring effective control of whether the funds have been used properly and efficiently.

8.3 Comments made by the Federal Ministry of Finance

The finance ministry stated that the purpose of the support under the Recovery Fund was not to achieve a short-term economic recovery in the first place but long-term structural improvements. The finance ministry added that it considered monitoring the use of funds to be a high priority. The Recovery Fund offered the opportunity to increase the number of programmes successfully implemented under the European Semester. The finance ministry urged for country-specific recommendations being attributed a "great binding force" and would regularly assume an active role in discussions on the further development of the European Semester. The aim was to strengthen the member states' responsibility for implementing structural reforms. The finance ministry added that the Recovery Fund included safeguards to protect the Union's financial interests. However, a classical type of co-financing was not provided for.

8.4 Concluding audit findings

Even though the finance ministry seeks to ensure that the Recovery Fund's resources are used effectively and contributes to the further development of the European Semester, we have reservations about this due to past experience with earlier support programmes, all the more so, because no co-financing is in place and the European Semester has not been reformed.

9 Conclusions

Due to the COVID-19 pandemic, government structures, companies, health and social systems and citizens all over the world have to shoulder enormous burdens. The pandemic also poses unprecedented challenges to the economy and society in the Union. All member states have been affected by the pandemic. However, some member states have neither sustainable public finances nor resilient government structures in place to take the steps they think are needed to stabilise the economy. This has resulted in the call for a joint European response marked by solidarity.

However, it is doubtful whether the Recovery Fund can meet the expectations placed on it and help address these challenges. The negative experiences with earlier EU programmes raise considerable doubts on the effectiveness and efficiency of the use of funds and therefore also on whether the long-term targets set can really be achieved.

If, in a few years' time, the member states note that hundreds of billions of euros have been spent without addressing the structural weaknesses, they may be reluctant to cover open bills. This will all the more be true by then because the wealthier member states may have to cope themselves with the follow-up costs of their national recovery programmes. If the economic upswing even fails to materialise, this could have a lasting impact on cohesion

within the Union. This is another reason why the repayment obligations should have been fixed before disbursing the funds.

The long-term risks associated with joint borrowing are of even greater concern because the Recovery Fund undermines the principle of ownership. In addition, the enormous guarantee volume to borrow at Union level provided by the member states enables them to effectively circumvent the fiscal rules and to allocate these funds to themselves as grants via EU programmes. Furthermore, the liability mechanism may promote selfish national behaviour. Overall, the Recovery Fund may weaken the Union as a community based on the rule of law and solidarity and may put at risk the essence and stability of the Economic and Monetary Union in the long term.

We are aware that the Recovery Fund is a policy project already decided upon. However, given the considerable risks involved, the federal government should ensure that joint EU borrowing and a circumvention of the fiscal rules does not become a permanent solution.

On 23 February 2021, the Senate, the German SAI's supreme decision-making body adopted this report.

Bonn, 11 March 2021

(Signed by)

Kay Scheller

President of the Bundesrechnungshof

German SAI