Bundes
rechnungshof

Special purpose report

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

Bonn, 11 March 2021

Special purpose report on the potential impacts of joint EU borrowing on the federal budget (Recovery Fund)

0 Executive Summary

As a response to the COVID-19 pandemic, the member states of the European Union (EU) have decided to implement 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 assigned 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 European 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 have 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 EU Commission would first have to search for liquidity within the Union budget. In a next step, the EU 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 EU 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 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.

However, 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. Not opting for this solution 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 EU 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 EU 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 EU 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 as 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 the resilience of the European Union and the long-term sustainability of the member states' domestic budgets. (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 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 Union 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 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 political 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)