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Publication date
2020

Document Version
Final published version

Link to publication

Citation for published version (APA):
Beetsma, R. (Author), Codogno, L. (Author), & van den Noord, P. (Author). (2020). Next Generation EU: Europe needs pan-European investment. Web publication/site, VoxEU.org. https://voxeu.org/content/next-generation-eu-europe-needs-pan-european-investment

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Download date:20 Jun 2021

Next Generation EU: Europe needs pan-European investment

Roel Beetsma, Lorenzo Codogno, Paul van den Noord 09 November 2020

Next Generation EU should not turn out to be a missed opportunity to initiate and fund genuine pan-European infrastructure projects with a high impact on potential growth. Roel Beetsma, Lorenzo Codogno and Paul van den Noord argue that the subsidiarity principle calls for such a pan-EU initiative.

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Epidemiologists advocate the use of a 'circuit-breaker' lockdown to fight the pandemic. The economic policy response should become the 'circuit-maker' to speed up the recovery once the pandemic is under control. Europe's leaders are well aware of this need, but we are concerned that institutional inertia will act as a drag.

Next Generation EU, the unprecedented fiscal package adopted by the European Council this summer, is a commendable endeavour. Its aim is to boost public investment with a three-pronged objective: (i) to boost aggregate demand; (ii) to support the most hard-hit countries in the pursuit of cohesion; and (iii) to strengthen the economic growth potential of the Union (e.g. Verwey et al. 2020, European Commission 2020a, 2020b, European Council 2020).

Indeed, Next Generation EU is about more than supplementing demand in the short and medium run. It is the EU's 'Roosevelt moment' (Codogno, 2020), aiming to not only compensate the near-term collapse in demand, but also promote deep structural reforms and reallocate resources to raise the economy's growth potential and achieve common policy objectives such as climate control.[1]

The bulk of the funds are channelled through the Recovery and Resilience Facility. Each country has a right to claim a fraction of the total pot for grants and loans, based on a prior agreed formula relying on a set of objective indicators. Figure 1 depicts the allocation of Next Generation EU funding over the Member States, broken down into grants and loans. Figure 2 shows the estimated Next Generation EU cash flows over time, together with the cashflows from the European Commission's Support to mitigate Unemployment Risks in an Emergency (SURE) programme and the support from the European Stability Mechanism (ESM).

Figure 1 Next Generation EU: Estimate of overall amounts as a percentage of national GNI

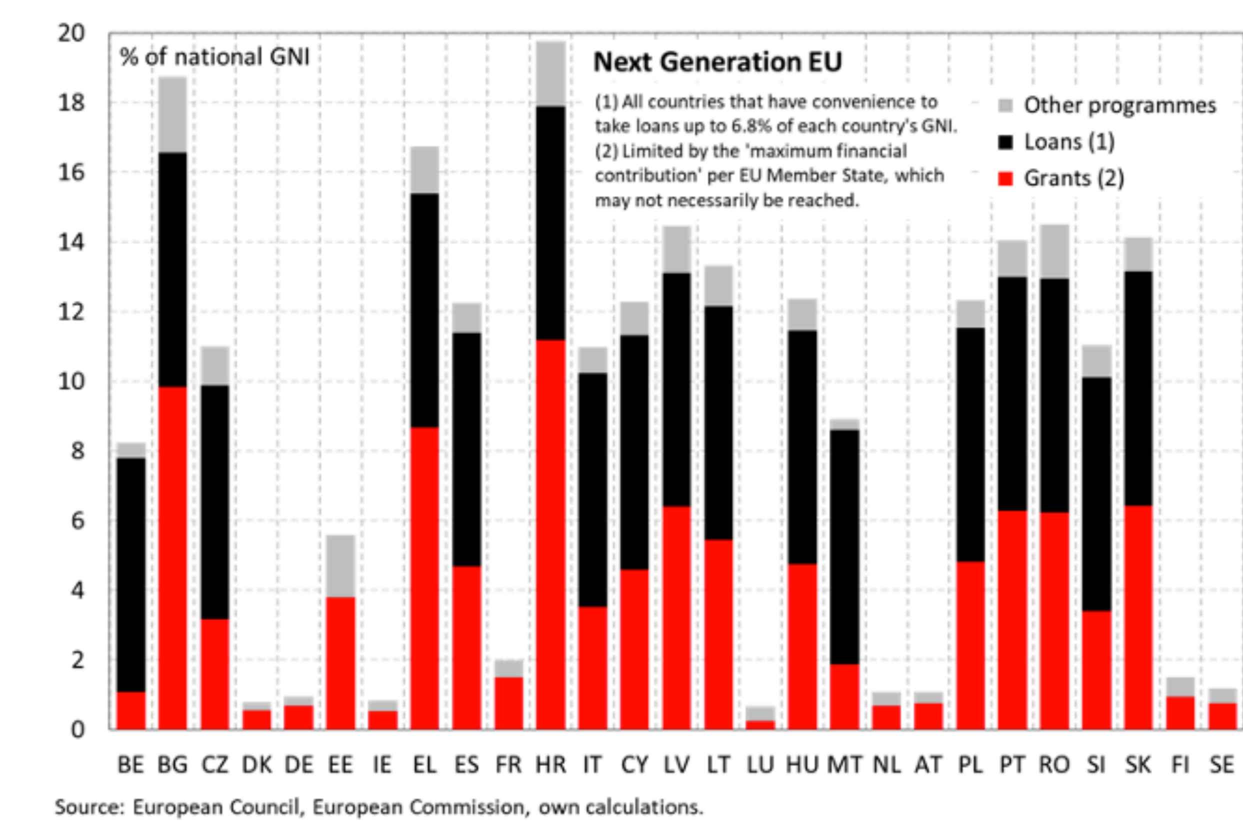
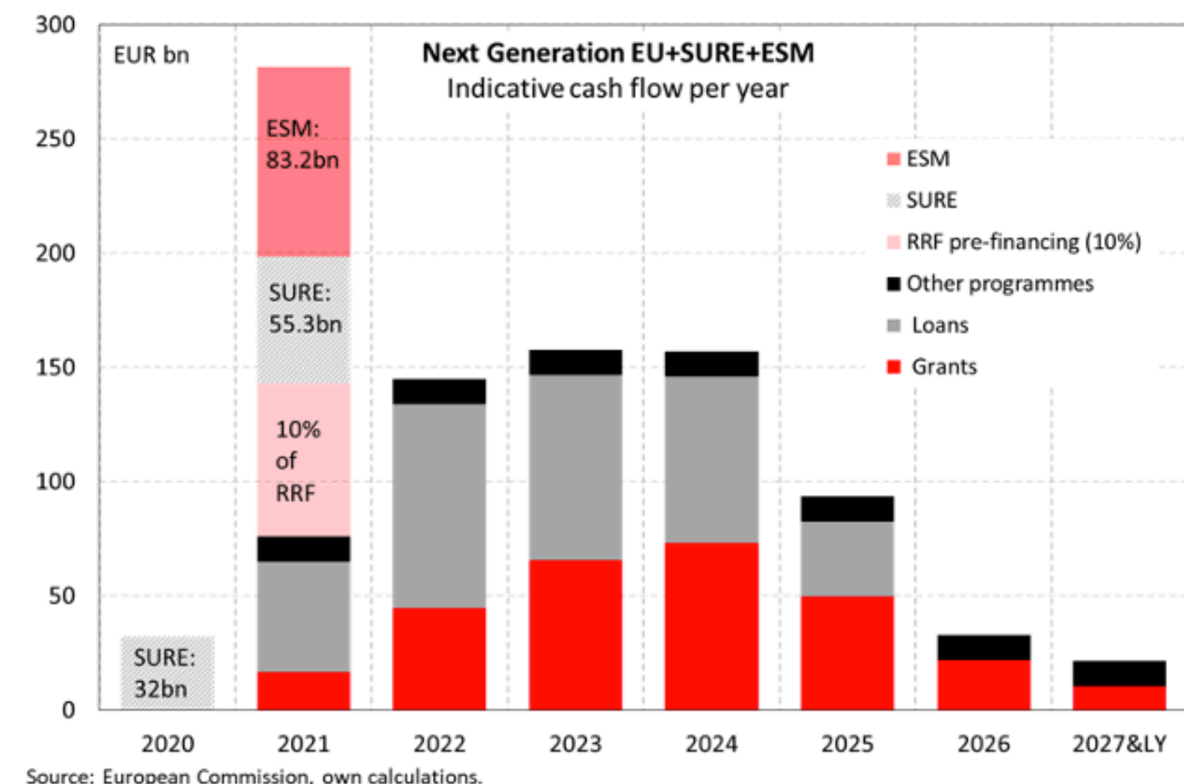


Figure 2 Next Generation EU: Estimates of cash flows in billions of euros



Projects need to fulfil certain conditions and should be reform- and investment-related, based on guidelines provided by the Commission. As such, projects should come as a complement to structural reform plans.

This approach has a strong macroeconomic rationale. Yet, it is subject to a number of risks, common to most EU policy initiatives that rely on countries submitting their own plans (even when subject to coordination such as the European Semester), and of which some are acknowledged to have long plagued the effectiveness of EU projects:

1. The additionality of the plans may turn out limited as countries use EU funds to finance existing projects or projects that would have been undertaken anyway. In that case, support funding can at most limit the debt increase of countries with limited fiscal space.
2. Countries could shun the take-up of conditional loans (Spain and Portugal have already hinted at that), preferring grants and market loans without strings attached. The latter are cheap even for the worst affected countries owing to risk sharing via the ECB's quantitative easing and the common bond issuance of the EU package itself.
3. Countries have limited administrative absorption capacity of projects: past experience shows that money is left on the table, because countries are unable to initiate sufficient adequate proposals which, at any rate, may clash with capacity constraints among private contractors or crowd out other viable activities.
4. Countries may be tempted to channel EU funding to social transfers or tax cuts or to launch pet infrastructure projects that are not financially viable or have a purely domestic-politics dimension. These should be left for national decision making and budgets, or not undertaken at all.
5. Spreading funds too thinly over small projects without a common strategy could lead to resources being misallocated. With the widespread increase in debt-to-GDP ratios across European countries impinging on income-producing future generations, the last thing we need is waste.

The EU is in dire need of pan-European infra-structure projects, pan-European meaning involving two or more countries and yielding spillovers from which the entire EU can benefit. Examples are high-speed railways, power grids with sufficient capacity to transport the electricity generated by renewable energy, infrastructure for hydrogen (produced by renewable energy to replace carbon energy), digital investments, but also human capital and mobility.

The bottom-up nature of this EU endeavour has a rationale: who else knows the needs of a specific country or region better than local administrators and technocrats? However, because of the bottom-up planning and submission of projects, these are unlikely to give sufficient weight to the EU-wide spillover effects inherent to large infrastructure projects which may therefore turn out underweighted.

Moreover, the scale of such investments is too large for national administrations to handle on their own. Not only do individual countries fail to internalise positive spill-overs, but they also find it inherently complicated to work together on large trans-border projects. A telling example is the Dutch 'Betuwe' rail track from Rotterdam to the German border, which has already been waiting for years for completion of the German part of the line, effectively leading to a huge waste of transportation capacity. In a way, the subsidiarity principle would argue for top-down rather than bottom-up in the case of large infrastructure projects.

Therefore, the EU (Commission and other European institutions), not primarily national governments, should initiate such genuine pan-European infrastructure projects that transcend national interests. The emphasis should be on projects with a high impact on sustainable growth (renewable energy, human capital, green mobility) that have broader spill-overs and a strong 'common good' characteristic and for which national governments are ill equipped.

Next Generation EU should be about providing the funding and direction for pan-EU infrastructure projects. It needs to become the 'circuit maker' that brings the EU economy together and better positions it in the post-corona world economic order.

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Endnotes

1 These are essential changes at the national level. Ideally, these should be complemented with a further completion of the EMU, such as with a central fiscal capacity (Codogno and Van den Noord 2020, European Fiscal Board 2020, Van den Noord 2020).

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