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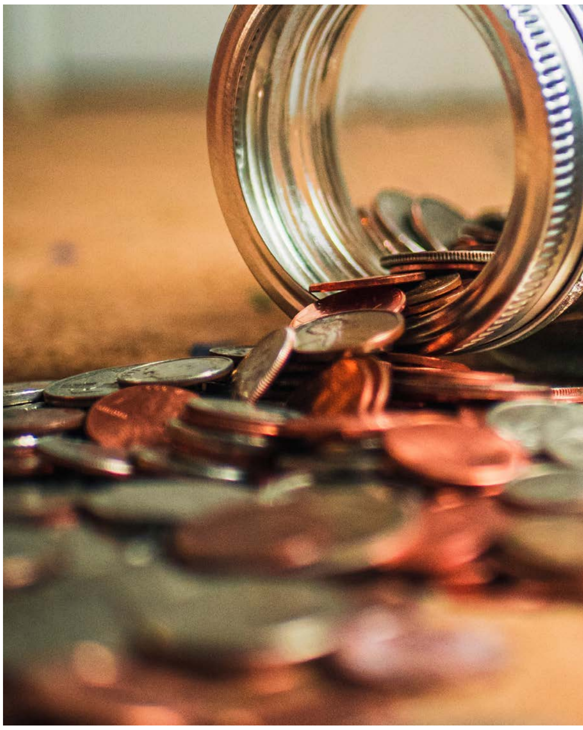
BLOG POST



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An ambitious plan without adequate financing?

How to address the underfunding risks for the REPowerEU proposal

This blogpost focuses on the financing dimension of the European Commission's recent REPowerEU proposal. It highlights that the current plan risks to remain seriously underfunded due to insufficient and unsuitable funding sources. The financing of REPowerEU needs to be fundamentally rethought to ensure that the 2022 Russian invasion of Ukraine accelerates rather than slows down the EU's climate ambitions. To this end, this blogpost makes two proposals: a modest one aiming to make the RRF loans more attractive to Member States and an ambitious one based on transforming unused RRF loans into grants.

I. Context

Just on its tracks to leave the economic fallout of the Covid-19 pandemic behind, the Russian invasion of Ukraine weighs heavily on Europe's economic recovery. The war painfully exposes the EU's dependence on Russian fossil fuels. It also exacerbates inflation pressures due to increasing energy prices and supply chain disruptions that accompany the global rebound from the pandemic. Subsequently, the economic growth outlook for 2022 and 2023 has lowered significantly. To attenuate price hikes for citizens, EU Member States have drawn up costly budgetary responses at the national level. Many of the measures, however, also extensively subsidise fossil fuels, money that would be urgently needed to phase-out fossil fuels and address the climate crisis instead.

II . The REPowerEU Proposal

I INVESTMENT NEEDS

To reduce Europe's dependence from Russian fossil fuels and to accelerate the green transition, the Commission announced its REPowerEU proposal on May 18. To achieve these goals, it states that additional investments amounting to €210bn are necessary between 2022 and 2027, and €300bn to cover the whole period until 2030. The expenditure areas are detailed in an accompanying staff working document. The largest identified investment needs are €113bn for renewables (PV, wind and hydrogen), €56bn for energy efficiency and heat pumps, €41bn for adapting industry, €39bn for the power grid and storage and €37bn for increased biomethane production. To adapt the existing infrastructure to the phase-out of Russian fossil fuel imports, the plan equally envisages to spend €10bn on new LNG infrastructure and pipeline corridors and €2bn each for the coal and oil sectors.

I FINANCING SOURCES

While REPowerEU details investment needs by sectors, **the financing sources of the plan remain considerably more vague**, provided in a simple factsheet. NGEU's Recovery and Resilience Facility (RRF) is supposed to provide the bulk of the financing for REPowerEU, drawing on the Facility's currently unused loans, amounting to €225bn. In addition, the plan intends to generate €20bn in new grants through the auctioning of Emission Trading System (ETS) allowances from the existing Market Stability Reserve and to allow the transfer of funds from cohesion policy (up to €26.9bn) and the Common Agriculture Policy (up to €7.5bn from the EAFRD) into the RRF.
Beyond these European financing sources, the Commission considers additional funding for the REPowerEU plan to come from the European Investment Bank, national funding and private investment. The current proposal, however, does not specify the size and type of financing that should be provided by these stakeholders.
As the Commission and Member States consider the RRF's national recovery and resilience plans (NRRPs) a success model so far, modified NRRPs are supposed to become the central instrument through which the required funds should be channelled for evaluation and implementation. To allow for climate-harming investments in oil and gas currently forbidden in the RRF Regulation, but deemed necessary for more energy security, the proposal envisages a softening of several existing criteria, such as the 'do no significant harm' principle.

III . REPowerEU financing challenges and shortcomings

The current REPowerEU proposal entails **serious underfunding risks for the twin priorities of reducing the dependence on Russian fossil fuels and accelerating the green transition**. If the EU really wants to build on the success model of the RRF, it needs to revive its logic: providing a legitimate balance between solidarity and responsibility mechanisms between Member States by linking European grants with national investments and reforms. At the national level, the provision of grants made it significantly easier to justify the acceptance of conditionality. The grant component of the RRF equally ensured that all of that money is actually spent by the Member States, increasing public investment across Europe.

But under the current REPowerEU plan, the grant component is smoke and mirrors. Additional investment needs cannot be met by simply shuffling money around. The transfer of cohesion policy and CAP funds only moves European funding between different spending and control mechanisms. Similarly, the use of the market stability reserve to create additional revenues might, in the end, only transfer resources from national budgets and EU ETS Funds (Innovation Fund, Modernisation Fund) to the RRF, as the selling of additional ETS allowances has a negative impact on the carbon price and thus on national and EU revenues linked to the ETS. Depending on the size of carbon price reduction, additional revenues linked to the market stability reserve could actually be cancelled out by revenue losses for Member States and the EU ETS Funds. To make things worse, the auctioning of additional ETS allowances would also allow for more CO_2 emissions in the short term, going at odds with European climate ambitions.

A significant amount of 'fresh' money for financing REPowerEU can thus only come from the unused loan component of the RRF, but there are several reasons why many Member States have not made use of their share so far. First, the RRF loans can be attributed to individual countries and subsequently add to national public debt, falling under the –currently suspended– fiscal rules of the Stability and Growth Pact. Member States with high public debt burdens and little fiscal space could thus be hesitant to further constrain their already limited fiscal room of manoeuvre in the future. Second, other countries might be unwilling to accept RRF loans because they come with conditionality. If a country can indebt itself with similar – or even with slightly higher – bond interest rates in the markets in comparison to the rates offered by the Facility, policy-makers will prefer to retain complete spending control. This creates an underfunding risk for the REPowerEU spending objectives.

IV • What is needed to adequately fund REPowerEU –Genuinely new RRF grants

The key element to repeat the perceived success of the RRF would be to once more **link European grants with national investments and reforms**. For this to work, truly additional revenues need to be made available. Neither the proposed use of the ETS Market Stability Reserve, nor the transfer of funds from cohesion policy and CAP can fulfil this function.

An ambitious option would be to **transform at least part of the unused €225bn of RRF loans into grants**. It is difficult to decide the exact size of additional grants on a purely technical basis but at least 50% of remaining loans turned into grants would surely provide a very strong incentive for Member States and send a strong political signal. As the final size of NGEU was to a significant extent based on political rather than macroeconomic considerations, we could actually draw on the central political proposal paving the way for NGEU. In May 2020, Germany and France proposed €500bn in grants through common EU borrowing for a European recovery fund. During the NGEU negotiations, this was changed into €390bn in grants and €360bn in loans. With the transformation of €110bn of the remaining RRF loans into grants, we could come back to the grant size of the initial Franco-German proposal. Transforming at least a part of the RRF loans into grants would allow to provide additional European grants without having to resort to a second common borrowing instrument, or to reopen the overall NGEU debt envelope.

Unfortunately, Art. 5 of the 2020 Own Resources Decision (ORD) specifies the share of grants and loans, meaning that an increase of the grant component in the RRF would require unanimity plus the ratification of an amended ORD in all 27 EU Member States, in addition to changes to the European Recovery Instrument (EURI) regulation and the

RRF regulation. There would, however, be no need to modify Art. 6 of the ORD, as the temporary increase of the own resources ceiling to cover the liabilities of NGEU common borrowing includes the full amount of €750bn already.

While politically difficult, this approach would also allow to address a number of other relevant issues. First, an amendment of the ORD, EURI and RRF regulations would allow to better articulate the solidarity mechanism to respond to the 2022 Russian invasion of Ukraine and its consequences, instead of relying on the solidarity logic underlying the common response to the Covid-19 pandemic. Second, the explicit adaptation of parts of NGEU to deal with energy dependence and the related need to accelerate the green transition should equally imply the development of a new contribution key of the remaining loans transformed into grants. The war has asymmetric effects on EU Member States, but with a different distribution from the Covid-19 pandemic. An amendment of the RRF regulation should take this into account, **reallocating grants particularly towards those countries that are very dependent on Russian fossil fuel imports and that have shouldered a large part of the influx of Ukrainian refugees**. In addition, a new contribution key could take into account in which countries investment in renewable energy projects would make most sense. Finally, changes to NGEU could also address a few broader problems that might hamper its implementation. For example, some of the deadlines linked to the NGEU budgetary guarantee for InvestEU might be too short to allow even for a partial execution of the programme. A deadline extension in Art. 3 (6) of the EURI regulation would help to avoid losing crucial financial support for accelerating the green transition.

V • An alternative approach to reduce underfunding risks –Make RRF loans more attractive

Should Member States not be able to agree on a new grant component for the REPowerEU plan, a more modest and clearly second-best solution to reduce the underfunding risks would be to **make the unused RRF loans more attractive for Member States**. Three changes could help to alleviate at least some of the material and institutional constraints on Member States' budgets. Some of them could also complement the RRF grant approach discussed above.

First, the loan agreements for the remaining unused RRF loans should allow for more favourable repayment conditions than currently available to Member States. **A front-loading of investments to achieve the REPowerEU objectives should thus be linked to a back-loading of the repayment of loans.** As illustrated by the existing Portuguese RRF loan agreement, RRF loans come so far with a 30-year maturity, including at 10 year grace period with the subsequent repayment of the principal over the course of the following 20 years. To make the remaining RRF loans more attractive, the loan maturities and the grace period could be further prolonged. In addition, the repayment of the principal could be concentrated towards the end of the NGEU repayment deadline in 2058. Such loan characteristics should especially be considered for those Member States that currently have a high public debt burden (such as Italy and Greece), reducing immediate fiscal consolidation constraints beyond the fiscal rules themselves. Backloading loan repayment towards the 2040s and 2050s would provide some more fiscal space for Member States in the 2030s. While the ORD specifies that debt repayment "shall be scheduled (…) as to ensure the steady and predictable reduction of liabilities", this should not exclude the possibility to back-load loan repayment to a certain extent.

Second, **the remaining unused RRF loans should be excluded from the common fiscal rules**. The renewed suspension of the European fiscal rules until the end of 2023 provides sufficient time to include such an exemption in the ongoing reform process of the Stability and Growth Pact. Especially for countries that already have a very limited fiscal room for manoeuvre, this would reduce immediate fiscal consolidation constraints and make the use of the remaining loans more attractive.

Third, some Member States have already exhausted their share of the RRF loan component (Italy, Romania, Greece) or at least used a part of their original share. While the current RRF regulation already allows for a reshuffling of unused loans "in exceptional circumstances" –a point which is reinforced in the proposed amendment of the RRF regulation– the remaining unused RRF loans should be reallocated from scratch among all 27 EU Member States. This could be done in two ways. The loans could be either allocated according to each country's GDP (the approach chosen so far for the loan component) or according to the national investment needs to achieve the REPowerEU objectives. Such **a reallocation of the loan component between countries** would only require a modification of the RRF regulation, but not of the EURI regulation or the ORD.

Conclusion

There are no short-cuts to adequately finance the current REPowerEU proposal. To avoid underfunding risks for the ambitious plan to reduce Russian fossil fuel dependence and accelerate the green transition, truly additional money needs to be put on the table. This blogpost has laid out two possible –and partly complementary– avenues that could reduce fiscal policy and rule constraints and incentivise EU Member States to achieve the objectives set out by the Commission. The provision of additional grants would surely be the best solution but would demand to overcome significant political hurdles. In the absence of an agreement on grants, the backloading of loan repayment and an exclusion of remaining unused RRF loans from fiscal rule requirements could also help to reduce underfunding risks for REPowerEU. Political leadership to ensure adequate funding is needed in this situation, where a hesitant approach will only lead to higher budgetary costs in the medium- and long-term.

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