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Fiscal Responses to the Covid-19 Crisis: Comparing China and the EU

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Abstract:

The EU reacted swiftly to the economic dimension of Covid-19 by designing new instruments to support the fiscal policy of Member States. But entry into force and implementation was slow due to various political hurdles with little action taking effect by the end of 2020. While EU legislation is underway to allow improved crisis responses, we argue that this legislation may actually be inefficient and detrimental to important EU policy objectives. We show that such EU support would have benefited only the wealthiest Member States. More generally, well-intended EU-funded stabilisation measures may actually be counterproductive in terms of EU cohesion, suboptimal in terms of stabilisation and regressive in terms of cross-country income distribution. By contrast, in China governments at all levels spent over 400 billion yuan on epidemic prevention and control in 2020. To support epidemic prevention and control, China increased the deficit rate from 2.8 percent to over 3.6 percent, cut taxes and fees, and issued special national and local bonds. These rapid fiscal policy responses are in stark contrast to the slow reaction by the EU and and made positive contributions to resuming economic growth early in the crisis. But we argue it would be counterproductive to strive for a similarly designed fiscal policy under the legal framework provided by the EU Treaties.

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Key Words: Covid-19, fiscal policy, macroeconomic stabilisation, EU-China comparison

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1. Introduction

The Covid-19 pandemic has caused a major trough in economic growth rates for all major economies, often unprecedented in size in postwar or post-communist times. There is wide consensus among economists that debt-financed expansionary fiscal policy is the best policy response to the economic dimension of this crisis. China, for instance, has greatly increased bond issuance all levels of government in response to the crisis. But many European countries – and in particular countries of the Eurozone – had high levels of debt already prior to Covid-19. Despite historically low interest rates and massive purchases of government bonds through the European Central Bank's Pandemic Emergency Purchase Programme (PEPP), the resurgence of the European sovereign debt crisis is clearly a concern among European policy makers and economists.

In this paper, we compare the fiscal responses of China and the European Union in the months after the outbreak of the crisis. We set out by describing the measures taken by the Chinese government – generally swiftly and well coordinated, cf. Ministry of Finance (2020). We then contrast this with the complex legal and institutional setting in the European Union, see e. g. Lucke and Neumann (2020). We analyze reform proposals which the European Union put forward already prior to the crisis and currently under scrutiny by the European Parliament and the Council. We argue that rules-based approaches to fiscal policy as proposed by the Commission are unlikely to be satisfactory and may actually undermine important objectives of European economic policy.

2. China's fiscal policies after the outbreak of Covid-19

While the spread of COVID-19 has had a significant impact on the global economy in 2020, China's gross domestic product (GDP) grew by 2.3% year on year, making it the only major economy in the world to achieve positive growth during the epidemic. During this period, the Chinese government adopted a proactive fiscal policy, which played an important role in easing economic pressure. In the following we give a systematic account of China's fiscal policies from the perspectives of government revenue and government expenditure:

A. Government fiscal expenditures

a) Funds for epidemic prevention and control

Governments at all levels in China spent over 400 billion yuan on epidemic prevention and control in 2020. To support epidemic prevention and control, the Ministry of Finance of China (MFC) and relevant departments have issued a series of policies and

measures, including subsidies for patients' treatment costs and temporary work subsidies for frontline medical workers.

China implemented the policy of subsidizing medical treatment expenses for patients. For medical expenses incurred by confirmed patients, after basic medical insurance, serious disease insurance and medical assistance are paid in accordance with regulations, and the part borne by individuals will be subsidized by the government. The necessary funds will be paid by local governments in advance, and the central government will subsidize 60 percent of the actual expenses incurred by local governments.

b) Transfer payment funds to localities

To support local governments in ensuring basic living standards, wages, and operating conditions, the central government provided transfer payments in a timely manner. The central government has stepped up efforts and provided transfer payments in advance to strengthen local government funding capabilities and support their efforts to prevent and control the epidemic. At the same time, the central government allocated funds for infrastructure investment and to enable enterprises to resume work and production. Through these measures, steady economic and social development was promoted.

B. Government fiscal revenues

a) Increased deficit ratio

Special measures were taken during extraordinary times as the fiscal deficit ratio was raised from 2.8 percent to over 3.6 percent in 2020. Specifically, the deficit climbed to 3.76 trillion yuan, which was up by 1 trillion yuan from that in 2019. The amount included 2.78 trillion yuan in central fiscal deficit and 980 billion yuan in local fiscal deficit, up by 950 billion yuan and 50 billion yuan from those of 2019, respectively (MFC, 2020).

The decision to raise the deficit ratio, on the one hand, sent out a clear and positive message that stabilized and boosted market confidence. On the other hand, it served as an effective counterbalance to the impact of reduced revenue and increased expenditure caused by the pandemic. It also strengthened the power of central fiscal macro-regulation, thereby making an important and special contribution to mitigating the impact of the pandemic, protecting market players, safeguarding employment and people's livelihoods, and enabling a fast economic recovery.

b) Tax and fee cuts

China's tax and fee cuts topped 2.5 trillion yuan in 2020, benefiting market players significantly. In 2020, China issued and implemented seven tax and fee cut documents including 28 items of tax and fee cut policies despite the fiscal difficulties (MFC, 2020). Among the aforementioned policies, emergency measures were taken to support pandemic prevention and to control and guarantee supply. These measures include fully refunding the incremental value-added tax credit of the key pandemic prevention and control material production enterprises and the one-time pre-tax deduction on

newly purchased equipment by enterprises for the purpose of expanding their production capacity.

Steps were also taken to help industries that were affected by the pandemic and faced difficulties. For example, the loss carry-over period was extended for enterprises in the transportation, catering, accommodation, tourism, film and other industries that were severely affected by the pandemic; cultural undertaking construction fees and the national film industry development special fund were exempted, as well as the civil aviation development fund paid by airlines; and real estate tax and urban land use tax were remitted for enterprises in industries that were affected by the pandemic.

The tax and fee cuts exceeded 2.6 trillion yuan in 2020, which effectively relieved pressure on enterprises as they sought to overcome difficulties. By the end of 2020, the tax and fee rate of sales income of the 100,000 key tax source enterprises across the country (the proportion of tax and social insurance fees paid by enterprises as a percentage of sales gains) was expected to decrease by 8 percent year on year (MFC, 2020). Such reduction provided strong support for various market entities to resume work and business, and for industries severely impacted by the pandemic to restore growth.

Strong efforts to maintain jobs and ensure people's wellbeing, targeted tax and fee cut policies, plus the inclusive tax cut policy for small and micro enterprises in recent years effectively reduced the labor costs of enterprises and strongly supported them during the difficult period. In 2020, 11.44 million new tax-related market entities were implemented nationwide, a yearly increase of 10.1 percent, which greatly safeguarded people's employment (MFC, 2020).

c) Issuance of special national bonds and local bonds

One trillion yuan worth of special treasury bonds was issued to support local public health infrastructure construction and anti-pandemic efforts, strengthen the weak points exposed by the pandemic, ensure adequate funding for pandemic prevention and control. The quota of local government bonds was significantly expanded, with the National People's Congress giving the nod to a debt ceiling of 980 billion yuan in general local government bonds in 2020, as well as 3.75 trillion yuan in local government special bonds in 2020. The latter is 1.6 trillion yuan more than the figure of the previous year (MFC, 2020). Those funds were mainly used to finance major infrastructure programs and livelihood services.

Local governments issued new special bonds. All the new special bonds issued by local governments will be used for the construction of major infrastructure projects, agriculture, forestry and water conservancy, municipal and industrial park infrastructure, and other fields. It can effectively make up for the shortcomings of public

facilities, and at the same time give play to the leverage role of fiscal funds to drive social investment and form a strong impetus to the economy.

While causality is difficult to assess, it is undisputable that the Chinese economy rebounded strongly in 2021. Current estimates of year-on-year economic growth are in the range of 8.5%. It seems fair to say that China may commend itself for having mastered the economic crisis which followed the pandemic very well.

3. The EU's fiscal response and the Commission's reform proposal

EU leaders have reacted to the pandemic's economic consequences by a number of improvised measures, not envisaged prior to the outbreak of the crisis. Among these is a 100 billion € support programme to mitigate unemployment risks in an emergency (SURE), a 240 billion € credit line for Member States of the European Stability Mechanism (ESM), and a 750 billion € recovery instrument "Next Generation EU" intended to supply debt-financed grants and credits to EU Member States via the EU budget.

These measures have in common that they make funds available without requiring Member States to increase their issuance of government bonds. Rather, the EU or the ESM will issue sovereign bonds on own account. Since this debt is backed either proportionately or mutually by all Member States, the countries hardest hit by the crisis (or those with precariously high levels of government debt) will – so the thinking goes – have greater access to emergency funds than under a stand-alone scenario.

However, the financial instruments set up to counter the crisis have been slow to take effect. At the end of the year 2020 no ESM country had applied to use the 240 billion € credit line made available via the ESM. Rumor has it that Member States shy away from a perceived stigma of being the recipient of ESM credits, which, according to Articles 3 and 12 of the ESM Treaty, are granted under "strict conditionality" only. Moreover, while the European Council agreed in May 2020 on the design of the 750 billion € recovery instrument, it took EU leaders until December 2020 to clear unforeseen political hurdles related to the "rule-of-law" mechanism and "Next Generation EU" is still waiting to see entry into force while the second wave of Covid-19 plagues the Continent. Finally, from the 100 billion € SURE programme, approved in May 2020, no disbursement took place before end-October and the actual instalments paid at the time of writing were only 17 billion €.

Overall, it seems that the complicated political and legal processes at Union level lead to considerable implementation lags. While there is no doubt that European leaders aimed at making available large European funds almost immediately after the size of the economic crisis became known, not much speedy action in response to Covid-19 can be witnessed.

This raises the question if other options to respond to a major crisis are available – and, if so, if they are better suited to serve the Union's overarching goals of economic growth and cohesion. One such option – deliberately designed to ensure fast decision-making – relies on the idea that financial support for countries hit by a major shock may be "automatically set on the basis of a formula" enshrined in European legislation, cf. European Commission (2018, p. 12).

Such a proposal is – since May 2018 - under consideration by the European Parliament and the Council[1]. The Commission, aware of the problem of slow crisis responses already before the outbreak of the pandemic, has brought forward a legislative proposal for the establishment of a "European Investment Stabilisation Function" (EISF)[2]. In this proposal, the Commission argued that in case of asymmetric shocks hitting some Member States, funds for macroeconomic stabilisation should be provided at Union level in a way which ensures a "swift and lean decision-making procedure", cf. European Commission (2018, p. 4). For this purpose, the EISF proposal foresees simple mathematical rules which determine eligibility and financial aid of recipient countries.

Rules rather than discretion? In essence, this is indeed the question, but under a completely different angle than in Kydland and Prescott's (1977) classical paper: For in terms of crisis response, European policy makers hardly bother about *time consistency*. Rather the trade-off is *time delays* linked to discretionary decision-making versus the *consistency* of rules-based support measures with the general economic policy objectives of the Union.

While time delays are clearly a problem in the complex discretionary decision-making process at European Union level, we will, in the sequel, shed some light on the rules-based approach advocated by the Commission in its EISF proposal. We will argue that support measures based on pre-agreed formulae may allow at best marginally faster crisis responses, but do so only at considerable costs.

4. Macroeconomomic Stabilisation at EU level

By introducing the Euro 20 years ago, the European Union (EU) opted for a common monetary policy while Member States would continue to have sovereignty over their fiscal policy. Especially since the beginning of the government debt crisis 10 years ago, this design has increasingly been criticized. For several years, both researchers and academic policy advisors have called for more fiscal policy coordination and centralized decision making (e.g. Wolff (2012), Allard (2015)). In fact, some economists

[1] COM(2018) 387 final

[2] The file was apparently delayed by the election of a new parliament in May 2019 and the outbreak of the pandemic in early 2020.

claim that a common currency also more or less *requires* a common fiscal policy (cf. Glienicker Gruppe (2013), Farhi and Werning (2017)).

For a long time, these positions were (and possibly still are) highly controversial. For instance, Galí and Monacelli (2008) show that a monetary union with decentral fiscal policies may well achieve the optimum outcome for the Union as a whole. Matthes and Iara (2016) also argue that existing instruments are sufficient and a further fiscal integration in the EU unnecessary. Kehoe and Pastorino (2017) argue that a fiscal risk sharing is not necessary in a monetary union if developed financial markets are in place. Also, the influential German Council of Economic Advisors in its annual report (2018) speaks out against a fiscal capacity at Union level.

Nevertheless, in 2015 considerations already developed by the former European Economic Union in the so-called Marjolin Report (Commission of the European Communities (1975)) and especially by Mc Dougall (1975) were taken up again at the most senior level. In the so-called "Five Presidents' Report" the EU aimed at "completing Europe's Economic and Monetary Union" by establishing a fiscal union (cf. European Commission (2015)). In this context, the five presidents called for the "setup of a macroeconomic stabilisation function for the Euro area" (in the following "stabilisation function") to create a fiscal union until 2025 at the latest. Similar proposals came from the European Commission (2017a, 2017b) as a "Eurozone budget". Also, Commission President Juncker addressed the presidents of the co-legislators on this issue in a Letter of Intent appended to his State of the Union address on 13.09.2017 (Juncker and Timmermans (2017)). He announced proposals for the "creation of a dedicated Euro area budget line within the EU budget" that shall provide for a "stabilisation function".

However, an EU stabilisation function faces significant legal obstacles. The European Commission wrote: "Any decision to set up such an instrument would need to take due account of possible legal constraints." (European Commission (2017a)). Undoubtedly, a solid legal basis for a Eurozone budget or a macroeconomic stabilisation function does not exist in primary European law. Treaty change is an option, but for various reasons not very likely at present. On the one hand, a significant number of the Member States seem to be unwilling to open the door for establishing a fiscal union in the first place (Hansegroup (2018)). On the other hand, even those willing to support further fiscal integration are concerned that the unanimity requirement for Treaty change gives undue leverage to some Member States pursuing unrelated – and possibly unwanted – political objectives.

Thus, for proponents of a deeper fiscal integration of the EU or of the Euro area, the question arises how and in which form instruments of a common fiscal policy could be implemented without Treaty change. Both the Commission (in its EISF proposal) and the Council (in its proposal for a "Budgetary Instrument for Convergence and Competitiveness" (BICC)) seem to have spotted the EU's competence for cohesion policy (Article 175 paragraph 3 of the Treaty on the Functioning of the European Union

(TFEU)) as the most promising point of departure.[3] This article serves as the legal basis in both proposals, cf. Council of the European Union (2019).

However, cohesion policy and macroeconomic stabilisation differ in various aspects: the focus (regional/sectoral versus national), the kind of economic disturbance it is supposed to mitigate (specific/idiosyncratic versus general/symmetric), the intended effect (supply-side versus demand-side), and the time horizon (mid-term versus short-term).

If Article 175 TFEU is used as the legal basis for the stabilisation function, the EU's macroeconomic stabilisation policy must conform to the goals and standards set for cohesion policy. As will be shown in detail below, this creates challenges that cannot easily be overcome and may induce disincentives and misallocations. Put more generally, the question arises which impact it has on the respective achievement of the EU's objectives when budgetary resources earmarked for cohesion policy (also) serve for macroeconomic stabilisation or when macroeconomic stabilisation is constrained by the requirement that it must promote EU cohesion.

5. The Legal Framework

The European Union derives its competences from the principle of conferral (Treaty on the European Union, Article 5). Thus, each legislative act of the Union requires an explicit legal basis in European primary legislation, i.e. either in the Treaty on the European Union (TEU) or in the Treaty on the Functioning of the European Union (TFEU).

The third part of the TFEU describes the internal policies and policy measures of the Union in twenty-four Titles. These Titles constitute the legal authorization for Union policy in various fields. They range from the internal market (Title I) to agriculture and fisheries (Title III), the area of freedom, security and justice (Title V), culture (Title XIII), environment (Title XX) and finally administrative cooperation (Title XXIV). Economic and monetary policy is treated under Title VIII, economic, social and territorial cohesion under Title XVIII.

This structure of the TFEU implies that the different policy fields enthrusted to the EU are on equal footing: Cohesion policy is neither super- nor subordinate to economic and monetary policy. Measures aimed at stabilising the economic and monetary union need to have a legal basis in Title VIII, not in Title XVIII. This was emphasized in 2009 by the European Court of Justice (ECJ) which ruled that Title XVIII provides the legal basis for policies whose "content does not extend beyond the scope of the Community's policy on economic and social cohesion" (ECJ (2009, No. 46)).

[3] We will not deal with the BICC in this paper as the proposal is still quite sketchy and lacks a legal text.

In other words: The EU's authorization to pursue cohesion policy cannot be re-dedicated to achieve other goals of the Union or of the Eurogroup (cf. Vaubel (2020)). In a legal opinion on the EISF proposal, Horn (2019) writes: „The political goal of economic, social and territorial cohesion is inapt to legitimize policy measures that are considered necessary to attain other Treaty objectives for which the necessary authorization is not provided in the respective other Titles of the Treaty."

Since Title VIII (Economic and Monetary Policy) does not provide a legal basis for a common Eurozone budget or for the macroeconomic stabilisation of the Eurozone, instruments designed for these purposes comply with EU law only if they primarily serve a different objective (e. g. cohesion policy) and thereby – uno acto – also lead to the desired macroeconomic stabilisation.

The Commission, in its EISF proposal, paid tribute to these legal constraints, by emphasizing both in the recitals and in the explanatory statement (and in European Commission (2017a, 2017b)) that the EISF shall enhance the Eurozone's resilience to "asymmetric shocks". This wording has presumably been chosen because asymmetric shocks may undermine the cohesion of the Union and would thus justify policy measures based on Title XVIII TFEU.
From a stabilisation perspective, however, this design seems bizarre. An adverse shock hitting the Eurozone may well be symmetric, e. g. the financial crisis or the Covid-19 crisis. There is no economic reason why the proposal for a stabilisation function should be confined to *asymmetric* shocks. In fact, as we will show later, the Commission's legal text essentially defines just any shock as "asymmetric". The wording chosen by the Commission is indicative of the legal constraints which – as we will argue – make macroeconomic stabilisation at Union level suboptimal.

Since Article 175 TFEU shall constitute the legal basis for the macroeconomic stabilisation of the Eurozone, it seems difficult to justify budgetary support for certain Member States by financial troubles they may be in. This is because the relevant criterion for providing assistance is the cohesion of the Union, and cohesion can only be assessed by a comparison with other Member States. By contrast, single-country indicators are uninformative about cohesion. Hence, the payment of budgetary resources conditional on indicators depicting general economic or social developments in a *single* Member State does not constitute – by definition – cohesion policy. This, again, constrains EU stabilisation policy, which may aim at stabilizing a group of countries irrespective of how this impacts on cohesion.

Further restrictions originate from the objectives of cohesion policy as laid down in primary law. In Article 174 TFEU, the objectives are defined to be *regional* and *structural*. Nowhere is cohesion policy framed in terms of Member State entities. Rather, Article 174 TFEU states that "the Union shall aim at reducing disparities between the levels of development of the various regions and the backwardness of the least favoured regions." Among the regions concerned, particular attention shall be

paid to “rural areas, areas affected by industrial transition, and regions which suffer from severe and permanent natural or demographic handicaps such as the northernmost regions with very low population density and island, crossborder and mountain regions.”

A general investment subsidy at country level is therefore hardly an instrument of cohesion policy. If, prior to an adverse shock, a Member State has investment projects in infrastructure or social housing of its growing, economically successful regions, these projects cannot be financed by cohesion EU funds. Essentially, stabilisation requires aggregate demand or supply policies and these, even if highly desirable in a specific situation, are typically unrelated with cohesion issues.

Article 174 TFEU also stipulates that “the Union shall develop and pursue its actions leading to the strengthening of its economic, social and territorial cohesion” “in order to promote *its overall* harmonious development” (our emphasis). The explicit mentioning of the Union’s “overall development” suggests that policies benefiting only parts of the Union – here: the Euro area[4] – may be difficult to reconcile with this wording. On average, the Eurozone countries are economically more developed than eastern and southeastern Member States that do not belong to the Eurozone. Thus, the establishment of a macroeconomic stabilisation function would have to respect that the objective of *overall* cohesion would not be undermined.

An exhaustive presentation of the legal constraints concerning the EISF is beyond the scope of this paper. See Horn (2019) for a detailed analysis. However, the practical restrictions resulting from the legal framework are highly relevant for economic policy. For this reason we now focus on the economic analysis of the Commission’s proposal.

6. The European Investment Stabilisation Function

In this section, we build on results by Lucke and Neumann (2020, 2021) by showing that the EISF rules would have led to grave misallocations of funds during Covid-19 and previous crises. They would have had suboptimal effects in terms of stabilisation policy, would have been distributionally regressive and would have undermined the cohesion of the Union. To make things worse, both discretionary support measures and rules-based allocation of emergency funds create disincentives for Member States to counter the crisis swiftly with own resources and may even induce them to strategically delay such measures.

[4] According to the Commission’s proposal, eligible for EISF support are Eurozone countries and members of the Exchange Rate Mechanism II (ERM II). Currently, only Denmark participates in the ERM II.

In the Commission's draft regulation for the establishment of a European Investment Stabilisation Function, Member States which belong to the Eurozone or participate in the Exchange Rate Mechanism II (ERM II), shall be granted financial assistance if they are hit by a severe asymmetric shock. Support shall take the form of loans for the funding of public investment projects and the form of grants which cover 100 % of the interest cost incurred on the loans. We call the latter the interest subsidy[5].

A large asymmetric shock shall be determined by a "double activation trigger": Firstly, the quarterly national unemployment rate (in the following u^h) has to exceed "the average unemployment rate in the Member State concerned over a period of 60 quarters preceding the quarter during which the request is made". Secondly, the same unemployment rate has to have "increased above one percentage point in comparison to the unemployment rate observed in the same quarter of the previous year" (in the following u_0). (No comparison with the level of the unemployment in other Member States is made.)

The second component of the „double unemployment trigger" essentially determines how high the granted financial support will be. Let $\delta := u^h - (u_0 + 1)$ be the difference between u^h and the unemployment rate u_0 increased by one percentage point (both measured in percentage points). The following simple equation is employed by the EU to calculate the loan amount S:

$$S = \alpha\beta\delta I^* \quad (1)$$

where α and β are exogenous parameters. I^* is the fictitious level of public investment that the Member State concerned would invest if it invested the same share of its gross domestic product as the EU average.

In the Commission's proposal, the parameters α and β take the values $\alpha = 11.5$ and $\beta = 0.66$[6]. One purpose of these values is to set an annual ceiling for the maximum amount of loans granted to a Member State, i. e. $S \leq \alpha I^*$. However, this ceiling is set quite high with $\alpha = 11.5$. Note that in 2019, public investment accounted for about 3 % of the Union's GDP. Thus, the ceiling for a potential loan is about a third of its GDP!

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[5] Eligible are Member States which are neither subject to a macroeconomic adjustment programme nor benefit from financial assistance by the European Stability Mechanism (ESM). Moreover, they must not have been reproved by the European Council for failure to take effective measures against macroeconomic or budgetary imbalances in the two years prior to requesting EISF support.

[6] The Commission justifies the values as follows: α "is determined such that with hindsight of the recent crisis, all the EISF support could have been provided to the Member States concerned, had the mechanism been in place." β is „determined such that for a shock that increases unemployment by more than 2.5 percentage points, the maximum support is made available to the Member State concerned. " Cf. Recitals 23 and 24 of the Commission proposal.

Moreover, the Commission has discretion to increase β from its basic value $\beta = 0.66$ to $\beta = 1$.

The Commission's discretion is limited by the fact that at no point in time loans granted under the EISF shall exceed a maximum of 30 billion €. However, the ceiling only refers to support from the Union budget. Yet the legislation explicitly allows for the possibility that the European Stabilisation Mechanism ESM (or its successor) approves complementary loans on the same conditions. Since in a major crisis formula (1) implies loans which easily exceed 30 billion € even for single countries, the Commission probably aims at such complementary financing under the ESM in order to be able to hand out the support it regards as necessary[7].

While the calculation of the loan ceiling refers to the *total* of public investment, loan funds may only be invested into *eligible* public investment. According to the Commission's proposal, these include all kinds of public investment focused on specific political goals (to be described in detail below). Moreover, any expenditure in the field of general or public education can be financed through these funds. Economically, the latter is certainly investment in human capital. But according to the legally binding EU regulation EU 549/2013 on the European System of Accounts such expenditure do not count as investment, but as consumptive government expenditure.

A separate legislative act[8] shall lay down the political goals that qualify investment to be eligible. It contains the "Common Provisions Regulation" that applies to seven European funds, including the so-called "Structural Funds" whose goal it is to strengthen the economic and social cohesion in the EU: the European Regional Development Fund (ERDF), the European Social Funds Plus (ESF+), the Cohesion Fund (CF), and the European Maritime and Fisheries Fund (EMFF)[9]. Investment projects do not need to be eligible under these funds – rather, it is merely required that they be in line with the objectives defined in Article 4 of the Common Provisions Regulation. Cohesion policy is committed to these objectives, but the objectives laid down in Article 4 are not confined to cohesion policy.

The five objectives laid down in Article 4 are quite general: A "smarter Europe", a "greener, low-carbon Europe", a "more connected Europe", a "more social Europe", and a "Europe closer to citizens". These objectives are extremely general. Among others, advancement in the following fields shall be promoted: "sustainable and

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[7] In fact, no substantial stabilisation effect could be expected from the EISF – except for the smaller Euro states – if the ceiling of all loans shall not exceed 30 billion € for all Member States over a period of several years. It could be a tactical calculation to set such a low ceiling in the legislative proposal to cause less political opposition by initially setting a minor loan volume. Perchance, the Commission seeks to initially "open the door just a crack" before further opening it in consecutive legislative steps. Depending on the extent to which this might succeed, the complementary financing under the ESM would then be dispensable..

[8] COM(2018) 375 final

[9] It is disputable whether or not the EMFF belongs to the cohesion funds. The EMFF may rather be an instrument of common fisheries policy only.

integrated development", "green and blue investments", "smart economic transformation". A restriction of these objectives to structurally disadvantaged regions in the sense of EU cohesion policy cannot be found in the legislative proposal.

A Member State may request an EISF loan once a year. If it meets the elegibility and activation criteria, the Commission shall automatically calculate the amount of the loan on the basis of the formula described above (cf. Recital 24). In the year the disbursement of the loan is made, the beneficiary Member State has to invest in eligible public investment an amount corresponding to at least the amount of the EISF loan.

It shall maintain its public investment at the average level of its public investment over the five previous years. If the Member State does not comply with these conditions, the Commission has to reclaim both the loan and the interest subsidy. Moreover, the Commission shall verify whether or not the Member State concerned has maintained its eligible public investments under the Structural Funds. However, noncompliance with this condition is not sanctioned.

7. Economic Analysis of the Commission Proposal

In the next sections, we provide an economic analysis of the EISF proposal, both qualitatively (this section) and quantitatively (subsequent sections). In the former, we focus on the potential conflict between cohesion policy and macroeconomic stabilisation policy. We adopt the common definition of cohesion policy as measures aimed at improving the economic *structure* in lagging or disadvantaged regions. This kind of structural policy typically operates irrespective of cyclical economic fluctuations. It is mainly focused on *supply*-side conditions and unfolds its effects only gradually over time.

By contrast, we define macroeconomic stabilisation policy as economy-wide (rather than regional) measures which stimulate aggregate *demand* in the short-term and which are applied solely during crises and recessions.

In addition, stabilisation policy differs from cohesion policy in that the latter is oriented toward known, historically or geographically determined country-specific conditions. These "grown" conditions have nothing in common with an unexpected shock, typically coming from outside, as is the case with stabilisation policy.

Cohesion policy and stabilisation policy are thus rather polar manifestations of national economic policy along several dimensions. As we will show below, the Commission is trying to overcome this by, on the one hand, firmly anchoring the legislative proposal in the field of cohesion policy, but, on the other hand, greatly expanding the traditional understanding of cohesion policy. This would mean that in future almost every (!) stabilization policy measure could be classified as cohesion policy.

Anchoring the EISF in cohesion policy (under Title XVIII TFEU) is achieved by at least four different elements of the Commission proposal: Firstly, by the choice of legal basis; secondly, by the (apparent) limitation of the EISF to asymmetric shocks; thirdly, by the requirement that cohesion-related public investment be maintained at unchanged levels even in a crisis; and fourthly, by the fact that the eligibility of public investment under the EISF is linked to policy objectives, which are explicitly also policy objectives of the Structural Funds.

Given its cohesion anchor, resources provided by the EISF must always contribute to a significant extent to public investment serving cohesion purposes. For if this were not the case – for example, because of a dominance of measures that would stimulate overall economic demand without a regional focus and only in the short term – a misuse of public funds would quickly be suspected. Critics might call for the EU Court of Auditors and possibly also the European Court of Justice (ECJ) to review the cases.

From the perspective of stabilisation policy, this means that the available funds cannot be used optimally because a considerable portion of them must be used for cohesion policy and must be distributed using the instruments of cohesion policy.

The Commission tries to lift this limitation by stretching the term "cohesion policy". For example, the concept of "asymmetric shocks" is widened to such an extent that it de facto includes symmetrical shocks. Recital 13 defines “asymmetric shocks” as those which affect one or more Member States significantly more than the average of the Member States. However, apart from the unlikely special case of almost the same impact on all countries, it is inherent in the average that some countries will always be affected more than the average. Consequently, a shock that affects all countries adversely – but to varying degrees – would be an asymmetric rather than a symmetrical shock. And indeed, the financial crisis of 2008 and 2009, which is based on an undoubtedly symmetrical shock (negative for all countries), is explicitly cited in Recital 4 of the EISF proposal as an example of an asymmetric shock.

Recital 13 refers to the fact that some countries will be hit "significantly" harder than others. This corresponds to the definition in Article 4 that a "severe" asymmetric shock exists if the national unemployment rate rises by more than one percentage point. But the extent of the shock ("significant" or "severe") is of course not a criterion for distinguishing between symmetric and asymmetric. According to the Commission's definition, *any* shock is a "severe asymmetric shock" if a national unemployment rate is above the long-term average and has increased by one percentage point within a year.

This implicit inclusion of symmetric shocks is obviously desired by the Commission. Nothing else can explain why the double activation criterion does not relate the development of the national unemployment rate to employment trends in other EU countries. This would actually be expected of an instrument of cohesion policy just as

much as of an instrument that is supposed to react specifically and exclusively to asymmetric shocks.

It should also be mentioned that in the Commission's proposal, the term „shock" is used in an unconventional way. This is because according to the definition in Article 4, just *any* event that meets the double activation criterion is considered to be a "shock". Nowhere in the draft law is there a requirement that a shock must be an exogenous event beyond the control of the Member State concerned. Therefore, an endogenous event, i.e. an event for which this Member State bears full responsibility, can also be considered a shock in the sense of the EISF and trigger financial support from the EU and other Member States.

For instance, it should be indisputable that the collapse of Lehman Brothers in 2008 which triggered the financial crisis was an exogenous shock for the EU. On the other hand, in 2010, the Euro crisis began with the downgrading of the credit ratings of some Eurozone Member States by major rating agencies – and this can hardly be seen as an exogenous shock, because ultimately the ratings of the rating agencies are merely the capital market's reactions to fiscal decisions by Eurozone governments – and are therefore endogenous.

Thus, the EISF legislative proposal would empower the EU to grant interest-free loans not only in the case of severe asymmetric shocks, but also in response to any adverse event which has a sufficiently strong impact on the unemployment of a Member State.

Such a competence of the Commission is also aimed for in the official justification of the draft law. There, the Commission writes that a recession is an event that "has a negative impact on its (note: the Eurozone's!) economic and social cohesion". Cyclical phenomena such as recessions are described here as a challenge for cohesion policy. Thus, stabilisation policy becomes a subset of cohesion policy. This is because the latter is interpreted in such a way that it is no longer confined to support disadvantaged regions only, but may – independent of developments in the rest of the EU – finance macroeconomic measures designed to boost aggregate demand of an individual Member State.

It is in line with this that EISF eligible investments do not necessarily have to be financed through the traditional instruments of cohesion policy. Rather, they must serve the objectives defined in Article 4 of the Common Provisions, to which the Structural Funds are also committed. But these objectives (a smarter, greener, more social, networked and citizen-centred Europe) have – possibly with the exception of networks – no cohesion policy content whatsoever. They do not *define* cohesion policy – they merely give direction to a cohesion policy already defined in principle elsewhere.

The stabilizing function embodied by the EISF can operate through investments under the Structural Funds, but it can also take the form of other investments as long as it can be assigned to one of the very general objectives of the Common Provisions. In

this view, in reversal of the above, cohesion policy becomes a subset of stabilisation policy.

The Commission's legislative initiative removes the distinction between such different economic policies as cohesion policy and stabilisation policy. This delimits the principle of conferral (Articles 4 and 5 TEU), because the treaties empower the Union merely for cohesion policy, but not for stabilisation policy. Therefore, as outlined above, stabilisation policy must be anchored in cohesion policy, but this anchoring implies a suboptimal design of stabilisation policy.

It is also to be feared that the original core of cohesion policy is negatively affected by the delimitation in its definition. For to the extent that a broadened understanding of cohesion policy prevails, the use of resources within the Structural Funds would presumably be less consistently focused on disadvantaged regions in the EU. Some, and perhaps many, of these funds could in future be channelled into public investment with a predominantly macroeconomic impact and serve the general objectives of the EU as laid down in Article 4 of the Common Provisions Regulation.

The fact that the stabilisation function is conceived as a kind of "rapid reaction force" may also contribute to a lower achievement of objectives within the framework of conventional cohesion policy. For in a crisis situation, the provision of additional financial resources to increase demand should be timely. This is why the explanatory memorandum to the EISF draft law and Recitals 23 and 24 repeatedly emphasize that the loan amount and the accompanying interest subsidy (100 percent of interest costs) are to be automatically determined by formulae. The Commission, in turn, is obliged to take the corresponding decision "without undue delay".

For its part, the Commission will have to attach great importance to ensuring that the approved funds are spent quickly. Since a considerable part of them must be allocated to traditional cohesion projects for the reasons described above, it is to be feared that in such situations even inferior or insufficiently prepared structural investments will be approved as eligible for funding. This could have a lasting negative impact on the efficiency of cohesion policy.

8. EISF and Covid-19

To test the effectiveness of a stabilisation function designed according to the EISF proposal, we simulate it using the most recent data of the Covid-19 crisis. We analyse which Member State would have been entitled at which point in time to receive which amount of EISF support if the EISF in the form now proposed had already existed at the outbreak of the crisis in early 2020. In the subsequent section we extend this counterfactual simulation to historic data which cover, e. g., the financial crisis of 2008–10 and the sovereign debt crisis of 2011–13.

Since activation of EISF support is tied to increases in unemployment, we use unemployment rates published by Eurostat to assess when and to what extent Member States would have been eligible. In accordance with the draft law, we only consider those Member States which are either part of the Monetary Union or belong to the ERM II (Denmark)[10].

It is noteworthy that unemployment rates often lag the business cycles and that there is a second, country-specific lag caused by the time span necessary to collect and compile unemployment data before the aggregate, nation-wide unemployment rate can be computed to which the double activation trigger refers.

For example, the Covid-19 crisis broke out in the first quarter of 2020. At the end of this quarter, i. e. by March 31, most countries had imposed a lockdown on their economies and it was perfectly clear that a major contraction was taking place. Yet in most Eurozone countries first quarter unemployment rates were unchanged or even lower than in the first quarter of the previous year, cf. panel 1 in Figure 1. The unemployment toll of the crisis materialized only gradually. This can clearly be seen by the histograms of unemployment rate changes in Figure 1, which shift more and more into positive territory as time goes by. (Cf. panels 2 and 3 for the second and the third quarter annual changes of unemployment rates in the Eurozone.)

< Include Figure 1 about here >

Second quarter unemployment rates were released by Eurostat September 8, 2020. This release was still incomplete with some countries reporting later. Hence, the Commission would have received requests for EISF support at the earliest by September 2020 and it seems unlikely that, even with speedy decisions from the side of the Commission, much EISF-funded public investment would have taken place prior to the first quarter of 2021. In other words: Although rules-based and designed for enabling swift action, EISF-based macroeconomic stabilisation would not come into effect much earlier than almost one year after a severe economic shock hit the Eurozone.

This assumes countries were eligible for EISF support already with second-quarter unemployment rates. However, in terms of unemployment, the worst was yet to come. When Eurostat released second quarter unemployment rates, just one country (Austria) met the double activation trigger. As panel 3 of Figure 1 shows, many countries experienced substantial increases in unemployment rates only in quarter 3. And even then, not more than six countries qualified for EISF support: Denmark, Finland, Luxembourg, Austria, Estonia and Lithuania.

It is stunning to see that four of these six countries are among the richest of the Eurozone. Table 1 lists today's EU Member States in descending order of their per-

[10] For ease of language, „Eurozone“ will refer to the Monetary Union plus ERM II in the sequel.

capita GDPs (as of 2019) along with the EISF support they would have received in response to Covid-19. Four of the seven most prosperous Member States would have received EISF support, totaling (according to the Commission's proposed formula) 89 billion €. Of the 13 less wealthy states, only two small countries, Estonia and Lithuania, would have been eligible (with EISF loans of 34 billion €). Thus, almost three quarters of all Covid related EISF funds would have been granted to Member States with high per-capita incomes. Apart from the two Baltic states, no other EU country would have received any support, with the five poorest countries (Hungary, Poland, Croatia, Romania, Bulgaria) not even being eligible.

< Include Table 1 about here >

Supporting the rich and not supporting the poorest is the exact opposite of what common sense would expect from EU cohesion policy. In the Covid-19 crisis, EISF support would have *aggravated* income inequality in the EU rather than ameliorate it. Moreover, even in terms of stabilisation policy the EISF would have missed its target almost completely. Column 3 of Table 1 lists the 2020 GDP growth rates as projected by the Commission. The (unweighted) average of these growth rates is -0.05. There are eight Member States whose GDP is projected to shrink by more than this: Belgium (-0.07), France (-0.07), Malta (-0.07), Portugal (-0.07), Italy (-0.09), Croatia (-0.09), Greece (-0.10), Spain (-0.12). None of these countries most affected by the recent crisis would have received any EISF support.

Coincidentally (or not?), some of the hardest hit countries in the Covid-19 crisis featured also prominently in the EU's sovereign debt crisis of 2010–13. In fact, high unemployment in these countries during the sovereign debt crisis and the preceding financial crisis of 2008–09 is partially responsible for these countries not meeting the criteria of the double activation trigger. Observe that these require the current unemployment rate to exceed the average unemployment rate of the past 15 years by one percentage point. Hence, countries which suffered major crises in the past are less likely to enjoy EISF support in the next crisis than countries which have not.

However, it would probably be inappropriate to just do away with such long-run averages of past macroeconomic data since these come close to the notion of a country's steady state. EU resources are intended to address major economic crises only and these are best seen as major downside deviations from the long-run steady state. By contrast, sudden declines in annual growth rates are not, by themselves, sufficient evidence of major crises, as such events may also occur e. g. when overheated economies experience some sort of sharp correction. It is not obvious that debt-financed interventions should take place in these cases.

Hence, it seems that both in terms of cohesion and macroeconomic stabilisation the EISF would have missed or even undermined important EU policy targets. We proceed to check if these types of results – obtained for the most recent data of the Covid-19

crisis – would feature prominently also in other real-world settings. For this purpose, we now check the functioning of the EISF in historic perspective.

9. Historical Simulations

In this section, we counterfactually assume that the EISF was already in existence since inception of the Monetary Union in 1999. In accordance with the legislative proposal, we only examine Member States of the Monetary Union or those participating in the ERM II at the respective time. In 1999, this group was made up of the founding countries plus Greece and Denmark. In 2004, it was joined by Estonia, Lithuania, Slovenia and in 2005 by Latvia, Malta, Slovakia and Cyprus[11].

Table 2 (in the Appendix) shows which Member State would have been entitled to request EISF assistance – in which year and in what amount. To calculate the amount of the requests for support, we used formula (1). We assume that, if necessary, the lending capacity of the EISF would have been increased by loans from the ESM, see Article 10 EISF. Essentially, the (fictitious) claims are concentrated in two periods: the years 2003–05 and the years 2008–14.

Let us first consider the first period: During 2003–05, 81 percent of the EISF's aid would have gone to countries that are among the richest and most efficient in the Euro zone: Germany, Luxembourg, the Netherlands and Austria. In total, 205 billion € would have been granted under the instrument, of which 185 billion € would have gone to Germany (about 10 percent of the total German national debt at the time). Portugal and Cyprus would have received the remaining 19 percent.

To calculate the interest subsidy (100 percent of interest costs), we assume that the loans granted according to EISF criteria would have had a term of 10 years (cf. Table 3 in the Appendix). The interest costs are based on the market yields for ten-year government bonds of the beneficiary country in the quarter following the triggering of the double activation criterion.[12]

Despite the slightly higher risk premium for the government bonds of Portugal and Cyprus, the distribution of the interest rate subsidy is not much different from the distribution of the loans. Over the term of the loans, Germany, Luxembourg, the Netherlands and Austria would have received a total of 82 billion € for interest rate subsidies, while Portugal and Cyprus would have received 20 billion €[13]. Thus, 80 per-

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[11] Unemployment rates are not available for all Member States with a lead time of 60 quarters prior to a possible entitlement year. This is especially true for the reunited Germany and the former socialist states. In these cases, we have formed averages over shorter periods of time, but these averages often still cover ten years or more.

[12] Data source: https://sdw.ecb.europa.eu/browse.do?node=9691124. Using the monthly data, we calculate the arithmetic mean of the quarter.

[13] The financing of the interest rate subsidy requires an intergouvernemental agreement. According to the Commission's proposal, that agreement shall provide for the Member State's financial contributions

cent of the stabilisation funds payouts – financed by all Euro and ERM II countries – would have benefitted some of the wealthiest EU Member States, notably Germany, Luxembourg, the Netherlands and Austria, while most of the poorer countries would have gone away empty-handed. Thus, in the period from 2003–05, the EISF would have had a regressive effect.

Handing out financial support that primarily benefits the richest Eurozone countries can hardly be declared a cohesion policy measure. However, it is not surprising that such a distribution of EISF support can occur, since the double unemployment trigger does in no way target the cohesion of the EU or of the Euro area.

Let us now turn to the second activation period of the EISF, the years 20014, which are characterized by the financial crisis and the subsequent Euro crisis. In the latter, significant financial aid was granted to Greece, Ireland, Portugal, Spain and Cyprus by the other Eurozone countries and through the ESM. According to the Commission's EISF legislative proposal, countries that receive such financial assistance cannot benefit from *additional* EISF support.

Nevertheless, we calculate the (notional) EISF loan amount for these countries also in years in which they received financial assistance from the European Financial Stability Facility (EFSF) or the ESM. This is reasonable because without this type of help the program countries Ireland, Greece, Portugal, Spain and Cyprus would have been eligible for EISF assistance for at least four consecutive years between 2008 and 2014: Their unemployment rates continued to deteriorate during the crisis even with EFSF and ESM help. Quite plausibly, aid handed out in a previous year helps stabilizing employment in subsequent years. Since financial aid was actually disbursed to the crisis countries in these years – albeit under different conditions – the effects of intended stabilisation by international lenders is already included in the data.

Financial support provided by the EFSF, IMF and ESM therefore serves as a surrogate for a (notional) EISF support granted earlier. This is, of course, only an approximation. However, it does enable us to draw as complete a picture as possible of the presumed impact of the EISF on the cohesion of the EU if it were confronted with a crisis similar to that of 2008–13.

We therefore assume that these Member States would have received loans under the EISF (supplemented by ESM loans granted according to the same criteria) instead of the financial support actually given. In this case, seventeen countries would have temporarily benefitted from EISF loans in the time from 2008–14: All Eurozone countries (plus ERM II) except Germany, Finland and Luxembourg.

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to be set in proportion to the respective return distributed by the European Central Bank to the national central banks. In the following, we assume that this agreement is ratified by all Member States and that enough means are contributed to the stabilisation funds to finance the interest subsidy as proposed by the Commission.

However, let us first look at the period of the financial crisis, which we date from 2008 up to and including the first quarter of 2010[14]. The financial crisis was undoubtedly a symmetric shock that had a negative impact on *all* countries. It resulted in a severe recession that affected all Eurozone Member States in 2009.

Despite the symmetric shock, the EISF's financial aid would have been surprisingly asymmetric, as Belgium, Germany, Finland, Italy and Luxembourg would not have been entitled to receive aid in the form of EISF loans.

This is surprising because some of these countries were affected disproportionately more strongly relative to the *average* recessive effect the crisis had in the Eurozone: We measure the average impact of the financial crisis by the gross domestic product of the entire Eurozone, which shrank by 3.6 percent in 2009. In Italy (-3.7 percent), Germany (-4.0 percent) and Finland (-6.4 percent), the impact was significantly worse in terms of GDP. Nevertheless, there would have been no EISF aid for these countries. On the other hand, the Netherlands (-3.5 percent), France (-2.8 percent) and Austria (-2.0 percent) would have been entitled to receive EISF loans.

This is difficult to reconcile with cohesion policy, even if, in contrast to previous practice, cohesion is applied to state entities. Note that in 2009 GDP per capita in Germany, Finland and Italy, i. e. countries which would not have received EISF support, would have been lower in 2009 than in the (notionally EISF-funded) countries Austria and the Netherlands. Italy also lagged behind France, which would have benefited from the EISF in 2009.

The technical reason for the better treatment of countries which were richer and with regard to their incomes less affected than others is the fact that EISF criteria are based solely on the development of the unemployment rate – and not on income. It is hard to find an economic reason for this. The historical simulation shows that a fiscal union that uses mechanical rules such as in the EISF proposal can have counterintuitive, undesirable allocation and redistribution effects.

In total, loans amounting to around 563 billion € would have been granted to five rather wealthy countries (France, Austria, Ireland, the Netherlands and Denmark) for the years 2008 to 2010Q1 while Italy would have gone away empty-handed. Spain, on the other hand, would have been granted 401 billion € in loans – this would have been the ceiling determined by $\alpha I*$. Nine other poorer countries (Portugal, Greece, Cyprus, Malta, Slovenia, Slovakia and the Baltic States) would have received a total of 159 billion €.

Comparing the aggregated loan amounts for richer countries (563 billion €) and poorer countries (561 billion €), these do not appear to be in obvious disproportion to each

[14] All requests for support depicted in Table 2 for 2010 go back to the unemployment rate in the first quarter of 2010.

other from a stabilisation point of view. The opposite is true, however, when it comes to the very different results for Italy and Spain.

In terms of cohesion policy aspects, the EISF is not convincing. The distribution of the loan amounts does not follow a clear scheme enhancing cohesion, even more so as Member States outside the Euro area (plus ERM II) would not have received any support. The same is true for the distribution of interest rate subsidies. The total amount of interest rate subsidies is 464 billion € for the loans calculated for the period from 2008–2010Q1. The largest amounts would have gone to Spain (166 billion €) and France (111 billion €) – about 60 percent of the total amount. Another 92 billion € (20 per cent) would have gone to the wealthy countries Denmark, Ireland, the Netherlands and Austria. The nine poorer Eurozone countries named above would have received the remaining 20 percent (about 95 billion €), while Italy and Southern and Southeastern states outside the Euro area would not have received any subsidies. It is not clear how that kind of distribution would have enhanced the cohesion of the Union.

Finally, we analyze the period 2010Q2–2014, which is usually associated with the sovereign debt/Euro crisis. In these four years, 83 percent of the loans disbursed would have gone to a single country, Italy. However, this is not yet the case in 2010 or 2011, casting doubt on whether the EISF would be able to provide financial aid early in a crisis. But in 2012 and 2013, Italy would have been entitled to EISF loans in the enormous amount of 634 billion €, combined with interest subsidies that would have added up to 334 billion € over the assumed ten-year term of the loans.

The other EISF loans during this period would have been relatively small and, once again, most of the funds would have gone to more prosperous countries. After Italy, the next largest loan amount (50 billion €) would have gone to the Netherlands, followed by Belgium (28 billion €) and Spain (26 billion €). Greece would have received only 14 billion € in loans over the four-year period, since it would have reached the ceiling αI^*. (The situation is similar for Spain). Finally, Austria (8 billion €), another wealthy country that was not a Eurozone crisis country, could have claimed EISF support.

It is difficult to see a convincing system in the EISF's automatic credit allocation. In particular, it is not apparent that the EISF – as claimed by the Commission – would be conducive to EU cohesion. In fact, further analysis shows that the correlation between the size of EISF loans and GDP (both expressed per-capita of the recipient country) is positive and significant: $(\rho = 0.4, \text{t-stat} = 2.8)$. This is indicative of undermining rather than enhancing the cohesion of the Union.

10. Disincentive Effects

Over the entire period 2008–14, there are only a few countries in the Eurozone that would not have been eligible for EISF loans at some point in time. One of these countries is the Federal Republic of Germany, although the financial crisis caused – in terms of GDP decline – the worst recession in its (postwar) economic history.

But employment losses in the financial crisis were very moderate despite the sharp drop in GDP: The unemployment rate did not rise by more than 0.7 percentage points and therefore the double activation criterion of the EISF would not have been met.

The relevant literature explains this "German employment miracle" – amongst other things – with active labor market policies (e. g. short-time work schemes, cf. Möller 2010, Burda and Hunt 2011). About 83 billion € were provided for macroeconomic and labor market stabilisation in three swiftly taken government decisions at the end of 2008 and in early 2009.

This highlights an incentive problem: Through the rapid deployment of its own resources in response to a crisis, a Member State may forfeit its opportunity to take advantage of EISF loans and the associated interest subsidies.

For instance: If Germany had reacted more slowly or reluctantly when struck by the crisis, unemployment might have risen to an extent which qualified Germany for EISF support. In fact, if unemployment had risen by 1.5 (rather than 0.7) percentage points, Germany would have been eligible for roughly 300 billion € in EISF loans and 100 billion € interest subsidy.

100 billion € in interest subsidies is a respectable amount. We do not claim that the German government would have been tempted to tolerate a rise in the unemployment rate twice as high as it has actually been (1.5 percentage points instead of 0.7). But the example demonstrates what enormous moral hazard problems smaller, financially weaker Member States would face if the EISF were to be set up as the Commission proposes. Especially countries with high debt levels might feel prompted to defer their own stabilisation policies in order to benefit from high, interest-free loans guaranteed by the Union budget or by other Member States.

This is completely contrary to the purpose of the EISF. According to the Commission's intention, the EISF shall enable a rapid response to asymmetric shocks – hence the design with simple activation criteria and the mechanical determination of loan amounts and interest subsidies. But as proposed, the EISF encourages counterproductive wait-and-see behaviour.

This not only applies to the disincentive effects in relation to own stabilisation measures. The funds made available through the EISF could also be deliberately applied for with a delay and thus be used suboptimally late. The reason for this is as

follows: In the course of a crisis, unemployment may rise over several quarters. In our simulations, we assumed that the affected countries would always apply for EISF assistance at the earliest possible point in time – i. e. in the quarter in which both activation criteria were first met. However, if the affected countries wanted to maximize EISF assistance, the earliest possible application date is not necessarily the optimal application date.

As we have shown in greater detail elsewhere, cf. Lucke and Neumann (2020), for most countries the optimum delay for the application would have been one quarter (Netherlands two quarters, Portugal three quarters). In some cases, such a delay would have been "rewarded" by hugely increased support. In absolute numbers, Italy would have gained the most by wait-and-see: EISF loans of 641 billion instead of 423 billion € plus the proportionate increase in the interest subsidy. In relative numbers, the Netherlands (in 2013) would have fared even better: It might have doubled its claims from 50 billion € to 100 billion € by sufficient tardiness in responding to the crisis and applying for EISF support.

A delayed application would not only be undesirable in terms of stabilisation policy, it would also have a negative externality for other Member States, which would have to finance the interest subsidy through the EISF stabilisation fund. First, the increased credit volume would naturally go along with an increased interest burden even with constant interest rates and, second, interest rates at a later date would not be constant but would involve a higher risk premium due to the higher level of national debt.

In order to avoid such disincentive effects (with negative externalities for all other Eurozone countries), it would be highly advisable to adapt the draft law in such a way that EISF support can only be applied for at the earliest possible point in time, and would otherwise lapse. However, this would not address the problem that affected Member States could feel tempted to forego their own rapid anti-crisis measures or to implement them in a reduced or delayed manner in order to gain the greatest possible access to funds that are guaranteed by the Union and whose interest costs are borne by other Member States.
Finally, with regard to the incentive compatibility of the EISF, it should be noted that its provisions represent a significant departure from the principle of conditionality which guided previous EU-funded assistance. Up to now, such assistance has only been granted in exchange for the obligation of the receiving country to implement a comprehensive program of structural reforms. Opinions may be divided on how successful the policy of conditionality has been and with what consistency the principle was applied to recipient countries' non-compliance. But the EISF gives up completely on tying lending to a commitment to structural reforms. Rather, the only condition attached to EISF loans is that the volume of previous Cohesion Fund investments be not reduced. And even a violation of this condition would not be sanctioned.

11. Conclusions

There is wide consensus that the best economic policy response to Covid-19 is debt-financed expansionary fiscal policy. China and the EU have both followed this path – albeit with substantial delay in Europe. This is although a number of discretionary measures to support debt-based expansionary fiscal policies were rapidly designed at EU level shortly after the outbreak of the pandemic. But most of these have been slow to take effect with some not being used at all and others still awaiting entry into force by the end of 2020.

The Commission's draft law on a EU-wide macroeconomic stabilisation function (EISF) would replace discretionary decision-making by a rules-based approach. Guaranteed by the EU budget and, if necessary, by the ESM, loans to Member States would be semi-automatically determined and made attractive by an interest subsidy financed by all Eurozone countries (plus ERM II). If put into law, political conflicts between Member States would no longer delay or interfere with the swift provision of funds to national governments.

However, a detailed analysis of this proposal casts serious doubts on the idea of a rules-based crisis response. The EISF is prone to misallocations which would be distributionally regressive, undermine Union-wide cohesion, disincentivise prompt national economic policy responses and cause negative budgetary externalities to other Eurozone countries. Moreover, the principle of conditionality, i. e. assistance provided conditional on pledges of structural reforms on the part of the recipient country, is abandoned.

Many of these weaknesses are not so much due to the specific EISF legislative proposal. Rather, they have their roots in EU primary-law. And this is where the EU is fundamentally distinct from China whose legal framework does not impose similar impediments. The European Treaties, however, do not authorize EU institutions to conduct macroeconomic stabilisation but reserve this as an exclusive Member State competence.

To circumvent this, the Commission proposes to view macroeconomic stabilisation as covered by its mandate for cohesion policy. But while the Treaties foresee cohesion policy to apply to the Union as a whole, the EISF proposal would provide macroeconomic stabilisation just for the enlarged Eurozone.

While this seemingly contradictory design could be corrected in a new draft law, tying macroeconomic stabilisation to EU cohesion policy seems unavoidable (without Treaty change). This entails the risk of grave misallocations: Since the stabilisation function must be of a cohesion policy nature, it will not necessarily be possible to use the loans optimally in terms of stabilisation policy. Cohesion measures are typically focused on supply-side effects, whereas in a crisis situation it is necessary to stabilize demand. Cohesion support is targeted at disadvantaged regions or sectors in need of structural

adjustment, while stabilisation policy is intended to have general macroeconomic effects. Cohesion policy is tailored to specific idiosyncratic and asymmetric circumstances, while stabilisation policy shall counter any kind of adverse shock which hits the whole macroeconomy. Finally, cohesion investments are designed to have medium or long-term impact, while the effects of stabilisation policy should unfold as rapidly as possible.

Anchoring macroeconomic stabilisation in cohesion policy not only implies legal restrictions which make the use of funds suboptimal in terms of stabilisation objectives. It also threatens to strip cohesion policy of its essence, because funds intended for classic cohesion policies might be diverted and flow into extraneous uses. This would have a negative impact on the EU's disadvantaged regions and sectors.

In addition, when it comes to the practical implementation, there would also be considerable doubt as to whether stabilisation support under the EISF does in fact enhance the Union's cohesion. Both our Covid-19 analysis and our historic simulation show that a major part of loans and interest rate subsidies would have gone to some of the wealthiest states of the Union while other, poorer and more severely affected countries would have received little help or would have been left completely empty-handed. In terms of income distribution between Member States, the EISF would often have had a regressive effect.

It is also problematic that the poorer countries of Southern and Eastern Europe, which do not belong to the Eurozone, would not receive any stabilisation support. In the event of a crisis, the cohesion of the EU would probably be reduced rather than promoted by the EISF for these countries. Moreover, nowhere does the draft law stipulate that recipient countries must spend the EISF funds to support backward regions of the country or industries in need of structural adjustment. Rather, each may spend the funds elsewhere, for example, to promote regions with high growth potential. This would undoubtedly run counter to the purpose of within-country cohesion.

But not only are the effects of EISF support unconvincing from both a stabilisation and a cohesion policy perspective. Further problems develop because the EISF creates considerable incentive problems and may give rise to undesirable attentism in national crisis responses. As this aggravates the initial effects of an adverse shock, it may lead to higher risk premiums on capital markets and, therefore, have negative externalities for the countries which finance the interest subsidy.

At the EU level, it seems doubtful whether rules-based approaches to macroeconomic stabilisation are a viable alternative to discretionary decision making in the face of a crisis. Discretionary measures, on the other hand, are unsatisfactory on own account because of considerable time lags and political hurdles delaying or preventing their entry into force. We are led to the conclusion that, either way, the potential for macroeconomic stabilisation on EU level is, at best, very limited. In realistic settings well-intended measures may actually turn out to be counterproductive, may delay

timely crisis responses and create negative spillover effects and costly budgetary externalities for other Member States.

Given these problems, the best precautionary measure seems to be sufficient fiscal space on the national level. If government debt-to-GDP ratios in normal times are well below the 60% threshold enshrined in EU law, no need would arise to provide Union loans to troubled Member States. Absent concerns about sovereign default, governments could raise debt on international capital markets and spend the funds fast and well-targeted to the situation of the own economy.

In fact, the high degree of integration of the EU's Common Market would ensure that expansionary fiscal policy at the national level would generate substantial spillover effects to the benefit of other Member States. Thus, a truly European crisis response may well unfold without interference by European Union institutions. Given sustainable debt levels, the key issue seems to be speedy decision-making and implementation. It is quite likely that this is much easier achieved in a decentralized way by national governments – and with results more beneficial to the well-being of the Union.

In China, by contrast, largely sovereign fiscal authorities do not exist at regional level. Here, a strong leadership at national level is indispensable for ensuring quick and appropriate fiscal policy measures. But this is due to the historical and political settings in China which are, of course greatly different from the way by which the European Union has developed from sovereign national states. Hence, EU leaders would be greatly misguided if they looked at the Chinese example as a desirable model for European integration. As we have shown in this paper, even the rather cautious attempt to provide more fiscal firepower at the Union level by means of a rules-based stabilization function is likely to be counterproductive to important EU objectives. Such measures face design and implementation issues which make them unreliable if not undesirable.

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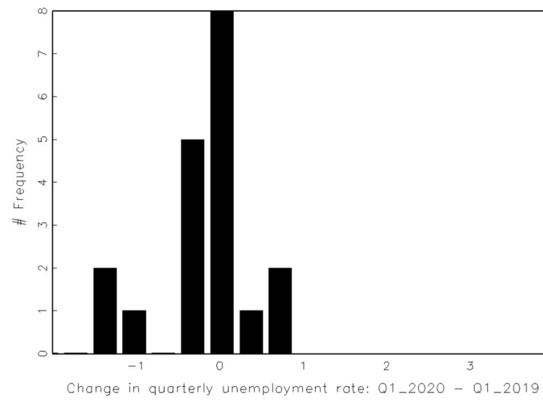
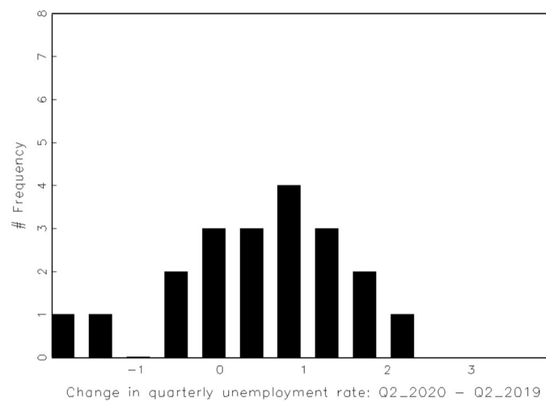
Figure 1:
Changes in quarterly unemployment rates for 20 Euro and ERM-II states:

Panel 1:
Q1 2020 relative to Q1 2019



Panel 2:
Q2 2020 relative to Q2 2019



Panel 3:
Q3 2020 relative to Q3 2019

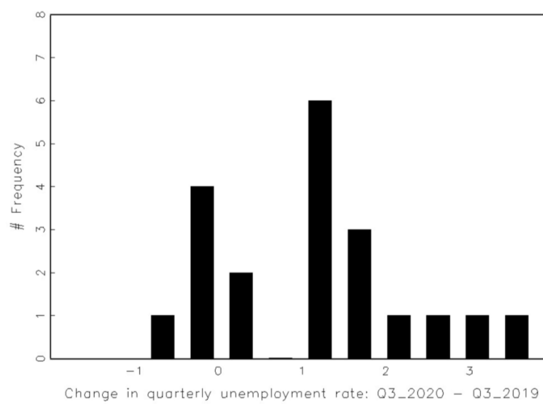


Table 1:
The Covid-19 Recession

Country	GDP per capita 2019 (1000 Euros)	projected GDP growth 2020	EISF support (million Euros)
Luxembourg	**102**	**-0.05**	**11,237**
Ireland	72	-0.02	
Denmark	**54**	**-0.03**	**19,113**
Netherlands	47	-0.03	
Sweden	46	-0.02	not eligible
Austria	**45**	**-0.05**	**24,173**
Finland	**44**	**-0.03**	**34,346**
Germany	42	-0.03	
Belgium	41	-0.07	
France	36	-0.07	
Italy	30	-0.09	
Malta	27	-0.07	
Spain	26	-0.12	
Cyprus	25	-0.05	
Slovenia	23	-0.05	
Estonia	21	-0.04	13,095
Czechia	21	-0.04	not eligible
Portugal	21	-0.07	
Lithuania	17	-0.01	20,345
Slovakia	17	-0.04	
Greece	17	-0.10	
Latvia	16	-0.05	
Hungary	15	-0.01	not eligible
Poland	14	0.00	not eligible
Croatia	13	-0.09	not eligible
Romania	12	-0.03	not eligible
Bulgaria	9	-0.04	not eligible

Source: Eurostat and own calculations.

Table 2: Historical Simulation: Entitlements to EISF loans according to the Commission’s proposal (in billion €)

	1999	2000-2002	2003	2004	2005	2006-2007	2008	2009	2010	2011	2012	2013	2014	2015-2018
Austria	-	-	-	5	-	-	-	40	-	-	8	-	-	-
Belgium	-	-	-	-	-	-	-	-	-	-	-	9	19	-
Cyprus	-	-	-	-	0,3	-	-	4	3	0,5	0,3	0,1	-	-
Denmark	-	-	-	-	-	-	-	55	34	-	-	-	-	-
Estonia	-	-	-	-	-	-	-	5	0,5	-	-	-	-	-
Finland	-	-	-	-	-	-	-	-	-	-	-	-	-	-
France	-	-	-	-	-	-	-	-	318	-	-	-	-	-
Germany	-	-	45	140	-	-	-	-	-	-	-	-	-	-
Greece	3	-	-	-	-	-	-	-	75	14	-		-	-
Ireland	-	-	-	-	-	-	61	5	4	1	-	-	-	-
Italy	-	-	-	-	-	-	-	-	-	-	423	211	-	-
Latvia	-	-	-	-	-	-	-	7	1	-	-	-	-	-
Lithuania	-	-	-	-	-	-	-	9	1	-	-	-	-	-
Luxembourg	-	-	1	3	-	-	-	-	-	-	-	-	-	-
Malta	-	-	-	-	-	-	-	0.3	-	-	-	-	-	-
Netherlands	-	-	-	11	-	-	-	-	46	-	-	50	-	-
Portugal	-	-	26	19	3	-	-	8	10	-	4	-	-	-
Slovakia	-	-	-	-	-	-	-	-	21	-	-	-	-	-
Slovenia	-	-	-	-	-	-	-	10	4	1	0,5	-	-	-
Spain	-	-	-	-	-	-		371	30	19	7	-	-	-

Source: Own calculations.

Table 3: Historic Simulation: Entitlements to Interest Rate Subsidies according to the Commission's proposal (in billion €, 10-year-term, return of 10-year government bonds at the time of proposal submission)

	1999	2000-2002	2003	2004	2005	2006-2007	2008	2009	2010	2011	2012	2013	2014	2015-2018
Austria	-	-	-	2	-	-	-	15	-	-	1	-	-	-
Belgium	-	-	-	-	-	-	-	-	-	-	-	2	4	-
Cyprus	-	-	-	-	0,1	-	-	2	1	0,3	0,2	0	-	-
Denmark	-	-	-	-	-	-	-	20	10	-	-	-	-	-
Estonia	-	-	-	-	-	-	-	NA	NA	-	-	-	-	-
Finland	-	-	-	-	-	-	-	-	-	-	-	-	-	-
France	-	-	-	-	-	-	-	-	111	-	-	-	-	-
Germany	-	-	18	57	-	-	-	-	-	-	-	-	-	-
Greece	1,7	-	-	-	-	-	-	-	47	16	-		-	-
Ireland	-	-	-	-	-	-	28	3	2	1	-	-	-	-
Italy	-	-	-	-	-	-	-	-	-	-	245	89	-	-
Latvia	-	-	-	-	-	-	-	8	0,8	-	-	-	-	-
Lithuania	-	-	-	-	-	-	-	14	0,5	-	-	-	-	-
Luxembourg	-	-	0,3	0,8	-	-	-	-	-	-	-	-	-	-
Malta	-	-	-	-	-	-	-	0,1	-	-	-	-	-	-
Netherlands	-	-	-	4	-	-	-	-	14	-	-	9	-	-
Portugal	-	-	11	8	0,9	-	-	4	5	-	5	-	-	-
Slovakia	-	-	-	-	-	-	-	-	8	-	-	-	-	-
Slovenia	-	-	-	-	-	-	-	4	1	0,4	0,3	-	-	-
Spain	-	-	-	-	-	-		154	12	10	4	-	-	-

Source: Own caclculations.