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Policy Brief

How to make the marriage work:
Wedding the Recovery and Resilience Facility and European Semester

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#EuropeanSemester
#EconomicGovernance
#RecoveryInstrument

A year into its existence, the Recovery and Resilience Facility finds itself closely wed to the European Semester. It is a difficult marriage, but it is a marriage made to last. Any debate on the future of the Semester will take place against the backdrop of the RRF experience. And any big future fiscal capacity at the EU level will not come without a Semester-style reform leg. It is therefore crucial to make this marriage work. This policy brief argues that this requires three things: 1) scaling back recommendations under the regular Semester, 2) balancing out the asymmetric powers that the Commission now has over different member states, and 3) striking the right balance between flexibility and enforcement of agreed plans.

Introduction

A year into its existence, **the European Union's (EU) new Recovery and Resilience Facility (RRF) finds itself closely wed with the European Semester.** Recommendations for economic reforms issued under the Semester have become a central feature of RRF conditionality, reporting processes for both procedures are now interlinked, and supervising implementation of national Recovery and Resilience Plans (NRPPs) will be the Semester's key task up to 2026.

This new marriage will not be easy. Over the coming years, the RRF will add teeth to the European Semester but could also replicate some of its long-standing flaws. **Either way, this marriage will have a lasting impact on the ongoing debates on the future of EU economic governance rules:** It is a marriage made to last. Any discussion on possible reforms of the European Semester will now have to take into account the prospect that an RRF-like procedure could well be replicated in the next crisis. And any potential large-scale fiscal capacity at EU level will almost certainly come with a Semester-style reform leg.

It is therefore crucial to make this marriage work. This paper argues that this requires three things: First, scaling back recommendations under the regular Semester in the years to come. Second, making a conscious effort to balance out the asymmetric powers that the Commission now has over different member states. And third, striking a delicate balance between flexibility and enforcement of agreed plans. Here we briefly sketch out how the RRF is integrated into the European Semester and recommend some guiding principles in making it happen as the marriage unfolds.

How the marriage works and why it matters: Integrating the Recovery and Resilience Facility into the European Semester

The European Semester serves to address a central conundrum of the EU: national social, economic, labor market and social policies have a big impact on the EU as a whole. At the same, the EU has little to no say in these policy areas. With the Semester, the EU attempts to address this issue by providing a framework for surveillance and coordination. This is anchored in a set of rules on how to keep budgets in check and address economic imbalances in the EU; its main output is a series of reform recommendations for each member state, which the Commission lays down each year.

A central point of criticism has always been that the Semester lacks credible sticks or carrots to incentivize compliance with its recommendations. The RRF now changes this.

To tap into the €723.8 billion (in current prices) in grants and loans available under the RRF, member states must develop national recovery and resilience plans (NRRP). These rest on two legs. On the one hand, NRRPs must set out in detail milestones and targets on specific investments that will be financed by RRF money. On the other hand, the plans must outline economic reform plans that "effectively address all or a significant subset of challenges identified in the relevant country-specific recommendations" (CSRs) of the European Semester. On this basis, member states can then, up to twice a year, ask for payments as soon as the relevant milestones and targets outlined in the NRRPs have been reached. **Only if the Commission is satisfied with the progress made does it grant the payment request after an opinion of the Economic and Financial Committee.**

Progress on NRRPs and payout of RRF money are, thus, intrinsically linked to implementation of those Semester CSRs included in the NRRPs. To ensure more efficiency in the process and avoid excessive administrative burdens for the member states (for details see also Figure 1), reporting obligations arising from the RRF have been streamlined with the Semester procedures. Under the RRF, member states must, independently of any payment requests, report twice a year on the progress made in achieving their NRRPs. These RRF progress reports are submitted once in April, as part of the National Reform Programs (NRPs) submitted under the Semester, and again in October, when Eurozone member states submit their draft budgetary plans to the Commission. The bilateral exchanges between Commission and member states under the Semester will now be merged with the dialogue on implementing the NRRPs under the RRF.

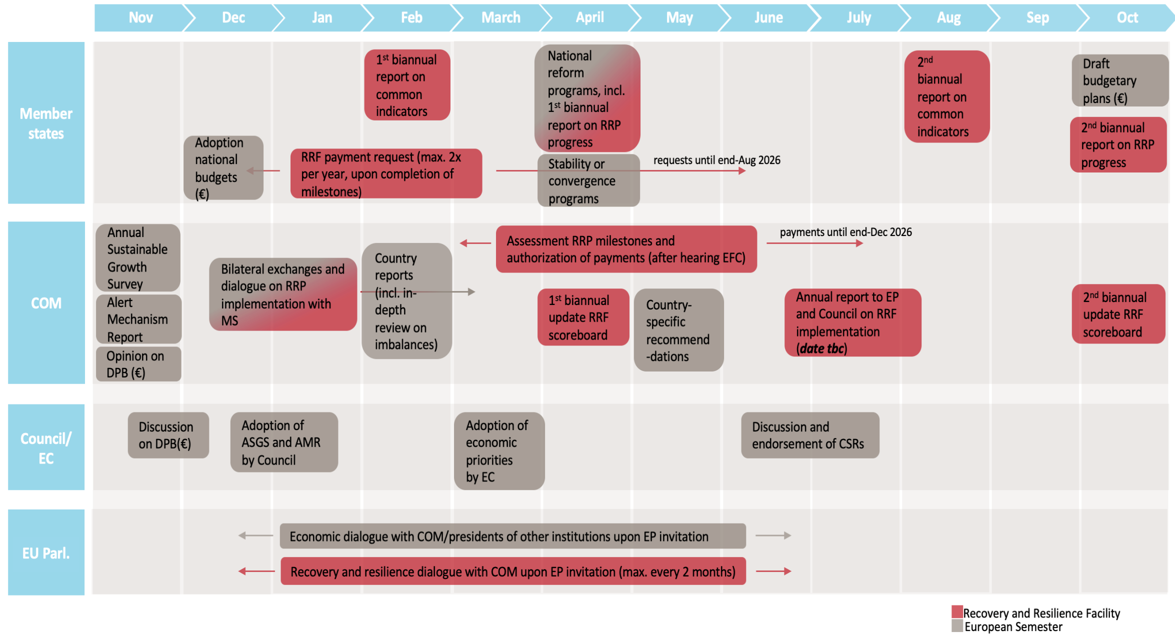

Figure 1 - Integration of Recovery and Resilience Facility into the European Semester

This new marriage between the RRF and the Semester is much more than a convenient formality. **The RRF reform leg will significantly boost the Commission's ability to push some countries into heeding its economic advice in the coming years.** And its impact on the continuing debate about reforming EU economic governance will last long beyond the official expiration date of the procedure in 2026.

On the one hand, a simple return to the pre-RRF Semester in 2026 can be virtually ruled out. The new process substantially increases the leverage of the Commission, makes it possible to incentivize reforms in exchange for money and sets a precedent for how important the Semester's output can turn out to be. This genie is out of the bottle. Any debate on reforming the Semester will now take place against the backdrop of the theoretical possibility that an RRF-like procedure could be replicated in the next crisis.

On the other hand, the decision to marry the RRF and the Semester also means that **any successor instrument for a permanent fiscal capacity at EU level – especially if large sums are involved - will likely come with a reform leg.** The Commission will want to keep its newfound leverage on economic coordination and the member states that have insisted on linking grants (and loans) to reforms are hardly likely to drop such linkage in the future. Ensuring that this marriage works well until at least 2026 becomes all the more important.

How to ensure a successful marriage between the RRF and the European Semester

Three things are necessary to ensure a successful marriage between the RRF and the Semester: First, scaling back recommendations under the regular Semester; second, making a conscious effort to balance out the asymmetric powers that the Commission now has over different member states, and third, striking a reasonable balance between flexibility and enforcement of agreed plans.

Scaling back recommendations under the regular Semester

The RRF introduces a new category of country-specific recommendations. Effectively it makes some CSRs much more binding than others. Of course, even under the regular Semester not all CSRs were equal. Recommendations issued under the Stability and Growth Pact (SGP) and the Macroeconomic Imbalances Procedure (MIP) could – in theory – be followed up with sanctions and fines. However, in practice, fines were never imposed, and European recommendations were often ignored as member states faced neither real sanctions nor incentives to heed Commission advice (see also Figure 2).

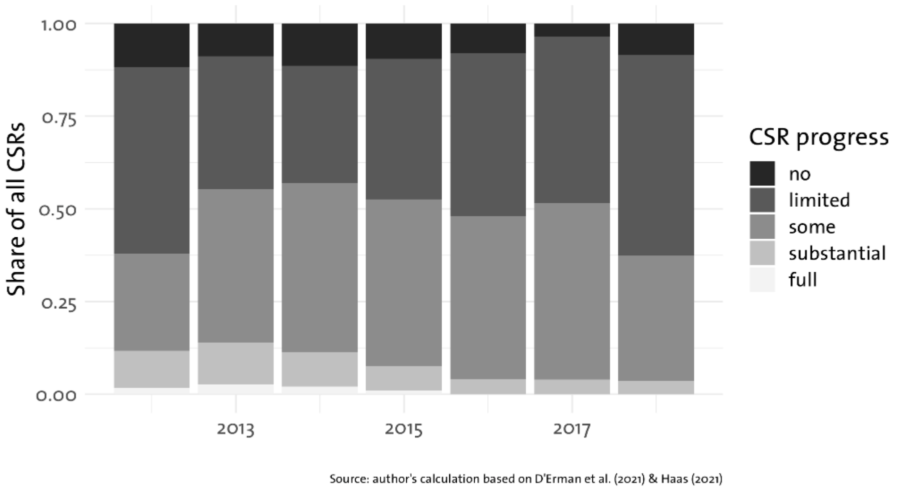

Figure 2 – Development of CSR implementation across all member states according to the Commission's official assessment. For details on the data see D'Erman et al. 2021

This changes with the RRF. The difference henceforth is: For those CSRs that are addressed in the NRRPs governments now must follow implementation agendas and reach specific milestones before they can request additional payments. This also means that in contrast to CSRs issued under the SGP or the MIP, non-compliance with NRRP-CSRs does not trigger a lengthy excessive deficit or imbalance procedure but direct and heavy financial loss. Moreover, **the Commission now has full discretion over its evaluation of milestones and targets and can postpone or cancel RRF payments without needing Council consent.**

This new procedure does not guarantee compliance. Assessing reform progress will remain difficult; some of the plans to address CSRs laid out in the NRRPs are rather vaguely formulated and leave a lot of room for interpretation and, often, the Commission will have to evaluate carefully whether addressing relatively small reform gaps is worth the political row of withholding RRF resources. However, the ability to withhold recovery money does constitute a qualitative shift towards more binding economic coordination.

The big question is what happens to those recommendations that fall outside the NRRPs. In the coming period, any national governments that receive a sizable amount of RRF funds will naturally focus on those CSRs that are addressed in their national plans. If compliance with CSRs stemming from the regular Semester was weak before the RRF, the relative importance of new CSRs outside the RRF will be even lower now that there are reforms with real money attached to them on the table. The same is true for the Commission, which will need to spend lots of time, bureaucratic resources and political capital on making sure that governments comply with the plans, including potential amendments (see below).

To avoid producing recommendations that are bound to be ignored, the Commission should therefore scale down its ambitions about what can be achieved with the Semester outside the RRF. Currently, it plans to return to the regular cycle, issuing new recommendations that focus on long-term reforms and complement the implementation of the RRF. However, given where the political focus will be in the coming years, it should seriously refrain from pushing for additional CSRs – especially outside the SGP and MIP. In essence, the Commission should only issue new recommendations if, at a later stage, it would also be willing to spend political capital on negotiating them into adapted NRRPs (see below on the adaptation process). Apart from that, upcoming European Semester rounds should focus on making sure that NRRPs are implemented and reduce the workload in all other areas.

Balancing out the built-in asymmetries in economic coordination under the RRF

For the next few years, the European Semester will be dominated by implementing the RRF. Potentially, this provides the Commission with a lot of leverage, not only when it comes to implementing fiscal or economic reforms. It can also use this new leverage for policies outside the traditional focus of the European Semester. Discussions in particular about enforcing the rule of law in Poland and Hungary through RRF conditionality highlight the new political reach of EU economic policy coordination. Leveraging large amounts of money to enforce policies beyond the fiscal realm has become a real possibility under the RRF.

However, this new stick is not equally big for all member states. Some countries will come under much more scrutiny than others. For one thing, national RRPs differ. As a rule of thumb, those countries that are eligible for large amounts of loans and grants under the RRF had to develop much more ambitious reform agendas to get Commission approval than those that received smaller sums. Moreover, countries that are more dependent on RRF money in the years ahead will need to ensure they deliver upon their reform promises. Governments in countries that receive little RRF funds or have enough fiscal room for maneuver of their own can ignore the Commission's reform wishes more easily.

The European Semester will, thus, develop a built-in asymmetry. It puts a lot of pressure on some countries and diverts attention from others. As an indicator of what this could mean in practice, Figure 2 plots distribution of recovery funds across member states. The big net recipients such as Italy, Poland, Spain, Romania and other Southern and Central European countries can receive transfers of between about 12 and 4 per cent of their national GDP up to 2026 and are likely to be put under close scrutiny in the process. At the same time, the direct benefits for countries such as Germany, the Netherlands, Austria, or Finland are much more limited and accordingly will play a smaller role in the RRF process.

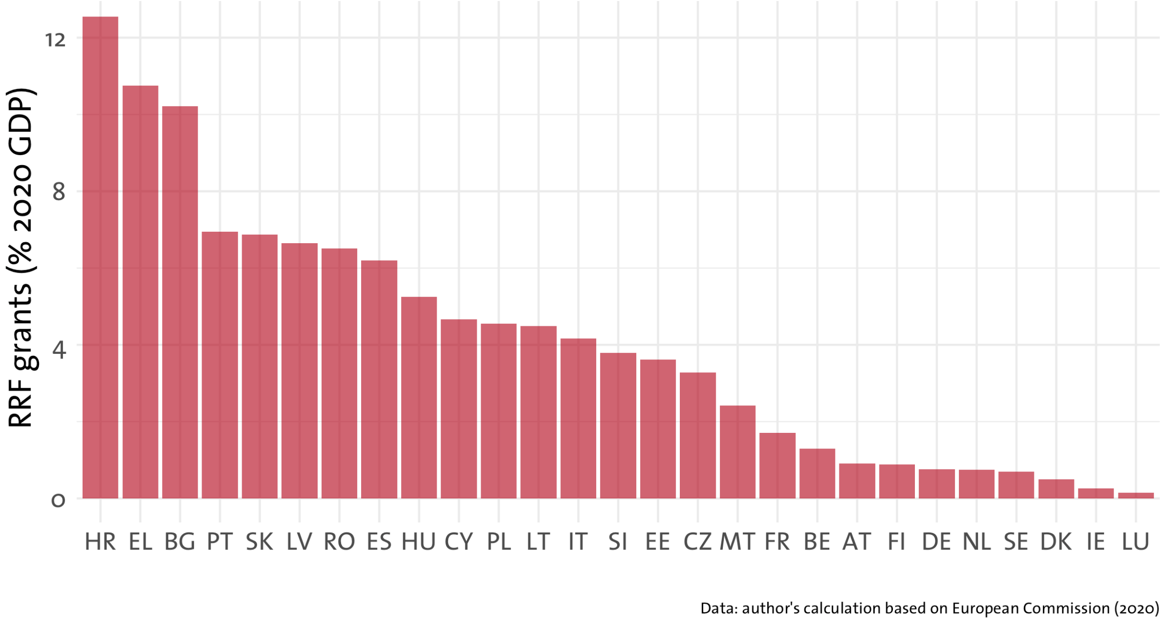

Figure 3 – Differences in overall RRF grants countries are eligible to until the end of 2026 as percentage of 2020 GDP

From a coordination perspective, this can be problematic. This is especially true when reform needs do not square precisely with RRF dependence. For example, out of the 12 countries which the Commission diagnosed as experiencing economic imbalances in the 2021 cycle, only seven now receive above average amounts of the RRF fund (as % of GDP). However, from a financial stability perspective, it could be as important to push for reforms that lead to more investment and consumption in countries with large current account surpluses such as Germany or the Netherlands as it is relevant to make sure that the structural reforms envisioned in the plans of countries like Spain or Greece are implemented.

In the coming years, the Commission will therefore need to make a conscious effort to balance out these asymmetries if and where it can. While a certain level of asymmetry is inherent in the process and cannot be eradicated, the Commission should nevertheless make sure that it treats all countries equally under the RRF. Reform progress in big and fiscally potent member states should be scrutinized as thoroughly as in those that are more dependent on European funds. The RRF's success will ultimately hinge upon the Commission's ability to ensure that EU money flows only in return for credible progress with the agreed reforms, no matter the member states or the sums involved. An impression that reform programs are, yet again, only enforced vis-à-vis those member states that need the money would not only irreparably harm the legitimacy of the RRF process but also upset EU political dynamics. **Therefore, the Commission should spend a lot of political capital on pushing all national governments to follow through with their plans** even if their objective incentives for compliance are lower.

In addition, the Commission may also seek to use both the SGP and the MIP to push for adjustments outside of the RRF. Given the large number of current account surplus countries the latter could be especially useful. While these measures will have less leverage than those within the national plans, pursuing them nonetheless signals that coordination must remain a symmetric effort.

Adapting the NRRPs when needed

The RRF, for the first time, introduces long-term reform and investment plans into the European Semester. Effectively, the NRRPs lay out more or less detailed milestones and targets for each and every investment and reform that member states have committed to undertake by 2026. However, much will happen between now and the final RRF payment. **As the NRRPs will be the key tool for steering economic coordination in the next half decade, a key question is, therefore, whether and under what circumstances NRRPs can and should be adapted.**

Such adaptions may become desirable for three reasons:

- First, some investment projects might not produce the desired results. **Plans for long-term investment projects are bound to change over the years and in a lot of cases it is already clear that the current plans are very unlikely to hold water until 2026.** This affects not only the technical level where specific targets and milestones might need to be changed but also the bigger picture. Down the road some projects will turn to be ineffective or inexecutable. In these cases, European resources are better spent elsewhere.

- Second, European priorities can change. This is true for both investments as well as reforms. Depending on the overall trajectory of the recovery and how the European policy agenda unfolds, some national investments might become more important than others for the EU as a whole. Similarly, new **reform needs can arise within member states that turn out to be particularly pressing from a European perspective.**

- Third, national priorities might change. Much of the current political buy-in from member states rests on the fact that national governments were able to choose a "substantial subset" of CSRs they would implement under the NRRPs. However, **national governments will change over time and new coalitions should be able to set (some of) their own priorities within the corridor of a European reform agenda.**

According to Article 21 of the RRF Regulation, member states can request that their NRRPs are amended if objective circumstances render relevant milestones or targets unachievable. Whether the reasons put forward justify such an amendment is at Commission discretion. **If member states want to amend their plans, this will come down to a political bargain between national governments and the Commission about whether and how NRRPs can be changed.** Critically, the Commission's guidelines on the NRRPs state that member states should *in particular* look at the CSRs from the 2019 and 2020 cycle when designing their plans. However, from a legal perspective there is nothing that keeps the Commission and member states from adding other reforms.

The Commission should use the leeway it has here. The RRF is a unique and, so far, temporary opportunity to bring about real progress in areas where national and European investment and reform priorities overlap. The European Semester will serve as the framework to discuss the necessary amendments to NRRPs to achieve such overlap. **To make sure that its capacity for economic steering is fully realized, the RRF will need some flexibility when these priorities change on either side of the equation.** Crucially, given that European resources are at stake it is also clear that in such instances European priorities must trump national ones. However, striking the right balance between flexibility and enforcement will be an important and politically tricky task for the Commission in the coming years.

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Way forward: A marriage made to last

The marriage between the RRF and the European Semester is made to last. In the long run, it will open new questions. The RRF can incentivize reforms through the big carrot of a lot of additional money. Whether member states would be willing to go through similar reform hoops if future fiscal capacities leave the EU with considerably fewer resources to distribute is one of these questions.

In any case, this marriage has fundamentally shifted the contours of the ongoing debate about the future of EU economic governance: **Tinkering at the margins of the process is no longer an option.** Any discussion about the future of the European Semester from now on needs to be linked to a debate about the future of a European fiscal capacity. And vice versa.

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