Box 9. Next Generation EU: driving economic recovery and supporting fiscal consolidation

The Next Generation EU (NGEU) programme is one of the solutions put forth by European authorities to facilitate a swift and sustainable economic recovery following the adverse socio-economic effects induced by the COVID-19 pandemic and, at the same time, to increase the EU economies' resilience to external shocks. The first formal steps to access recovery funds had already been taken by end-2021. However, this process is expected to speed up amid further relatively high uncertainty caused by the persistence of the public health crisis and, more recently, by Russia's invasion of Ukraine.

This box aims to contextualise the role of the new NGEU programme in fiscal consolidation. This process is necessary given the ongoing excessive deficit procedure initiated against Romania, which is due for completion in 2024, and it could be spurred by a favourable impact on the macroeconomic framework and/ or by the access to cost-effective financing via the absorption of European funds allocated under the Next Generation EU programme.

Romania and the economic recovery package

Shortly after the outbreak of the public health crisis, both national and supranational authorities reacted promptly to contain the adverse effects of the pandemic. In 2020, the European Commission (EC) proposed, for the first time ever, to activate the general escape clause in the Stability and Growth Pact (SGP), allowing EU Member States to manage the pandemic through uncapped spending, even amid a temporary overshooting of the budget deficit targets set out in the SGP. Furthermore, in order to boost economic activity, especially given the unexpectedly strong negative effects of the health crisis, European officials agreed to establish the NGEU recovery package.

Its aim is to increase the resilience of EU countries, with a particular focus on fair climate and digital transitions. Under the Recovery and Resilience Facility (RRF), i.e. the NGEU instrument with the largest allocations[1], the approval of the National Recovery and Resilience Plans (NRRPs) whereby projects were proposed for financing was contingent on assigning at least 37 percent and 20 percent of allocated funds to climate objectives and digitalisation, respectively. All EU countries with already approved national plans have complied with these requirements. The highest shares of funds earmarked for meeting the climate target were seen in Austria, Bulgaria, Denmark, Luxembourg and Malta, whose NRRPs provide that more than 50 percent of the RRF funds should be assigned to the transition to a green economy. As regards digitalisation, Austria and Germany are well ahead of the rest of the countries (Chart A).

[1] In the case of Romania, the RRF allocation accounts for around 90 percent of total NGEU funds. Similar developments have been recorded in the other countries benefitting from NGEU funds.

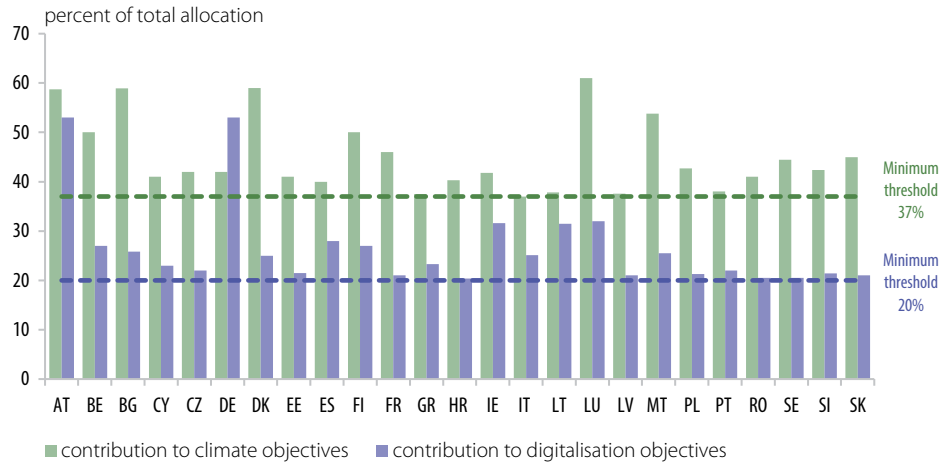


Chart A
Share of RRF spending on climate and digitalisation objectives

Source: European Commission, NBR calculations

Romania's NRRP provides for the allocation of 41 percent of the EUR 29.2 billion[2] to climate objectives. In the spotlight are sustainable transport and energy efficiency. Moreover, Romania contributes 20.5 percent to digitalisation objectives, largely focusing on e-governance, digital public services and digital technology projects.

The EU Council approved Romania's NRRP in October 2021 and pre-financing for RRF grants had been disbursed by end-2021, shortly ahead of pre-financing for loans[3]. Disbursement requests to the EC are to be submitted twice a year and will be met based on the status of fulfilment of targets and milestones set by the authorities under the NRRP. According to EC data, Romania's NRRP has 215 targets and 292 milestones for reforms and investment, respectively.

Despite being the recipient of nearly all financial allocations, the RRF is not the only instrument targeting climate and digital objectives. REACT-EU is another programme under the NGEU. Out of Romania's total allocation of around EUR 1.5 billion, about 16 percent are earmarked for the green transition and approximately 6 percent for digitalisation, close to the European average.

Overall, the NGEU is expected to contribute to robust economic growth, along with improved economic resilience. However, the magnitude and persistence of the positive effects generated by this programme depend on the type of investment being financed (Valenta *et al.*, 2021). Moreover, the literature points to possible spillover effects and significant second-round effects. Pfeiffer *et al.* (2021) emphasise that these could increase the overall impact of NGEU funds by up to one third. Picek (2020) stresses the importance of coordination between Member States in the implementation of NGEU-funded projects. In order to maximise potential spillover effects, it is essential that Member States also adopt stimulus measures to boost the economy.

2 This amount is to be reassessed in accordance with Article 11(2) of Regulation (EU) 2021/241 of the European Parliament and of the Council of 12 February 2021 establishing the Recovery and Resilience Facility. In calculating the maximum financial contribution, the data from the European Commission Autumn 2020 forecast are to be replaced by the actual outturns.

3 Pre-financing for grants was disbursed in early December 2021 and that for loans in January 2022.

The NBR's in-house assessments of the impact on Romania's macroeconomic parameters rely on its Model for Analysis and Medium-Term Forecasting (MAMTF), complemented by a number of expert judgments and assumptions[4]. Against the backdrop of the ongoing fiscal consolidation, attracting a relatively larger volume of substitutive loans is assessed as more likely to materialise. Their impact on the budget deficit will be favourable, whereas that on the macroeconomic framework relative to a baseline scenario excluding financing from NGEU resources would be limited, given the substitution of investment projects that were already due for funding (mainly from domestic budgetary sources). Another influence on the magnitude of the NGEU's effects comes from the phasing of investment projects. Specifically, early implementation of eligible projects would lead to gradually larger spillovers over time and thus to a greater economic impact throughout the whole period (2022-2026). By contrast, in the event of a disorderly transition, the authorities could become overly eager to spend the allocated budget, while the implemented projects would not necessarily make a significant contribution to economic growth owing to their low efficiency.

The latest assessments carried out by the NBR based on the information available at the time of the simulations show a more than 4-percentage point cumulative impact of NGEU funds on economic growth 2021 through 2026, including spillover effects. In 2022-2023, the impact is estimated at around 1.4 percentage points, but wider-ranging effects cannot be excluded, especially in the event of implementing highly complex projects and ensuring their smooth financing[5].

Against this backdrop, a revival of economic activity is, *ceteris paribus*, expected. On the one hand, gross capital formation would experience the most significant changes. Both green and digital transition projects are assessed to improve the growth potential of the economy. On the other hand, the recovery of economic activity will also be supported by a swifter increase in consumption amid households' real disposable income picking up as a result of the boost in economic activity.

Romania in the context of the excessive deficit procedure

Hence, Romania has a unique opportunity to increase the volume and share of investment in the economy. Moreover, according to the stated purpose of the NGEU programme, support is facilitated for the sectors most affected by the COVID-19 pandemic. At the same time, however, further fiscal consolidation is needed. Following the 2019 fiscal slippage, which occurred before the onset of the public health crisis, in March 2020 European officials took the first formal steps in the excessive deficit procedure initiated against Romania[6]. Although 2022 was the initial deadline set by the EU Council for reducing the ESA budget deficit below

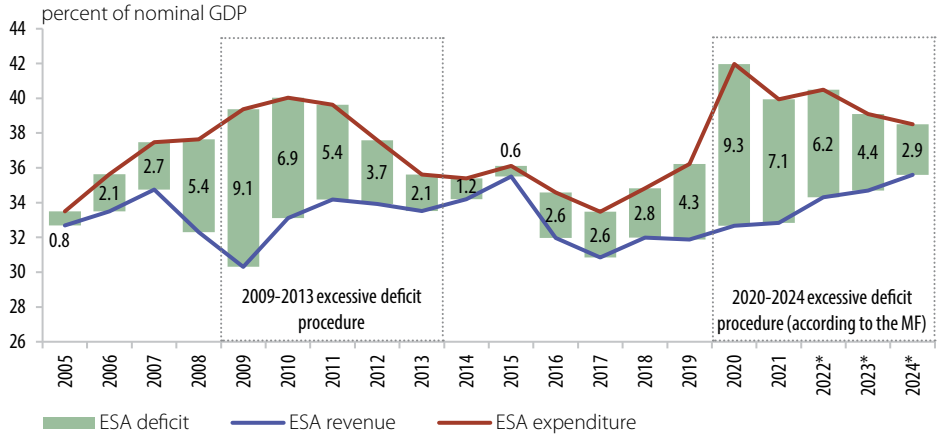
4 Both direct and spillover effects were considered. For further details on multipliers of EU funds, see Box 1 "Assessment of the impact of the EU structural and cohesion funds on economic growth" in the 2018 *Annual Report*.

5 For alternative scenarios on the impact of EU funds, see Box 3 "Next Generation EU: prospects for a swift economic recovery" in the 2020 *Annual Report*. It also depicts the main effects on the broader macroeconomic framework.

6 In 2020, the activation of the general escape clause in the Stability and Growth Pact had no impact on this process, given that the ESA budget deficit had exceeded the 3 percent-of-GDP threshold as early as 2019.

the 3 percent-of-GDP threshold, the extraordinary macroeconomic context, marked by the adverse economic effects of the COVID-19 pandemic, led to an extension of this deadline to 2024[7].

The Convergence Programme for the 2022-2025 period outlines the budget deficit adjustment path, in line with the European Commission's recommendations (Chart B). The deficit figures are also confirmed by the Fiscal and Budget Strategy for the period of 2022-2024. Fiscal consolidation is expected to be achieved largely by reducing the government expenditure-to-GDP ratio. In this regard, significant savings are projected for staff costs and intermediate consumption expenditure. As for revenues, following a rise foreseen for 2022, they are anticipated to witness marginal increases. Nevertheless, the budget deficit adjustment path could be hampered by a number of factors such as the management of the energy crisis or the escalation of military conflicts.



*) MF projections according to the 2022-2025 Convergence Programme

Source: Eurostat, 2022-2025 Convergence Programme, NBR calculations

Chart B
Developments in the budget deficit – historical data and outlook

This is not the first time Romania has been subject to the excessive deficit procedure. Due to the drastic revenue shortfall amid the 2008 financial crisis, the budget deficit surged from 2.7 percent of GDP in 2007 to 5.4 percent of GDP in 2008, leading to the opening of this procedure against Romania in 2009. The return to values below the 3 percent-of-GDP threshold materialised in 2013. This owed to both a rebound in revenues and a lower expenditure-to-GDP ratio.

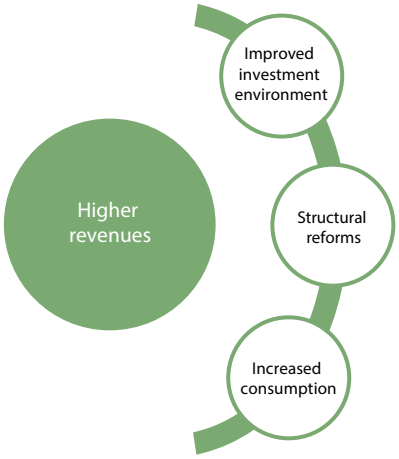
Interaction between the NGEU and the excessive deficit procedure – to what extent can the fiscal consolidation process be supported?

Compliance with the proposed budget deficit targets becomes all the more necessary as access to financing on international markets is expected to turn more difficult for countries with larger and persistent imbalances. Given the rapid normalisation of monetary policy, amid a significant rise in the annual inflation rate, emerging economies in need of large external funds may face increasingly high

[7] For more details on the European Commission's recommendations, see: https://ec.europa.eu/info/sites/default/files/economy-finance/com-2021-530-1_en_act_part1_v3.pdf

financing costs. In addition, any deviation from the adjustment path Romania has committed itself to in the context of the excessive deficit procedure appears to be vital from the perspective of the regular assessments of the sovereign credit rating.

Chart C
Potential revenue-boosting channels



Source: NBR assessments

As illustrated above, the implementation of NGEU-funded projects is likely to contribute to a swift economic recovery. The absorption of these funds would brighten the macroeconomic picture, which would also imply more budget revenues via several channels (Chart C).

On the one hand, the rise in investment, fostered by accessing NGEU funds, could generate new jobs, causing both revenues from payroll taxes and social contributions collected to the general government budget to go up. Such developments could also be driven by wage increases, amid a possible re-emergence of labour shortages, particularly in certain sectors, such as those involving the transition to a green economy or a high level of digitalisation. Moreover, an improved investment environment would also have a favourable impact on firms in the market, enhancing their performance and profitability and implicitly the resources transferred to the government budget.

Furthermore, the implementation of NGEU funds is assessed to exert a positive impact on consumption. In this context, higher indirect taxes could contribute to narrowing the budget deficit as non-government consumption picks up.

Structural reforms are anticipated to have beneficial effects on the economy as a whole. They are designed to improve the economy's output potential, inter alia by alleviating external and domestic vulnerabilities in a lasting manner. With regard to the budget deficit, the fast-paced implementation of reforms could help increase taxpayers' compliance. Implementation of structural reforms, particularly in the fiscal area, could boost revenue collection, contributing also to improved voluntary tax compliance.

On the other hand, the government deficit is also subject to opposite influences, but these are smaller in quantitative terms as compared with the direct positive effects and the spillover effects associated with NGEU funds. Insofar as loans, i.e. the repayable component of the RRF, are additive, they will put more pressure on the budget balance, which will be partly offset by the more favourable macroeconomic prospects. There is, however, an opportunity for low-cost financing, a particular feature of the RRF, in line with the need to boost economic activity. Therefore, accessing loans is desirable as well, especially if they have a substitutive nature[8].

[8] They finance investment projects that should have been supported from other sources in the absence of the NGEU. In this context, the budgetary impact relative to a baseline scenario excluding NGEU financing is rather small in terms of government deficit (possible influences coming from the volume of interest expenditure).

In conclusion, the investment projects and reforms financed by the NGEU programme underpin a swift economic recovery. At the current juncture, given the increase in risks and, in particular, uncertainties surrounding future economic developments, early access to NGEU funds should be a priority. From this perspective, strict compliance with the RRF targets and milestones takes on a new dimension, given the high stakes of both economic recovery and the possible beneficial influence on fiscal consolidation.

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