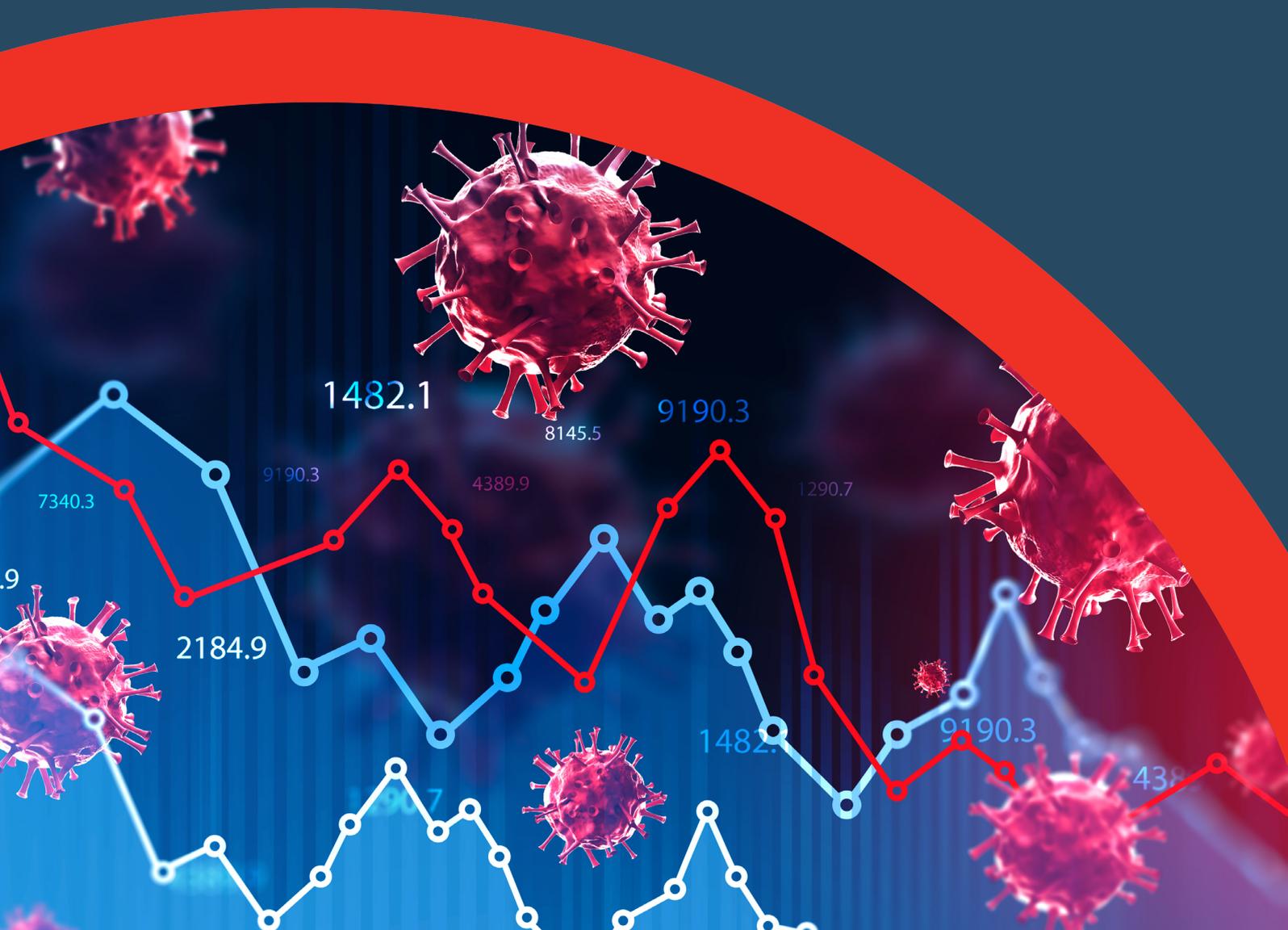


# NAVIGATING THE COLOSSAL ECONOMIC RESPONSE TO COVID-19 IN EUROPE: A V4 PERSPECTIVE

Policy Brief

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## NATIONAL FISCAL IMPULSE IN THE EARLY ABSENCE OF A COMMON PAN-EUROPEAN APPROACH

Immediate fallout from the pandemic has been met with short-term fixes to keep economies humming at a low grade until the virus outbreaks are contained. In the absence of a shared pan-European fiscal response at the early pandemic stage, many EU Members States resorted to discretionary fiscal action. V4 is no exception. The Czech Republic, Hungary, Poland and Slovakia have utilized fiscal space<sup>1</sup> to tackle the fallouts from the coronavirus crisis, which took toll beyond the initial manufacturing sector disturbance. Cross-country differences in magnitudes of covid-19's fallout will have varied depending on the length and strictness of lockdown measures imposed, but also depending on structural factors, such as their regional value chain resilience and the value-added of the services sector, which nosedived all across the board.

The V4 leaders have responded with a various calibration of policies targeting firms and workers, as well as some financial, liquidity, tax and social provisions. All V4 economies have introduced wage compensation schemes for businesses and the self-employed, tax and/or social contributions payment deferrals or exempts, state guarantees to secure liquidity, and have expanded healthcare funding (Table A). These measures will be likely financed by a mix of sources, including deferring, and/or reallocating some expenditures, new borrowing and deposits. In any case, restoring fiscal headroom will be challenging post-corona, and the question how to foster the recovery – as key economic actors, including households, firms, and sovereigns may face balance sheet recessions – goes beyond the capacity of national policy.

**Table A. V4 Economies' Pandemic-related Fiscal Discretionary Measures<sup>2</sup>**

Category	Pandemic-related discretionary fiscal measures (broad description)	Slovakia	Czechia	Poland	Hungary
FIRMS	Wage compensations/subsidies for firms and self-employed	x	x	x	x
FIRMS	Health insurance, social security (temporary) waivers/subsidies	x		x	x
FIRMS	Easing administrative burden on businesses, relaxing labor code	x			
TAX	Deferral of payroll and corporate tax payments for firms, penalty waivers	x	x	x	x
TAX	Tax deduction of this year's losses / allowing inclusion of loss carryback	x		x	
TAX	Small business tax exempt/waivers or sector-specific exemptions				x
EMP	Extension of unemployment benefits for affected workers	x			
EMP	Kurzarbeit (short-work scheme) / wage compensation per employee	x			
EMP	Subsidies for individuals without income or cash support for retired	x			x
FINANCIAL	Loan payment deferrals	x	x		
FINANCIAL	Rent payment moratorium	x	x		
LIQUIDITY	State guarantee programmes	x	x		x
LIQUIDITY	New business micro-loans, liquidity loans			x	
SOCIAL	Healthcare sector worker bonus		x		
SOCIAL	Parent allowance of young children related to school closures			x	
<b>Fiscal Impulse in % of GDP</b>		<b>0,30 %</b>	<b>2,00 %</b>	<b>6,50 %</b>	<b>0,39 %</b>

Sources: For measures IMF Policy Tracker, <https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19#H>; for Fiscal Impulse estimates: Ceyhun Elgin, Gokce Basbug and Abdullah Yalaman 'Economic policy responses to a pandemic: Developing the Covid-19 economic stimulus index', CEPR Covid Economics Vetted and Real-time Papers Issue 3: April 10 2020, Available at: <https://cepr.org/content/covid-economics-vetted-and-real-time-papers-0>

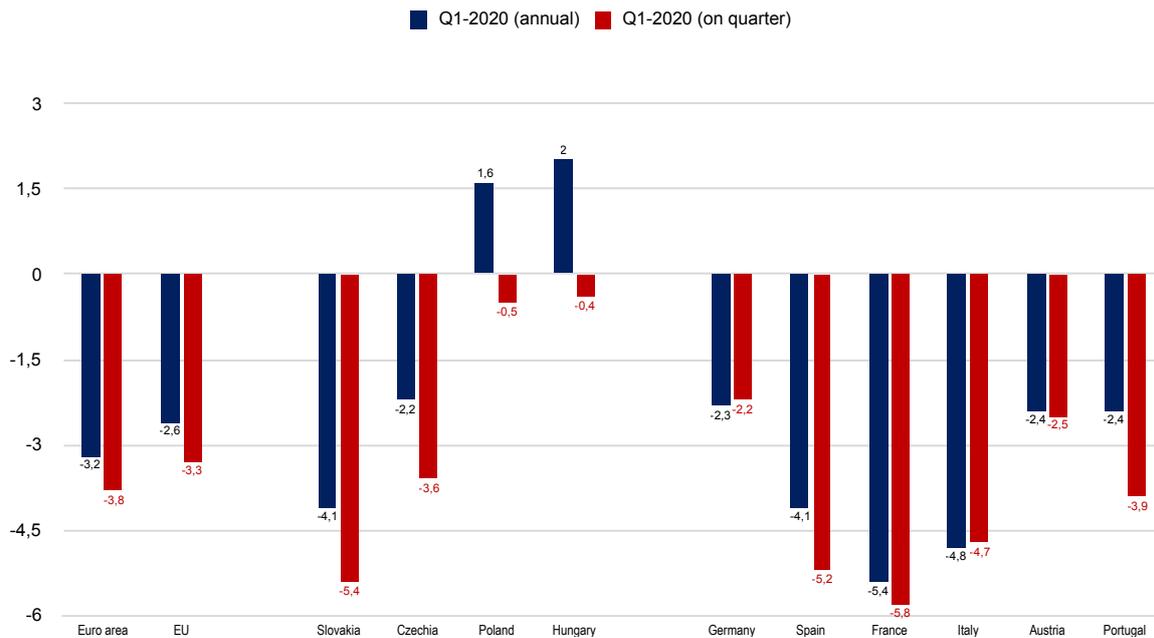
Notwithstanding national economic policy efforts, a violent double-digit contraction is expected in Q2-2020. In the meantime, the European statistical office, Eurostat, has published preliminary Q1-2020 GDP growth estimates for European major markets, as well as V4. Taking Slovakia as a case study, based on its implied performance in the first three months of the year, it would seem that the link between successfully containing the virus and placing the economy into a standstill (i.e. the tradeoff between managing the sanitary and economic crisis), holds. Slovakia managed<sup>3</sup> the corona virus outbreak extraordinarily well, with lowest per capita death rate in the region and in Europe, but as the preliminary data suggest, at a sizeable economic cost. Its economy seems to have taken the deepest dive in the V4 region, measured on both, annual and quarterly bases (Figure 1).

<sup>1</sup> Budgetary room that allows a government to provide resources for public purposes without undermining fiscal sustainability

<sup>2</sup> Fiscal measures of May 20, 2020. The list may not be exhaustive. Measures are described broadly; each country's calibration may differ in scope and size. Immediate fiscal impulse estimates have cut-off dates as of April 1, 2020 and include direct measures. For methodology, consult the primary source.

<sup>3</sup> <https://www.bloomberg.com/news/articles/2020-04-28/european-nation-with-least-virus-deaths-proves-speed-is-key>

Figure 1. The Estimated Pandemic Bill for Q1-2020



Source: Eurostat.

Though, some leaders<sup>4</sup>, including OECD Secretary General and others<sup>5</sup> have argued that it is ‘a false dilemma to have to choose between lives and livelihoods’. Admittedly, such dilemma may be short-lived, and may increasingly fizzle as economies get geared up for becoming pandemic-proof (i.e. operational even in the future instances of outbreaks and physical lockdowns). But profound structural change takes political commitment and time, so the ‘dilemma’ may have had economic merit in the short run.

The country-specific structural makeup, however, may partly explain some differences in fallouts across V4, in addition to the lockdown measures. For example, recent Penn World Tables data<sup>6</sup> suggest that Slovakia is the most open<sup>7</sup> economy in the V4 region. This means, it is also most vulnerable to economic and supply chain distortions in its external environment. Relative performance on the digital front does not seem to explain the divergent fallouts of the coronavirus on V4, as Slovakia seems to outperform<sup>8</sup> both, Hungary and Poland. The OECD digital data<sup>9</sup> toolkit is also inconclusive. Both data sources rather suggest that the V4 region has a lot of catching up to do in terms of going digital, both vis-à-vis EU27 and the OECD average.

## NAVIGATING THE EUROPEAN RESPONSE

The consensus converges around the notion that national discretionary measures are insufficient. Most leaders have agreed that the common, systemic, symmetrical shock – albeit with asymmetrical outcomes – requires a common European response. What they could not agree on was the size and shape of the common response package, stalling on the ‘corona-bond’ issue. The hardest hit ‘southern’ countries – which have included Italy, Spain and France – demanded a mutualized fiscal instrument collectively issued and backed by all euro area countries to finance the recovery.

**“If Europe does not rise to this unprecedented challenge, the whole European structure loses its raison d’être to the people. We are at a critical point in European history.”**

**Italy’s prime minister, Giuseppe Conte**

The idea behind a ‘corona-bond’ is simple. By pooling risk, hardest-hit countries, such as Italy, would benefit from the financial rectitude of prudent countries like Germany. Of the funds raised in the markets, the lion’s share would be received by the hardest-hit countries but at lower rates of interest than they would have to pay if they were

4 <https://www.france24.com/en/business/20200518-covid-19-oecd-chief-says-it-s-a-false-dilemma-to-say-choice-between-lives-and-livelihoods>

5 <https://www.forbes.com/sites/joshuacohen/2020/03/26/tradeoff-between-public-health-measures-targeting-covid-19-and-the-economy-is-a-false-dichotomy/>

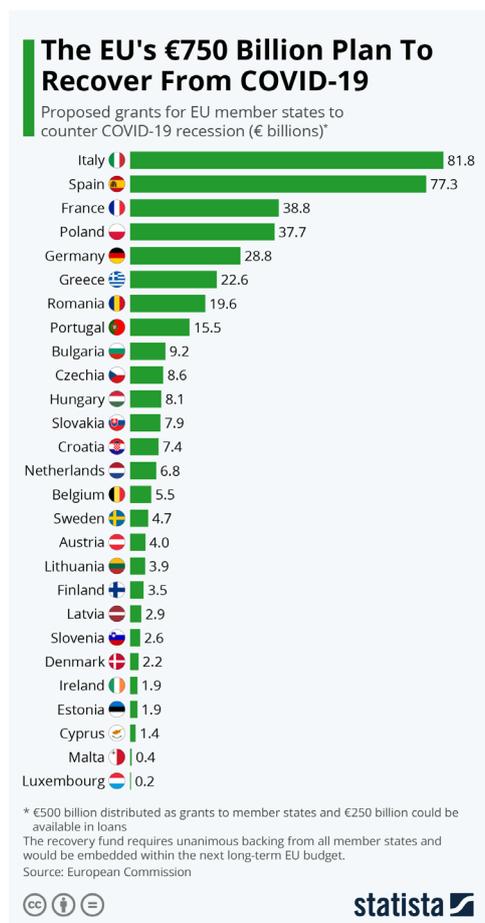
6 [https://ourworldindata.org/grapher/trade-openness#:~:text=Trade%20Openness,that%20country's%20GDP%20\(in%20%25\).](https://ourworldindata.org/grapher/trade-openness#:~:text=Trade%20Openness,that%20country's%20GDP%20(in%20%25).)

7 Trade openness is measured as the sum of a country’s exports and imports as a share of that country’s GDP

8 <https://ec.europa.eu/digital-single-market/en/desi>

9 <https://goingdigital.oecd.org/en/>

Figure 2



issuing their own sovereign bonds. Lower borrowing costs for Europe's most affected would help prevent another sovereign debt crisis, freeing up much needed funds to facilitate recovery.

The 'frugal' countries (initially led by Germany, Austria, Netherlands, Sweden, Finland) – who promote lower EU spending and tight fiscal discipline – have been categorically opposed to the 'corona-bond' and its adaptations. This has been mostly on the notorious grounds of moral hazard that have hampered efforts towards a common fiscal mechanism in past crises. It is the basic idea that pooling risk encourages irresponsible spending, and fiscally conservative countries end up financing reckless spending of others. Moreover, in frugal countries, it is politically toxic and possibly unconstitutional to fund Italian or Spanish debts with German or Austrian taxpayers' money. It has been hotly debated whether the moral hazard reasoning holds up under the circumstances like these, brought forward by the coronacrisis, where all countries have been symmetrically hit by the shock. If the 'corona-bond' was to be institutionalized and used as a one-off (i.e. only for the corona-related crisis), the moral hazard argument dissolves. This is because the economic adversity and related money transfers within the Union do not result from fiscal negligence or recklessness that fueled a macroeconomic imbalance and backfired, but from an exogenous symmetric and systemic shock.

Nonetheless, by setting the 'corona-bond' issue aside, on April 9, EU leaders arrived at a €500bn compromise deal<sup>10</sup> consisting of safety nets in total amount of €240 bn for Eurozone's overwhelmed healthcare systems under the umbrella of European Sta-

bility Mechanism (ESM), the bailout fund generated by the eurozone debt crisis. The €100 bn fund called SURE<sup>11</sup> has been made available to keep EU jobs and businesses afloat, while SMEs are to be aided by an EU-wide loan scheme, as well as the European Investment Bank (EIB) loan guarantees<sup>12</sup>. The 'corona-bond' issue ultimately climaxed in the Franco-German proposal, marked by surprising turnaround of frugal Germany on the issue, which some have called the EU's Hamiltonian moment<sup>13</sup>. Hamiltonian or not, the proposal crosses lines never crossed on several fronts, potentially increasing the firepower of EU's policy toolkit and the flexibility of EU fiscal policy, and maybe marking the beginning of a new European chapter leaned toward fiscal federation. Here is where the lines have been crossed towards an uncharted territory:

- ▶ It proposes grants over loans as a form of financing (i.e. cash transfers)
- ▶ It involves common issuance of EU debt guaranteed by its own budget/revenues<sup>14</sup>
- ▶ It entails new sources of EU joint tax revenues (i.e. EU will need to levy new taxes on its own account) stemming from activities that transcend national boundaries, such as carbon dioxide emissions, financial and digital transactions

Responding with a counterproposal, the frugals vehemently objected to grants over loans and favored a strings attached approach, quoting structural reform conditionality<sup>15</sup> and rule of law conditionality<sup>16</sup>. European Commission Chief Ursula von der Leyen followed the Franco-German suit on May 27 by unveiling even bigger, €750 bn recov-

10 <https://www.consilium.europa.eu/en/press/press-releases/2020/04/09/report-on-the-comprehensive-economic-policy-response-to-the-covid-19-pandemic/>

11 [https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-financial-assistance/loan-programmes/sure\\_en](https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-financial-assistance/loan-programmes/sure_en)

12 <https://www.eib.org/en/about/initiatives/covid-19-response/index.htm>

13 <https://www.businesstimes.com.sg/opinion/franco-german-proposal-can-be-europes-hamiltonian-moment>

14 This is as opposed to backed by all Member States budgets, using funds raised by national governments, like in case of 'corona-bond' proposals

15 The idea that loan/grant recipients should have to carry out structural reforms to make their economies more resilient

16 Linking the MFF fund disbursement to addressing deficiencies in rule of law "as including in particular endangering the independence of judiciary, failing to prevent, correct and sanction arbitrary or unlawful decisions by public authorities, and limiting the availability and effectiveness of legal remedies". Full text available at: <https://www.europarl.europa.eu/legislative-train/theme-new-boost-for-jobs-growth-and-investment/file-mff-protection-of-eu-budget-in-case-of-rule-of-law-deficiencies>

ery fund proposal<sup>17</sup>, coined *Next Generation EU*, involving both forms of financing, €500 bn in the form of grants and €250 bn as loans. This is on the top of the proposed EUR 1.1 trillion under Multiannual Financial Framework (MFF). The plan also emphasizes EU policy priorities surrounding healthcare, energy transition, and digital policy. Potential country allocations are presented in Figure 2.

## V4 REACTION TO THE RECOVERY FUND PROPOSAL

The V4 region took a ‘semi-frugal’<sup>18</sup> stance, generally supporting the initiative but voicing reservations. Poland, which urged Commission to have an ambitious budget earlier, and the region’s top beneficiary, called<sup>19</sup> the plan ‘a success’. Slovakia got behind the proposal but shared the frugal countries’ interest in linking funds to structural economic reforms. Slovak Foreign Minister Ivan Korčok called<sup>20</sup> for fiscal responsibility and for all countries to be able to access the new funds. Hungary was, to the contrary, least satisfied. Hungarian prime minister Orbán labeled<sup>21</sup> von der Leyen’s proposal ‘absurd and perverse’, as rich countries would get financed by the poor as a result. Czech leaders expressed<sup>22</sup> that less developed EU economies should retain access to same volumes of funding as in current programming period and stressed the importance of cohesion and investment funds in the traditional sectors.

As a starting point, it is essential that V4 leaders treat the aftermath of the pandemic at its face value – as an EU-assisted opportunity to heal the dents in their economies made by the coronavirus and rebuild for future prosperity. This is as opposed to hijacking the EU joint recovery efforts to force a parallel agenda. A balanced approach between grants and loans that Europe can get behind may aid the stability of the shared solution. As previously mentioned, resilience-strengthening structural reforms are overdue in the V4 region and beyond, whether linked to fund disbursement or not. A degree of economic reform conditionality – despite receiving ‘bad rap’ in past crises – may be hence warranted. The EU policy priorities, moreover, stressed by the von der Leyen plan, check all the boxes where V4 countries must make progress on if they want to become more prosperous and resilient, including improving the quality, efficiency, and expanding the capacity of its healthcare systems, enhancing its digital economies, and zooming onto to the quality of its growth – steering away from pre-corona model towards a green growth strategy.

Conditionality linked to the rule of law (RoL), is, of course, a result of the culmination of a series of past events and a longer standing meddling of the EU with some controversial decisions, notably, taken in Hungary and Poland, including<sup>23</sup> concerning judiciary reforms and other forms of democratic deterioration. Importantly, if RoL conditionality is institutionalized, some V4 countries may not be eligible for these new funds, unless they comply with EU’s RoL demands. It goes without saying that rule of law and democratic institutions constitute EU’s basic philosophical underpinnings, and EU unites its like-minded Members under the umbrella of such core values. It is thus essential that the EU has its house in order to that end, and heralds them on the inside and out. It is EU’s enduring soft power, its building bloc, and something not to be eroded. On the economics side, it is an empirically-backed longstanding economic commandment<sup>24</sup> that good governance produces superior economic outcomes.

If the long-yearned-for nexus between EU budget funding and RoL conditionality comes to fruition in the corona context, however, it is vital that Member States undergo equal and transparent procedures – be it peer reviews or other formats – and the comprehensive evaluations of each Member State’s RoL standing is based on a measurable, quantifiable and credible indicator. It is not clear that the EU has such symmetrical mechanism readily at its disposal under current circumstances, and that the RoL conditionality can be operationalized in the context of the next MFF. In any case, such initiative, if carried out as outlined earlier, has the power to unite and strengthen the very foundation of the EU.

17 [https://ec.europa.eu/info/files/eu-budget-powering-recovery-plan-europe\\_en](https://ec.europa.eu/info/files/eu-budget-powering-recovery-plan-europe_en)

18 <https://visegradinsight.eu/the-other-frugal-four-v4-eu-budget/>

19 <https://www.euractiv.com/section/politics/news/how-eu-member-states-reacted-to-the-commissions-recovery-fund-proposal/>

20 <https://www.politico.eu/article/franco-german-recovery-deal-meets-resistance/>

21 <https://www.politico.eu/article/viktor-orban-eu-recovery-fund-plan-absurd/>

22 <https://www.euractiv.com/section/politics/news/how-eu-member-states-reacted-to-the-commissions-recovery-fund-proposal/>

23 [https://www.europarl.europa.eu/thinktank/en/document.html?reference=EPRS\\_BRI\(2018\)621869](https://www.europarl.europa.eu/thinktank/en/document.html?reference=EPRS_BRI(2018)621869)

24 <https://www.worldbank.org/en/topic/governance/overview>