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Borrowing in the European Union: from a pure national model to the antechamber of a European fiscal federal solution

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ABSTRACT

In this article, the author presents the evolution in the European Union of different borrowing models going through a path which starts out with a purely national model, passes through stages of hybrid (national and European) models, to reach the final stage, a purely European model. The European Union is being pushed, after the Sovereign Debt and the COVID-19 crises, to move from pure national borrowing models to new hybrid ones, starting with the proposals for the creation of Eurobonds and safe assets in the aftermath of the former crisis and evolving with this latter crisis to a European hybrid solution, notably with the package Next Generation EU. Here, European Commission borrowing capacity is fully recognised as a way to finance EU expenditures to be eventually backed up by new own tax resources. This decision is considered as an antechamber of a European fiscal federal solution.

1. Introduction

27 May 2020 will be remembered as the day when the ‘Pandora’s box’ of fiscal federalism was opened at the European Union (EU) level, and when the construction of a fiscal union, side by side with a monetary union, was implicitly admitted at the highest level, the level of the European Commission (EC). Indeed, the EC – as a major response to the economic and social impacts of the COVID-19 crisis – presented a proposal for the creation of a new recovery instrument named ‘Next Generation EU’, which can be described as an ‘Alexander Hamilton moment at the EU level’, but which also meant that history repeats itself: once again, we can say that the intensifying of European integration has over the years been favoured by moments of crisis – what is usually labelled as the ‘Monet curse’ (SCHELKLE 2017).

This new instrument will be interlinked with the EU budget, through the next Multiannual Financial Framework, MFF (2021–2027) and so the total financial firepower of the EU budget would rise to €1.85 trillion (the equivalent to 2% of EU Gross National Income, GNI), combining the €750 billion associated with the ‘Next Generation EU’

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1Portuguese Public Finance Council (CFP).

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instrument with targeted reinforcements to the MFF 2021–2027. The ‘Next Generation EU’ (NGEU) relies on three main pillars: i) Support investments and reforms, including a new recovery and resilience facility and the new REACT-EU initiative; ii) Kick-starting the EU economy by incentivising private investment; iii) A New Health Programme at the EU level. Departing from this initial proposal, the President of the European Council presented his new proposal for the long-term EU budget and the recovery package, the ‘negobox’. The 17–21 July European Council, after tense negotiations, managed to reach a political agreement regarding the final proposal to be sent to the European Parliament. One of the notable features of this new instrument is that for the first time EC borrowing capacity is fully recognised as a way to finance EU expenditures and eventually backed up by new own tax resources. The objective of this article is therefore to explain – by analysing a path leading through different borrowing models at the EU level – the way in which this recent political decision can already be considered as an antechamber for the creation of a new Debt Agency or a European Treasury, that is, to give rise to a pure European (fiscal federal) solution.

In fact, even more than in other crises, the sense of a European ‘common interest’ (SCHIMMELFENNIG 2014) has now been lightened by the COVID-19 pandemic. The prompt and much more firm reaction from the EU policy leaders in comparison with the last sovereign debt crisis management – marked by contradictions and political bargaining impasses – can be now explained by two main reasons: firstly, the nature of the shock, a common and not asymmetric shock and mostly a shock that is not driven by the misconduct of some Member States – a fiscal profligacy motive – but instead from an exogenous and uncontrollable cause; secondly, the anomalous and dramatic consequences of the crisis from a health, economic and social point of view, implying common disruption in the functioning of European societies and their way of living. So, unlike other moments where much of the development of risk-sharing mechanisms at the EU level corresponded not necessarily to well-designed governmental responses and only emerged by accident or default (SCHELKLE 2017, pp. 40–41), the pandemic crisis management has so far relied on well-targeted pragmatic and timely measures and, what is more, it has been led by a new sense of ‘solidarity’. The next months will show whether this new centripetal dynamics in the integration process – which can firstly be denoted in the new EU competences in areas typically decentralized, e.g. health care – will or not become irreversible. The tension with centrifugal forces has now been diluted while not eliminated, as certain moments in the process of crisis management have already shown. The evolution of the pandemic may play a role here.

2. Different borrowing models considering their evolution at the EU level

2.1. Borrowing at different levels of government in the light of the main prescriptions of Fiscal Federalism

First of all, it should be mentioned that the theoretical idea of fiscal federalism includes several forms of fiscal decentralization, whatever the type of political or administrative structure existing in a country or groups of countries: unitary state (regional or not), federation, confederation, or even supranational-type organizations as is the case with the
EU. The basic conditions for the normative prescriptions of Fiscal Federalism to be applied are hence the existence of different decision layers or governments with the capacity to interfere, to a certain extent, in the determination of the level of that circumscription’s revenues and expenditures.

As explained by CABRAL (2016), the conventional normative approach, in a departure from the generalized idea of ‘finance follows function’ (SHAH 1991), proceeds to establish the normative criteria for the following – functions assignment, revenues or tax assignment, intergovernmental transfers (e.g. general objectives, types of transfers, microeconomic effects, equalization criteria), and local borrowing (SHAH 1991). While the first item corresponds to the expenditure side, the three remaining items correspond to the revenue side (three main sources of sub-central financing).

From the perspective of the central or higher decision level – which in the EU setup corresponds to the EU ‘government’ itself – one can highlight the main theoretical features: i) As for functions assignment, MUSGRAVE (1959) claimed that the objectives of income redistribution and macroeconomic stabilization should be mostly assigned to the central government, whereas the ‘heart of Fiscal Federalism’ (that is of decentralization) should remain with the allocation branch; ii) As for tax assignment, according to the taxonomy also proposed by MUSGRAVE (1983), whereas progressive redistributive taxes and taxes suited for economic stabilization should be centralized, as well as taxes on mobile factors (in order to avoid beggar-my-neighbour policies, trade leakages and perverse tax competition), resident-based taxes such as taxes on sales or excises are better suited for intermediate governments (e.g. regions or states) and taxes on immobile factors should be best suited for the local level; iii) In order to cope either with vertical imbalances (the gap between expenditures and tax revenues) or with horizontal imbalances (the differences in fiscal capacity between identical lower governments or jurisdictions), the central government can use grants in favour of those same lower levels of governments; iii) Finally, as for the borrowing capacity (lato sensu), the central government is of course the main legal centre of debt issuance in a country, both through bonds and loans. Such financing capacity is – together with the capacity to create taxes – a basic cornerstone of State Sovereignty; ultimately, the ‘Treasury’ is the central debt agency of the Sovereign.

On the other hand, such borrowing capacity (through bonds and loans) is not, in principle, prevented for lower levels of government – intermediate and local governments. This debt capacity is the ‘Tail’ of the coin where the ‘Head’ is tax autonomy: intermediate and local governments have the possibility to issue debt because they can use their own taxes (assigned to them in accordance with the above tax assignment criteria) to back up present and future debt to be issued. Debt autonomy is to a large extent a corollary of tax autonomy. However, in order to prevent soft budget constraints that could lead to fiscal profligacy and uncontrolled debt issuance, and ultimately to debt default (that could spill over to the central government through the need of a bailout), fiscal unions have instituted mechanisms aiming at hardening those budget constraints – such mechanisms can mostly be either market-driven (through market discipline) or rely on the definition of fiscal rules (see TER-MINASSIAN and CRAIG 1997).

Having considered these basic insights of Fiscal Federalism Theory, two additional observations should be now made.
In the first place, it should be noted that taxes and borrowing are made to finance the fundamental (current and capital) expenditures of a government, of any government. As for the central government, taxes and debt issuance are used primarily to finance its own central expenditures (according to the above functions assignment criteria). However, this upper level of decision maintains some kind of fiscal ‘responsibility’ vis-à-vis their respective lower levels of government – the idea of national solidarity and cohesion justifies such intervention. For example, as mentioned, central governments provide grants to subcentral governments to address regional disparities both for equity and efficiency reasons (e.g. the smooth functioning of the national internal market).

In the second place, one should note that the central government borrowing capacity (lato sensu) is not in principle designed to resolve debt crises of lower levels of government. The central government borrowing capacity is primarily made to ensure its own needs and expenditures – specifically investment or other capital-type expenditures. Only in severe circumstances or major crises and in order to reinforce (discretionary) transfers to those lower levels of government or to lend them money, in order to finance recovery programmes, may the central government be eventually forced to increase its own indebtedness levels so as to meet the urgent needs – which are also national solidarity-based needs – arising from its constituencies. Even in this case, based on this solidarity principle, the required central debt (issued on behalf of the Sovereign) will be backed by future taxes to be collected and assigned to this same central government.

This being said, I will in the next sections present the main types of borrowing models, aiming then to analyse the way the EU has evolved in this matter until the present, considering in particular the recent budgetary decisions related to the creation of the NGEU. As will be shown, this recent political decision can already be qualified as an antechamber of a European fiscal federal solution.

Figure 1. Different types of borrowing models considering the EU situation and its evolution. source: author’s own design.
2.2. Brief presentation and description of different types of borrowing models

Let me start by presenting Figure 1.

The first basic distinction I would like to make is between, on the one hand, National models and, on the other hand, European models. What drives this distinction is the fact that in the former cases (national models) sources of financing (e.g. revenues) are used to finance national expenditures from the very beginning, accounted for as such in the Member State budgets, whereas in the latter cases (European models) we are dealing with expenditures that are first and foremost European expenditures, accounted for as such in the EU budget or in EU specific lines/instruments of expenditures (even if they are ultimately treated as transfers to other sectors, including Member states and/or regions). Consequently, the possible use of external sources of financing (e.g. debt issuance/borrowing) as a way to finance such expenditure is accounted, in the former case, as national debt (registered as a national financial liability) and, in the latter case it is registered as European debt (a European liability).

There are then two basic features that allow for a second kind of distinction, now within each of the national and European models. In national models, what distinguishes the ‘pure’ from the ‘hybrid’ model is the following: i) In the pure model, national debt is backed only by national taxes and in the hybrid model it may evolve to combine with some kind of European tax own resources (even if this is a weak and not entirely required possibility); ii) In the pure model, the risk premium is entirely a national premium, whereas in the hybrid model – through certain risk sharing mechanisms – we can have a partial replacement of national by European risk premium.

In turn, also within European models what distinguishes the ‘pure’ from the ‘hybrid’ versions is the following: i) In the hybrid model, there is a strong possibility to backup European debt not only through national taxes, but mostly through European tax own resources, whereas in the pure model such kind of European resources should be entirely used to repay European debt; ii) In the hybrid model, some sort of national risk premium may subsist, whereas in the case of the pure model it is only the European risk premium that is at stake.

3. The national borrowing or debt model and its two versions

3.1. Introductory remarks: the two versions of the model

When considering the EU situation, it can be seen that Member States have full borrowing capacity because they are the Sovereigns. However, it should be noted that in the light of the Fiscal Federal model they are conceived as intermediate governments, with the central (upper) level being the EU. For this very reason, the EU (and in particular its Economic and Monetary Union, EMU), not (yet) being a fiscal union, has decided to set up a model of fiscal policy coordination (contained in the Stability Pact and in the Treaty on Stability, Coordination and Governance in the EMU, TSCG) that is ‘inspired’ on the basic principles of the Fiscal Federalism, made to harden Member State budget constraints. In particular, it can be seen that although the E(M)U has not suppressed the so-called market discipline (national risk premium has not disappeared as the recent Sovereign Debt crisis has shown) the fact is that the model enclosed in the aforementioned legislation is typically rules-based (the institution of fiscal rules related to budget balance, structural balance and debt).8
In any event, the main legal centre for public debt imputation is still those inter-
mediate governments and not the central government (the EU). Hence, unlike that
which typically occurs in a classic fiscal federal model (HINAREJOS 2014), the EU has
been practically deprived of that borrowing capacity.9 This happens for several reasons,
the most important being the political and philosophical option – throughout the EU
construction – of preserving within the Member States one of the basic cornerstones of
sovereignty which is their (exclusive) borrowing capacity. As noted by CABRAL (2020),
the transposition to the European setup of Fiscal Federalism prospects has been
impaired due to some general limitations, starting with the E(M)U’s own ontological
ambiguities. In fact, it is acknowledged that the EU has, since its inception, been a ‘novel
hybrid’ (McNAMARA 2015), swinging between a federation and an intergovernmental
organization and pulled either by centrifugal or centripetal forces (CABRAL 2020). In
turn, as also mentioned by McNAMARA (2015), the E(M)U is not a politically embedded
entity, lacking a sense of partnership or cohesion, a common identity (VERDUN 2010),
which explains for example the alleged taxpayer resistance to increased financing for
the EU budget, with the argument that it might involve some moral hazard by some
European members. This argument – present in the fiscal/budgetary policy domain as
well as in other areas of integration, e.g. the Banking Union10 – is in turn the reflexion of
a major fracture in the EU and that the last sovereign debt crisis amplified. In the
collective book edited by BRUNNERMEIER et al. (2016), the main message was that the
process of crisis management reflected a ‘battle of ideas’ between the (ordoliberal)
German and the French intellectual traditions: for the former, a strong emphasis on
responsibility/accountability and a concern with the potential moral hazard of lender of
last resort activities; for the latter, the recognition that crisis management requires
political flexibility and so constraining the freedom of government to borrow could
be antidemocratic.

Moreover, the same crisis (being of a financial and fiscal nature) deepened ancient
economic, civilizational and even ethnic divergences between core and peripheral coun-
tries, and above all between Southern and Northern countries, respectively the ‘Sinners’
and ‘Saints’ in the European integration (DYSON 2014): the former – the opportunist –
obessed with ‘cheating’; the latter – the frugal or the ascetics – obsessed with ‘punish-
ment’ (GUISO et al. 2013; MAJONE 2014).

3.2. The specificities of the national hybrid model: debt mutualization versus debt
securitization

Considering this background, it is not then surprising to verify the political resistance
during the last crisis to accept – while it could be justified by the very nature of the
crisis – moving from a pure national borrowing model to a hybrid one, closer to
a European solution, despite the proliferation of proposals. The initial ones made in
the aftermath of the sovereign debt crisis, for implementing debt mutualization at the
EU level (the Eurobonds) faced immediate and strong political resistance, with Germany
at the head and based once again on the moral hazard argument. For this very reason
and attempting to circumvent the argument, another line of proposals – should I say
less ambitious from this point of view – was developed with the intention of making
sovereign assets safer while definitely abdicating from the use of debt pooling
3.2.1 Debt mutualisation: the Eurobonds

Inspired by the seminal proposal for the creation of Eurobonds (De GRAUWE and MOSEN 2009), DELPLA and WEIZSÄCKER (2010) proposed a model of debt pooling relying on two categories of bonds: a blue and a red bond. As for the former, EU countries should pool up to 60% of their national debt under a joint and several liability as a senior sovereign debt, thereby reducing the borrowing cost of that part of the debt. As for the latter, it would correspond to any additional debt beyond a country’s blued bond allocation and would be issued as national and junior debt, with a procedure for orderly debt default. This would thereby increase the marginal cost of public borrowing, which would help to enhance fiscal discipline (Idem, 2010).

The Stability Bonds initially proposed by the EUROPEAN COMMISSION (2011) – to be discussed with several possible options – took on a specific design in the proposal made by UBIDE (2015) a few years later. The idea was to create a partially financed euro area debt up to 25% of GDP throughout the full spectrum of yield curve maturities. Beyond this threshold, countries would have to finance their own debt, which would ensure market discipline and help to mitigate moral hazard. These bonds (rated at AAA) would be issued by the EDA in close cooperation with national debt agencies and would be supported by tax revenues. The revenues could result from transferred national tax revenues (e.g. a share of VAT) or, at a subsequent stage result from a European tax (e.g. a carbon tax). Stability bonds would ensure a response to country-specific shocks and they would help countries to stabilize their economics (Idem, 2015).

3.2.2 Debt securitization: safe assets

According to RIET (2017, 6), a safe asset as ‘a marketable financial claim on public or private sector entities that investors consider to offer a convenience yield because of its special attributes in terms of moneyness, liquidity, volatility and in particular its safety.’ The safe asset, combined with appropriate regulation that gives the correct weights to sovereign bonds, would be able to cope with two problems that the Euro crisis has revealed: i) doom-looping between sovereign debt and banking debt; ii) the flight of capital to a safe haven in the event of distress (BRUNNERMEIER et al. 2012).

BRUNNERMEIER et al. (2012) therefore proposed the creation of this new class of synthetic bonds, labelled as European Safe Bonds (in short, ESBies)¹¹: they are European, because they are issued by an EDA in line with the EU Treaty; they are safe, by being designed to minimize the risk of default; they are bonds, freely traded in markets and held by investors and central banks. The idea is to use the techniques of securitization, diversification and tranching to engineer an instrument with an extra safety and liquidity premium in the market, without involving debt mutualisation (RIET 2017). For this objective, a special purpose vehicle (SPV) acquires a maximized portfolio of government bonds from all euro area countries with market access in a fixed proportion. Against this portfolio as collateral, two tranches of a synthetic bond would be issued (Idem, 2012): i) A relatively large tranche of senior bonds (the ESBies themselves) with a senior claim on the cash-flow from this pool of government bonds and; ii) A relatively small tranche of European Junior Bonds (EJBies) with a junior claim on these payments. Losses on the SPV’s

(LANNOO and THOMADAKIS 2019, 31). Next, I will detail the basic features of these two types of proposals.
portfolio would first be borne by EJBy holders, leaving taxpayers safe. The SPV would be able to generate a ‘risk-free’ yield curve if ESBies were offered with a range of maturities (RIET 2017).

Against the belief in the safety properties of these SBBS, De GRAUWE and JI (2018) argue that the creation of a safe asset does not eliminate national government bond markets: as a result, the potential for destabilizing flows across the borders of the monetary union remain. National risk premium therefore would remain. Furthermore, it is observable that during crises, the correlation pattern of yields changes dramatically: yields in high risk assets become highly positively correlated reflecting the dynamics of contagion; at the same time as investors are looking for safe havens, the yields in safe assets tend to decline sharply (De GRAUWE and JI 2018).

3.2.3 Final comments
When comparing the two models detailed here – debt mutualisation and debt securitization – with the insights obtained from fiscal federalism theory and practice, it should be emphasised that these proposals for the issuing of Eurobonds or SBBS at the EU or at EMU level mean, at the same time, less and more than the natural profile for the issuing of debt/bonds in a federal setup that implies the institution of a debt agency or a ‘true’ Treasury (CABRAL 2020).

They mean less because they are still very far from the perspective of having a central level assigned with the prerogative of borrowing and/or issuing typical Treasury bonds (or bills) as a normal way to fund federal state needs. Typical treasury bonds imply a full sense of debt pooling – debt issuing is made ‘in the name and on behalf’ of that sovereign state (including implicitly all its constituencies) – an idea that is not entirely assumed even in the Eurobonds model. The EU lacks this mark of fiscal sovereignty. What is more, the possibility to issue debt in a normal federal setup is in principle, as mentioned before, related to the pursuit of tasks (and public expenditures) developed at the central level and which are not made in principle (only in exceptional cases) to finance intermediate or lower levels of government (CABRAL 2020).

However, at the same time, these proposals for debt pooling and debt securitization mean more than typical Treasury bonds. In fact, they were assumed to have a specific purpose, which is to solve or prevent a debt crisis of intermediary levels of government (which are actually also sovereign governments). This is abnormal if one considers the usual fiscal federal setup: the role of the Treasury is neither established to cope with debt crisis in the lower levels of government nor to resolve their difficulties to obtain financing in the markets. Additionally, in the case of the SBBS, it should be noted that this was presented to mimic the benefits of a true treasury bond (a national safe asset by nature), nevertheless using elements of financial innovation, in particular those of structured finance, an endeavour that is at the same time audacious and intricate (Idem, 2020).

On the other hand, the existence of these safe assets at the central level – e.g. Treasury bonds and bills – is made to grant additional safety to other assets issued by sub-central governments or even other types of public or private entities benefitting from some kind of central government guarantee. The risk premium related to these other assets can benefit from the (low) risk premium of the Sovereign assets themselves. Some kind of risk sharing thus occurs in this setup. It should be recalled that the proposals for creating both Eurobonds and the SBBS were, despite their very different nature, motivated by the
concern to create some sort of risk pooling at the E(M)U level, reducing yield spreads between core and peripheral countries, thereby ensuring smooth debt market access conditions for all Member States through the reduction of idiosyncratic risk premium. In this respect, they intended to be the first step – together with the non-conventional monetary policy implemented by the European Central Bank in the aftermath of the Sovereign Debt crisis (e.g. asset purchases programmes) – made to ‘replace’ at least partially national with a European risk premium.

In any case, it can also be said that neither the Eurobond version nor the SBSs one corresponds (yet) to a European borrowing model because issued debt is still a national debt even if a part of it can already be accounted for as European debt. First of all, the joint liability or common safe asset is still being used to finance national expenditures and not the EU budget (or like) expenditures. Secondly, the possibility given – in the case of the Eurobonds model – of issuing a joint liability through a new European Debt Agency does not even mean that part that of debt should be repaid through European tax own resources. The repayment still mostly relies on national tax revenues to be collected in the future. This is so with the exception of the stability bonds in UBIDE’s (2015) version, where the proposer accepts, as seen before, using revenues from a European tax (e.g. a carbon tax) in a subsequent stage.

At this point, mention should be made of one of the recent and controversial proposals introduced after the outburst of the pandemic crisis and which was greatly inspired by this Eurobonds model. Indeed, certain EU political leaders (including those of France, Spain and Italy) have proposed – as a way to prevent a new sovereign debt crisis following the COVID-19 crisis – the creation of the so-called ‘coronabonds’, once again a debt mutualization instrument. Issuing debt collectively would help to reduce the possibility of a change in debt market sentiment that could escalate into new sovereign debt crises, first and foremost affecting highly indebted EU economies. The fact is that the immediate understanding that – as in the case of the former Eurobonds – this might entail some kind of moral hazard or fiscal imprudence led to the immediate rejection of the proposal, not only by Germany, but also by a group of countries (the ‘frugal’ ones), namely the Netherlands, Austria and Finland. This short episode in the management of the crisis was important to show that the recovery from old compound fractures (including the mutual North-South distrust) had not been complete and had remained latent. However, despite this ‘momentum of distress’ the EU did not this time face any sort of impasse or retreat. On the contrary, it was possible to move on – one could use here MAJONE’s (2014) metaphor of the bicycle, according to which integration must be kept moving forward, especially in a crisis, for the bicycle (the EU) not to fall. Benefitting from an enthusiastic and prompt reaction from the pivotal European leaders (with President von der Leyen at the head), what was more interesting to observe then was that the EU was, unconsciously or not, jumping to a stage of deeper integration than the Coronabonds model was actually meant to be (in fact this was still a national while hybrid borrowing solution). With the impulse given with the adoption of the NGEU, the EU definitely entered into a more ambitious stage of the integration process in this domain, a European debt/borrowing model.
4. The European debt model and its two versions: the EU Recovery package as the antechamber of a pure fiscal federal solution

4.1. The recovery package: main financial implications

As mentioned above, on 21 July 2020 the European Council reached a historic agreement with respect to the financial response given by the EU to the destructive economic effects caused by the COVID-19 crisis. On this date, EU leaders agreed on a comprehensive package of €1 824.3 billion which combines the multiannual financial framework (MFF) and the Next Generation EU (NGEU). Regarding the latter – the major novelty of this agreement – it should be highlighted that this recovery effort will be allocated to seven programmes in the form of loans (€360 billion) and grants (€390 billion), mostly allocated to the Recovery and Resilience Facility (€672.5 billion) to be used in investments and reforms, notably for the green and digital economy. In turn, the €1 074.3 billion multiannual financial framework for 2021–2027, reinforced by the NGEU, will also support recovery from the socio-economic fallout of the COVID-19 pandemic.\(^2\)

What is also noteworthy from this unprecedented financial package is the recognition that the EU, mostly represented by the EC itself, will now also be forced to raise new types of revenues, should they be directly allocated to the EU budget or to specific funds/facilities to be created. Indeed, the EC, in its initial 27 May proposal acknowledged that this ‘fire power’ would imply both the creation of new own tax resources and the (novel) possibility ascribed to the EC to borrow in financial markets up to 750 billion euros (long-term loans to be paid throughout future EU budgets – not before 2028 and not after 2058).\(^3\)

In this regard, mention should be made of the inaugural financial operation adopted to finance the SURE program (one of the first EC initiatives after the outbreak of the pandemic crisis, consisting of emergency support to protect jobs and work) and that consisted of the issuance of 17 billion euros in innovative social bonds. According to the press release of October, 21\(^4\): ‘There was very strong investor interest in this highly rated instrument, and the bonds were more than 13 times oversubscribed, resulting in favourable pricing terms for both bonds.’ This investor strong appetite is no more than the confirmation that we are witnessing a financial product perceived as safe by the market, because it is benefiting from a new European risk premium.

4.2. Assessing the EC’s borrowing capacity: past examples and the evolution towards a (hybrid) European borrowing model

Despite the aforementioned EU principle of budget balance, that according to BEGG (2012) prevents the EU from borrowing or running a surplus, the fact is that particularly after the last financial and sovereign debt crises the borrowing capacity of the EC has increased in itself or together with strategic partners in order to finance supporting instruments provided either through the EU budget or outside of it.\(^5\)

Firstly, the EU introduced the European Financial Stability Mechanism (EFSM) (Council Regulation (EC) No. 407/2010),\(^6\) offering macroeconomic support for Euro area member states experiencing severe financial difficulties, being the
Commission authorised to borrow on the capital markets or from financial institutions in order to finance the respective loans (FERRER et al. 2016, 148). In particular, since the creation of the EFSM for Ireland and Portugal, the EU has become a frequent benchmark issuer: since 2011, around 54 billion euros has been raised through fifteen issues of bonds (Ibidem, p. 148). However, due to EFSM limited capacity to respond to the crisis suffered at that time by these EMU countries (FERRER and ALCIDI 2018), a different temporary mechanism was created outside the EU budget – the European Financial Stability Facility (EFSF) –, aimed at providing financial support to Ireland, Greece and Portugal under the respective (first) assistance programmes.

Outside the EU budget, other tools were also developed in the aftermath of the sovereign debt crisis. This was first and foremost the case of the European Stability Mechanism (ESM). But this was also the case with instruments aimed at supporting projects that contribute to economic growth financed through additional funding sources other than the EU budget. In particular, the *Investment Plan for Europe* launched by President Juncker in 2015 (the so-called ‘Juncker Plan’) intending to promote EU investment on a massive scale in areas such as infrastructures and communications. The main pillar of the ‘Juncker Plan’ was the *European Fund for Strategic Investment* (EFSI). It was created as a very large instrument outside the standard structure of the EU budget and with the potential to mobilise investments (target 315 billion euros) that rival the size of the cohesion policy (351.8 billion euros) (FERRER et al. 2016; RINALDI and FERRER 2017). This Fund provides an EU guarantee to mobilize private investment. For this objective, the Commission works together with its strategic partner, the European Investment Bank (EIB) Group. A crucial element of EFSI is its capacity to leverage private and public investment in Europe and its respective multiplier effect. According to RINALDI and FERRER (2017), the EFSI appears to be on track in leveraging private investment to reach a target multiplier of x15 for the total portfolio after three years of operations (RINALDI and FERRER 2017).

One of the most important consequences of this development was that the EU, although rejecting the debt pooling approach yet gradually evolving to become a ‘safe haven’ not only to assist countries in financial/debt difficulties (e.g. the case of the EFSM) but also to promote economic recovery leveraging public and private investment in EU Member States. As noted by RIET (2017, pp. 39–40) in all these cases ‘given the explicit fiscal backing from all euro area countries, all Member States, or the EU budget, these European institutions tend to have a very high if not the highest credit ratings’. Moreover, since the aforementioned financial assistance package (the EFSM), the EC adapted itself not only as a borrowing entity but also as a lending entity, notably in exceptional cases of crises or financial difficulties. In fact, it then borrowed from debt markets at a lower cost so that it could provide assistance to countries with cheaper loans as well, thereby partially replacing, once again, a national risk premium with a (new) European one.

Now, fostered by the new pandemic crisis and within the NGEU that capacity is definitely expected to assume a different dimension and nature with the consolidation of a European (hybrid) model. As described previously, this package will include both grants and loans and for both cases, the EU borrowing capacity will have to increase. Even
in the case of loans, what is at stake is to ensure Member countries lower costs in debt financing, based on this new ‘European risk premium’.

4.3. EU tax own resources as a backup for this new borrowing capacity

What is new in this rescue package is indeed the European aspect of it. As a consequence, this new borrowing capacity is clearly linked to the increase of EU tax capacity and revenues assignment. However, it should be noted that to become a true tax ‘federal’ system, amongst other aspects, it has to evolve from a call-rate based system (where, for example, tax resources coming from VAT are usually accounted for by Member States as a public expenditure, an amount to be transferred to the EU budget) to a typical tax system where EU taxes are directly borne by taxpayers to be directly allocated to the EU budget.

In turn, the idea of diversifying away EU own resources is not new (CABRAL 2020) with important discussions being made, for example, in 1998 and 2004. Again, in 2011, in the proposals for the reform of the own resources system, a financial transaction tax and financial activity tax, revenues from auctioning under the greenhouse gas Emissions Trading System, a charge related to air transport, an EU VAT, and EU energy tax and an EU corporate tax were discussed (SCHRATZENSTALLER 2014, 348). Then, more recently, in 2018, the EC renewed the discussion about the system of EU own resources. In the proposal presented to the Council,18 besides the reform of the VAT based own resource, the EC suggested new tax resources, notably relying on the environmental and digital economy.

In this regard, the EC then proposed a Digital Services Tax,19 recognizing that current tax rules, based on the physical presence of activities, are no longer adequate to pursue the development of the digital economy20 The intention in this proposal was hence to ensure a fair and harmonized system of digital services taxation, and to ensure a level playing field for businesses operating in the EU (fostering the construction of the ‘Digital Service Market’). The Digital Service Tax regained importance in the context of the current pandemic crisis, being associated with the financing of the new recovery package. It is indeed, together with CO2 emissions taxation, one of the strongest candidates for becoming a future EU own resource and so to work as ‘the’ tax back up for the new EC borrowing possibilities now opened under the same package. Additionally, it is still to be clarified whether these new resources will have a temporary nature (only to finance the temporary financial package now created) or if they will become a permanent resource of the EU budget (therefore entailing its significant redimensioning, clearly above the traditional 1% of EU GNI).

5. Conclusion: the NGEU as the antechamber of a fiscal federal solution

The E(M)U is being pushed, after the Sovereign Debt and the COVID-19 crises, to move aside from pure national borrowing models to new and hybrid ones, starting with the proposals for the creation of Eurobonds and safe assets in the aftermath of the former crisis and evolving with this latter crisis to a European hybrid solution – notably this new package, NGEU. Within this solution, European Commission borrowing capacity is fully acknowledged as a way to finance EU expenditures that will have to be eventually backed
up by (new and enlarged) tax own resources. This recent political decision can already be considered as an antechamber for the creation of a new Debt Agency or a European Treasury, that is, to give rise to a pure European (fiscal federal) solution.

In fact, a temporal alignment of factors – the common and severe nature of the crisis calling for an initial reaction from the French-German axis followed by very pro-active leadership in the main EU institutions (EC, European Council, European Parliament, and the European Central Bank) – fostered this abnormal movement towards the centralization of competences (e.g. health care), expenditures and resources at the EU level. The new borrowing capacity is simply an expression of this movement. However, this is not new nor strange. As amply shown in the Fiscal Federal literature and shown by historical events around the world, centralization usually occurs in times of war, distress, deep recessions and calamities. The appeal for a robust centralized government is on those occasions stronger and more legitimate. Monet’s curse is just an expression of this inevitability. Collective action is then determined by a new sense of ‘solidarity’ which is no more than an instinct of (collective) survival. However, even if diluted, the centrifugal forces in the EU are not eliminated and political resistance to the federal path now traced is still upheld. Moreover, ancient sources of disintegration, such as the North-South distrust tend to persistently emerge in the course of such negotiations.  

It is too early to say what the final outcome will be and if the fiscal federal path will be trodden until the end – a reinforced EU budget in a permanent manner, fed by new and enlarged own resources backing up a full borrowing capacity. Much will depend on the evolution of the pandemic crisis in the next few months and on the capacity of Europe to react after such devastation. What we know is that if this last stage is reached, the EU will have led itself into a different existential dimension.

Notes

1. The opinions expressed in this article are the author’s alone and do not represent any position or point of view of the CFP.
2. The Franco-German plan a few days previously (21 May), presented by President Macron and Chancellor Merkel was indeed qualified as such. See: https://www.ft.com/content/2735a3f1-bc58-477c-9315-c98129d12852
4. For a complete overview of federal arrangements, see WATTS (2008).
5. Due to the applicability of a ‘fiscal equivalence’ principle or to the subsidiarity principle, the geographical scope of the benefit is seen as the principal criterium used to identify whether the collective good (or merit good) should be a local, regional, or a national one and to determine accordingly, the level of government to which the allocation function should be assigned.
6. Throughout this article I will use the expression ‘borrowing capacity’ in a lato sensu to include not only the strict capacity to contract loans, but also for other forms of public debt issuance, including the issuance of bonds.
7. For example, during the COVID-19 crisis, some U.S. states have asked for federal advances to meet increasing unemployment claims. See the news item here:https://www.politico.com/states/california/story/2020/05/05/9-states-ask-36b-in-federal-advances-for-unemployment-claims-1282530.
8. It should also be noted, in this regard, that the E(M)U model is a mixed model, when compared with the German and US federal models. In the EMU there is a centralization of fiscal rules (they are set by the European legislation) – which is clearly inspired on the German
centralized model – but, on the other hand, a bailout from the centre is forbidden (Article 125 of the Treaty on the Functioning of the UE), which resembles the U.S. fiscal federal tradition.

9. From a legal point of view, the EU borrowing capacity is firstly limited by the principle of the (EU) budget balance. As noted by Begg (2012), the requirement inserted in the Treaty on the Functioning of the EU – TFEU (Article 310) – to balance the annual budget- means that the EU is not able to borrow (or run a surplus) as a means of managing demand. So, only in very limited circumstances is the EU allowed to borrow, even if, as we will see further on, this capacity has substantially increased after the Sovereign Debt crisis both regarding supporting tools created inside the EU budget and new financial instruments promoted outside the same budget.

10. In this regard, HOWARTH and QUAGLIA (2016) stress that the concern with moral hazard, especially in the case of Germany, explains the incompleteness of the Banking Union, notably the limited scope of the single supervision mechanism and the resistance to implement a European Deposit Insurance Scheme.

11. Further on, also labelled as Sovereign Bond-Backed Securities (SBBVs) (ESBR, 2018).


15. Prior to the crisis, the EC could already borrow in the market but only in limited circumstances to finance two instruments: the BoP facility (created in 1988) and the Macro Financial Assistance (set up in 1990). In this case, the EU budget guarantees the support given.


21. To this should be added a more recent but not least important source of disintegration related to the national applicability of the rule of law, as the Hungarian and Polish NGEU’s blockage threat reveals.

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