Towards a European Reconstruction Fund

How should Europe respond to the economic crisis? Luis Garicano argues that the Commission issue consolidated annuities to finance a €1 trillion economic reconstruction package

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The idea that Europe's response to the economic crisis should be based on the issuance of common perpetual bonds has been slowly gaining ground, but proposals that entail substantial increases to member states' debt risk hampering growth for decades to come.

This column argues that the time has come for genuine European spending financed through European borrowing. It examines the legal and financial issues around the possible implementation of a proposal for the Commission to issue consolidated annuities ('EU Consols') to finance a €1 trillion economic reconstruction package.

After being first proposed by Francesco Giavazzi and Guido Tabellini (2020), the idea that Europe's response to the economic crisis should be based on the issuance of common perpetual bonds has been slowly gaining ground. They first highlighted that issuing at ultra-long or perpetual maturities would take advantage of the low-yield environment, eliminate refinancing risk, and send a strong signal of European unity to the market.

Nevertheless, their proposal would entail a substantial increase to member states' debt. Both authors suggest member states should issue perpetual bonds backed by their joint tax capacity. Given how high debt levels are in many countries, this would threaten to hamper growth for decades to come. It operates under the same logic as the three instruments (the ESM, the EIB, SURE) in the Eurogroup's deal – namely, that European issuances should only be used to generate more debt in member states.

The time has come for genuine European spending financed through European borrowing. To this end, Guy Verhofstadt and I recently proposed that the Commission issue consolidated annuities (or 'EU Consols') to finance a €1 trillion economic reconstruction package (Garicano and Verhofstadt 2020). Our proposal, in line with the European Parliament's 17 April resolution, would see the money spent (and not lent) along the EU budget's future-oriented priorities.

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We propose that to prevent any increases in the financial contributions of member states, the additional EU-level (interest) expenses must be paid for with new revenue sources at the EU level.

Since then, this proposal has been taken up by the Spanish government and is one of the contending landing zones for the Reconstruction Fund debate. Building on our previous articles, in this column I expand on the proposal's legal and financial implementational aspects.

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The establishment of a European Reconstruction Fund that would secure the financing needed for a swift recovery of the Union's economy would be carried out by means of Article 122 (1) TFEU

The economics

The grand bargain that we put forth to member states is that they can keep their contributions to the EU's next seven-year budget – a matter of constant bickering – at current levels. In exchange, we ask them to drop their reluctance to allow the creation of new, modern EU-wide streams of revenues that could bring between €26 billion and €38 billion a year.

These new revenues would be used to pay the interests on the EU Consols. Of the potential sources of revenue that have been discussed (including the Financial Transactions Tax and the Carbon Border Adjustment Mechanism), we put to use four that have already been designed and proposed by the Commission:

1. The Emissions Trading System (ETS): today, all of the revenues from the ETS are kept by member states. To ensure that they do not lose any existing revenues, we follow President Michel's February proposal: only ETS revenues in excess of the average amount member states received in the 2016-18 period (about €8 billion) would flow into the EU Budget.

   ETS revenues are the most volatile of our proposal, but we can work with existing estimates of €20 billion in total annual revenues in Phase IV of the program (WWF 2020). For reference, in 2018, it generated €15 billion, growing more than 150% with respect to 2017. Net, the ETS would entail €12 billion in annual EU revenues.

2. Plastic-based contribution: the European Court of Auditors estimates this would amount to €7 billion a year from a €0.8 per kilo call rate. Applying the maximum call rate allowed for in the proposed Regulation (€1.0 per kilo), we can increase revenues by 25% to yield around €9 billion a year.

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3. Digital tax: the Commission's 2018 proposal for a 3% tax on revenue on large tech companies is the only new revenue we propose that has not been formally proposed as a new 'Own Resource'. Assuming a 100% call rate on the revenue estimates of the 2018 proposal, the digital tax could bring in around €5 billion. According to the Commission's impact assessment, however, potential revenues could be as much as €10 billion (European Commission 2018).

4. Common Consolidated Corporate Tax Base (CCCTB): approving the CCCTB as proposed by the Commission in 2018, and applying a 3% call rate on member states' revenues, would generate €12 billion a year, according to the European Court of Auditors.

This would be the only new revenue to the EU budget that would reduce existing revenues that member states already have. However, we would expect this reduction to be offset by a general increase of revenues due to the harmonised tax rates.

Taking into account the perpetual nature of the Consol's principal, how much leverage could these new sources of funding allow for? We see three main precedents of publicly syndicated long-term bonds that could help us ballpark the coupon of the EU Consols:

1. Israel in 2020: Israel secured $1 billion in dollar funding through 100-year bonds to combat the COVID-19 crisis. Five times oversubscribed due to the unprecedented context and nature of the issuance, they priced at a 4.5% coupon.

2. Austria in 2017: Austria raised €3.5 billion by issuing a 100-year bond at a 2.1% coupon, which now trades at a 1% yield. It is the sovereign bond with the longest maturity in the EU.

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3. European Stability Mechanism (ESM) in 2018: the ESM issued almost €1 billion in 40-year bonds at a 1.85% coupon, which now trades at a 0.7% yield. It is the longest-dated debt issued at the European level.

The first conclusion to draw from these precedents is that our trillion euros would have to be issued progressively and not all at once. Putting this aside, and taking into account the above, the Commission's AAA rating, and the ECB's support, we find it fair to conservatively estimate a 2.5% coupon on the annuities (Alogoskoufis and Langfield 2020).

With all the key financing figures in mind, Table 1 shows the issuance potential of different combinations of new resources and coupon rates.

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Table 1

New EU revenues	Billion €	Interest rate					
		0.5%	1.0%	1.5%	2.0%	2.5%	3.0%
Digital + CCCTB	17	3,340	1,670	1,113	835	668	557
ETS + Plastic	21	4,238	2,119	1,413	1,060	848	706
ETS + Plastic + Digital	26	5,178	2,589	1,726	1,295	1,036	863
ETS + Plastic + Digital + CCCTB	38	7,578	3,789	2,526	1,895	1,516	1,263

Inside or outside the budget?

Under our proposal, the Commission would use its existing powers to borrow in the markets and would start issuing annuities when the next long-term EU Budget begins in 2021. The proceeds would finance a new European Reconstruction Fund. The spending of the fund would be aligned with the EU budget's priorities, also potentially co-financing EU programmes in lieu of national authorities.

When designing the Reconstruction Fund, it is essential that we stay away from intergovernmental solutions such as the establishment of a Special Purpose Vehicle (SPV), as some countries are currently proposing. Acting in such a way is not only plagued with issues regarding the lack of democratic accountability, judicial protection and burdensome decision making – as is well understood by now – but also has four crucial implementational difficulties:

Externally assigned revenue: in the EU Budget, earmarking is not permitted. There are some exceptions (deemed 'assigned revenue'), but it is difficult to see how a Reconstruction Fund could fall into any of the categories for which the exception is permitted (see the Financial Regulation).

Furthermore, the size of the instrument would pose problems as regards the autonomy of the Union's law, as it would legitimately raise the question: is this not a parallel budget to which no EU rules apply? The possibility of establishing the Reconstruction Fund on the basis of certain Own Resources permanently earmarked to feed it therefore seems legally unwise if left outside the EU Budget.

Time: we have eight months before the next seven-year EU Budget starts. It is imperative to act fast. Past experience proves intergovernmental agreements are not a speedy option, as shown by the ESM, which took years to finalise.

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Accounting: even if we followed the example of the European Financial Stability Facility (EFSF) – an SPV set up while the ESM Treaty was being finalised – and established a provisional fund while the intergovernmental treaty is negotiated, a central accounting issue would arise. For accounting purposes, the debt issued by the provisional fund, and the guarantees provided to it by member states, would have to be consolidated into the national accounts (Eurostat 2019). Correspondingly, the gross debt of member states would increase substantially, defeating the very purpose of the fund.

Legal certainty: the national law of the member state in which the SPV is located would apply, leaving the door open for said country to unilaterally change its applicable law. This could have an impact on the fund's governance, the execution of the guarantees and even the possibility for shareholders (the member states) to withdraw under ordinary private-law conditions. This uncertainty would surely translate into higher interest payments for the annuities, as is the case of systemically higher yields paid for by the EFSF with respect to the ESM (ESM 2019).

At the same time, to make the Fund work within the EU Budget, the current budgetary treatment of outstanding European debt – a legacy of the sovereign debt crisis – must be changed. In 2010, when the European Financial Stabilisation Mechanism (EFSM) was established, the Commission decided that the entire balance of its loans should fit within its yearly budgetary 'headroom'.

This means that the total loans outstanding in any given year must be below the difference between the budget's spending ceiling and its 'Own Resources ceiling', which determines the maximum amount of money the EU can mandatorily request from member states in any year (today fixed at 1.20% of GNI). The idea was that this would provide creditors the maximum degree of certainty that the Union would repay its obligations. However, the decision severely hampers the EU budget's ability to issue debt and counter the economic effects of the crisis.

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Because of it, the EFSM alone, with its €47 billion in loans, consumes the entirety of the EU budget's headroom, forcing the Commission's SURE programme to be backed beyond the headroom (and the Own Resources ceiling) by member state joint pro rata guarantees.

It is hard to argue in favour of this decision in economic terms. After all, the only money that the budget of a particular year should guarantee is that which has to be paid in that year. Neither do legal considerations apply, as no specific impediments can be found in the EU Treaties.

Because of this, we propose that this budgetary treatment of EU loans be put to rest, and that only the interest be guaranteed in the budget of any given year, with only these counting towards the Own Recourses ceiling. The rest of the payments would be simply assumed by the Union, in the same way member states assume their respective debts.

The consequences of such a change would be felt immediately. Under our proposal, for instance, the required increase of the budgetary headroom would be relatively small: €26 billion only amounts to 0.19% of EU27 GNI (assuming a 7% GDP drop from the economic crisis; IMF 2020).

How to set it up within the EU legal framework

The establishment of a European Reconstruction Fund that would secure the financing needed for a swift recovery of the Union's economy would be carried out by means of Article 122 (1) TFEU. By utilising this legal basis, the Council would be allowed to take, *"in a spirit of solidarity,"* the *"measures appropriate to the economic situation."*

This temporality safeguard is not only politically tenable but further reinforces the validity of Article 122 (1) TFEU as the appropriate way to finance the reconstruction from Covid-19, an exceptional occurrence for which no member

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state is to blame. Acting in this way would attain the Union's goals as established in Article 3 (3) TEU, most notably *"to promote economic, social and territorial cohesion, and solidarity among member states."*

Unlike the EFSM and SURE, Article 122 (2) TFEU would not serve as the European Reconstruction Fund's legal basis. Its narrower conception of solidarity exclusively entails loans. The gravity of the current situation, however, calls for a different kind of action, setting aside the logic of European borrowing for loans.

Providing a long-term legal basis for the European Reconstruction Fund would require the use of Article 352 TFEU, better known as the 'flexibility clause', which served as the basis for the Commission's proposed integration of the ESM into the EU legal order. Although legally sound from the outset, it certainly is not as politically attractive as Article 122 (1) TFEU.

First, it is too broad as it does not require an exceptional 'economic situation' to justify its deployment. Second, it does not provide for such a temporality safeguard. And, third, the flexibility clause hinges on unanimity and cumbersome national procedures (see, for example, the Bundesverfassungsgericht's Lisbon decision).

Compatibility with Article 310 TFEU

Under Article 310 TFEU, the EU Budget must be balanced and expenditure must equal revenues. This is an obligation that is, however, nuanced by the following provision, Article 311 TFEU, which stipulates that "the Union shall provide itself with the means necessary to attain its objectives". As argued by Grund *et al*. (2020), this is a moment in which all over the globe national governments are looking for extra funding.

Therefore, setting up a Fund that maximses the efficiency and efficacy with which financing operations are carried out is justified. This would allow the Union to guarantee the financial stability of the single currency by preventing

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further strain on member states' finances. It is important to highlight that actions taken through Article 122 (1) TFEU are strictly temporary, and exceptional, in nature.

Compatibility with Article 125 TFEU – the 'no bailout clause'

By acting *"in a spirit of solidarity"*, the member states would not need to impose conditionality for the funds provided. This is justified given the lack of blame and moral hazard, unlike in the sovereign debt crisis, for a pandemic that affects the Union as a whole.

Article 122 (1) TFEU is, however, an exception to the famous 'no bailout clause'. It must therefore be justified to take these extraordinary measures. It is worth noting that in Pringle, the Court of Justice ruled that the obligation enshrined in the 'no bailout clause' meant member states must remain subject to the logic of the markets when incurring in debt.

As long as they are not incentivised to set aside or reduce budgetary discipline, Union action is allowed. Several safeguards are in place to guarantee this is the case. First, the fund and its spending would not be managed by member states. Instead, it would be managed by the Commission, the guardian of the Treaties, in accordance with the Union's priorities. Second, the Fund's establishment does not entail the mutualisation of existing nor future debt beyond what is necessary for the achievement of the instrument's goal: to provide, in a spirit of solidarity, assistance to member states in light of the outbreak.

Compatibility with 123 TFEU

Some have expressed concerns over the supposed impossibility for the ECB to purchase EU Consols given their perpetual maturity and the self-imposed limits currently in place for its various quantitative easing programmes.

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The risk, this reasoning goes, is that by doing so, the ECB would breach Article 123 (1) TFEU's prohibition on monetary financing. The European Court of Justice's case law on the matter paints a different picture. In both Gauweiler and Weiss, the Court stated that the ECB, when conducting monetary policy, is granted broad discretion to accomplish its objective of maintaining price stability.

Only two limits, in relation to Article 123 (1) TFEU, would apply: that the ECB shall not directly purchase the government's debt; and that its actions, similarly to the logic discussed above as regards the 'no bailout clause', should not de-incentivise member states from conducting sound budgetary policies. At any rate, the Court would recall, the ECB has the possibility to sell, at any time, the bonds it purchases.

Crucially, no exact safeguards to be put in place by the ECB were defined by the Court. It deliberately left the matter wide open, stating that in a potential review of a programme's legality, it would take into account the context and economic situation on which decisions had to be taken (including the actions put forth by other central banks). The ECB could, therefore, make full use of its powers in a flexible way so long as this did not exceed what is necessary to achieve its goals.

At a time in which a pandemic has ravaged our Union's economy, it is difficult to argue that the Court's interpretation would change. This is even more so the case in light of the ECB's secondary objective as per Article 282 (2) TFEU: to support the general economic policies of the Union. ■

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