

Section 6.4 of the draft Working Document reads:

“In line with the principle of subsidiarity enshrined in Article 5(3) TFEU, it is important to estimate at what level of government an EPG is best offered. For the purposes of this assessment, the theory of fiscal federalism can be regarded as a suitable framework. As a general guideline, this model posits that **the financing of EPGs should take place at the same level where they are provided**, thus restricting the conceptualization of the notion of European public good to “pure” EPGs and to EPGs “by aggregation” both financed and delivered at the domestic level, without leaving room for hybrid combinations.”

Applying this as a guiding principle of EU economic governance would represent a sea change in the approach to the EU budget and policy framework. Let me illustrate this with the following stylised representation.

<b>Provision</b> <b>Funding</b>	<b>EU public goods</b>	<b>National public goods</b>
EU	A. No transfers (defence, cyber security, climate, pan-European infrastructure)	B. Transfers from EU to national budgets (e.g. NGEU) motivated by spillovers
National	C. Transfers from national budgets to EU (foreign policy, competition policy, internal market)	D. No transfers

Currently, most EU programmes and responsibilities fall in the categories B (national public goods co-financed via the EU budget) and C (EPGs financed by national contributions), so they are either EPGs funded at the national level via national contributions to the EU budget (C), or they are national public goods funded from EU sources (B). This is clearly conflicting with the principle of fiscal federalism. Why is this problematic?

Programmes under C essentially refer to the multiannual framework – the EU budget as we have known it for many decades – with national contributions to the EU budget used to finance the provision of EU public goods such as the internal market or foreign policy. Many of these programmes are of a regulatory or operational nature and therefore their call on fiscal resources is relatively limited. But even at this level of fiscal resources conflicts over the “juste retour” are recurrent. If country X feels it contributes “too much” and does not “benefit enough” at least the perception is that a transfer between countries occurs.

With the onset of the pandemic, a *new constellation of funding and provision emerged*, labeled in the table as B. It involved the issuance of debt by the EU to fund support to national budgets of member states that were most hit by the pandemic. Because ultimately the member states guarantee this debt, this involves a transfer between member states.

In some ways NGEU resembles earlier emergency support such as under the ESM, and in the public perception among the so-called “frugal” member states this is considered to violate to non-bailout principle in the Treaty. This may or may not be factually correct, but, in any case,

it does involve cross-border transfers to provide public goods at the national level, although this is motivated by cross-border spillovers (if the Italian government fails, the euro area fails).

Programmes that are currently being considered or developed, such a common military, cybersecurity, climate policy, etc.) are labelled as A in the table. This represents a new constellation of provision and funding. These are “pure” EPGs (which are non-rival and non-excludable from the point of view of member states), with ideally their funding also managed at the EU level for the reasons mentioned in the Working Document. Specifically, funding these at the EU level would prevent concerns over the “juste retour” that could stifle the development of these EPGs.

The public perception that EU debt issued for the purpose of financing EPGs would imply transfers to “weaker” member states and moral hazard is thus wrongheaded. In fact, they prevent transfers and yield benefits for these stronger member states. Suppose that every member state were to provide its own share of EPGs (e.g. military) and to fund this nationally. There are two risks: (i) weak members contribute too little (in which security is suboptimal) or (ii) they do contribute their fair share but are unable to finance this without running into fiscal sustainability problems – eventually entailing a bailout.

With EU bond financing neither of these risks occur. Therefore, even the “frugal members” are better off. Moreover, as the volume of EU debt increases, this becomes more liquid as well and therefore yields could fall. Especially so, if the attractiveness of the euro as a global currency would strengthen and the EU could capture some of the “exorbitant privilege” that is now reserved for the EU dollar.

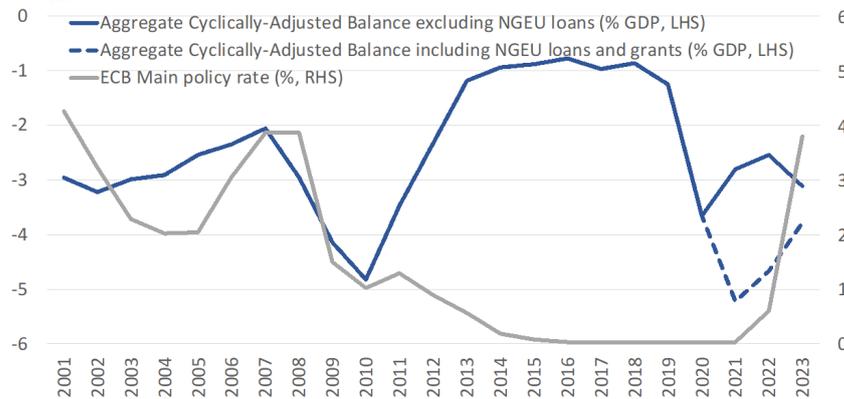
Moreover, I would argue that the development of EU own funding instruments – both tax and debt – would offer a major opportunity to strengthen the EU economy and would thus be perfectly in line with the pursuit of “strategic autonomy”.

As I have argued in my own report to the European Parliament, an EU corporate tax and an EU wealth tax could be developed to fund EPGs. Both satisfy a number of criteria for “optimal taxation” of EPGs, notably that (i) their revenues cannot be attributed to a particular member state as these tax bases are relatively footloose, (ii) they can help reduce tax distortions (especially avoidance and evasion); (iii) they help pursue other EU policy goals such as macroeconomic stability, and (iv) require little coordination as the tax bases are well defined (BEFIT in the case of corporate tax) though work is needed for a EU wealth tax. I will briefly elaborate this.

*First*, endowing the EU with a proper tax base and the power to issue debt would provide the EU with scope to conduct a counter-cyclical fiscal policy in support of monetary policy. It is well-known that corporate profit tax proceeds move in a strongly procyclical fashion). This is likely to be the case for a wealth tax as well since its tax base (financial assets and real estate prices for instance) is strongly correlated with the business cycle. Moreover, an EU wealth tax could help stem inequality in the wealth distribution which has been found to exacerbate financial instability due to a higher saving propensity, low interest rates and excessive risk taking.

*Second*, the discretionary nature of investment of EU public goods would allow the timing of expenditure to be adapted in case of major shocks, in lockstep with monetary policy. As the chart shows, the experience with NGEU has been that its fiscal stimulus effect provided welcome support to monetary policy.

## Fiscal and monetary policy mix



Source: ECB, European Commission AMECO database, author's computations. ECB policy rate refers to the fixed-rate or variable-rate tenders of the Main Refinancing Operations; the cyclically adjusted balance refers to the aggregate for the 27 EU Member States.

*Third*, important stabilisation effects may be expected to emerge also from the creation of a European 'safe asset' in the form of EU bonds. One purpose of such a 'safe asset' is to create a security that banks could buy to serve as collateral for interbank loans and ECB funding, instead of national sovereign bonds. Its advantage is that it would reduce the risk of the 'banks-sovereign doom loop' whereby fiscal stress and banking stress feed onto each other in a vicious circle, not least since capital would flow from periphery to core sovereign debt, the latter being the de facto safe asset. Moreover, by providing a benchmark yield an EU safe asset would also facilitate the functioning of the EU capital markets and convergence.

*Fourth*, the hallmark of a safe asset is its ability to retain value in the event of market turmoil and its almost perfect liquidity. Its real yield (nominal yield less the expected rate of inflation) carries no risk premia other than a small term premium (which solely depends on the maturity of the security). As such it serves not only as a refuge in times of market turbulence, but also as the reference for the pricing of other financial securities. By fostering the international role of the euro, yields could fall and new fiscal space created.

*Fifth*, perhaps even more fundamentally the creation of EU debt, underpinned by a proper tax base, could help the euro filling the void in the international financial architecture as the safety of the US dollar and US treasury debt is rapidly being undermined by the Trump administration. This is yet another dimension of "strategic autonomy" worth pursuing in my view.

All-in all, I see the creation of an EU sovereign bond underpinned by a proper tax base as a win-win for all member states.