# Free fiscal money: exiting austerity without breaking up the euro

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We propose that the governments of the crisis-hit countries of the Eurozone **stimulate internal demand by issuing and allocating Tax Credit Certificates (TCC) and Tax-Backed Bonds (TBB) to be used as quasi monies.** As state-issued monetary instruments, these bonds and certificates would be complementary to the euro and add to the domestic spending power without generating new debt. Our proposal is consistent with the existing rules and limitations under the Eurosystem and European institutions.

## The crisis of the Eurosystem

Even prior to the creation of the euro, several highly reputed economists had noted that a European single currency for economies featuring different competitiveness, productivity levels, and inflation dynamics would hardly serve as an engine of growth for all countries in the area in the absence of strong policy cooperation at the European level. Regrettably, their predictions have become reality.

The single currency system divides the European countries, rather than linking them together. Since the breakout of the global financial crisis in 2007-08, the single currency has acted more as a brake to the growth of the Eurozone and its individual member countries than as a catalyst for regional development. With a fixed exchange rate, and absent a regional fiscal policy as well as other adjustment mechanisms capable to absorb idiosyncratic shocks, the single currency has proved totally inadequate to match the growth needs of each member country. Intra-regional trade and financial imbalances and high and still rising public debt have been the necessary consequences.

Due to the intrinsic rigidities of the single currency, creditor countries – especially Germany – defend the adoption of contractionary policies by debtor countries such as Italy, France and Spain as well as other countries of Southern Europe. In order to ensure full recovery of their credits, the former have imposed austerity measures on the latter, including drastic labor cost cuts, severe reductions of welfare entitlements, and punitive tax hikes. Public debts denominated in a currency that individual countries do not control autonomously – and which de facto represents a foreign currency for them – force governments to undertake pro-cyclical policies. And the economies that are less competitive enter a crisis spiral, inevitably dragging along the so-called “virtuous” countries as well. Instead of facilitating convergence among the 18 Eurozone members, the euro exacerbates their differences and exasperates the reasons for conflict.

The Eurozone, and especially the Mediterranean countries, find themselves in a dramatic situation: either their economies stagnate or, worse, they fall into depression as consumption and investment (both public and private) progressively shrink. The ECB tries to give oxygen to the monetary system, yet banks throughout the area hold liquidity and refrain from lending it to the economy, most notably small and medium size enterprises. Unemployment and job precariousness grow spectacularly as a result, and territorial and social disparities widen.

It seems like Europe has forgotten its founding objectives of full employment, sustainable development, and well being for all its citizens: rather, the official priority of the EU institutions aims exclusively at improving the external competitiveness of each country via austerity measures and "structural reforms". However, addressing competitiveness through structural reforms takes long and requires resources. Also, austerity has proven to be a total failing and has run even counter to the very objectives it was intended to pursue: it is not just a coincidence that, under austerity, public debts in the most vulnerable economies have kept growing bigger. The attempt to apply the Fiscal Compact, with additional doses of fiscal adjustment every year for many years to come, would make things even worse.

The crisis is jeopardizing the survival of any integration design. The European economy is sick and risks to infect the world economy. Proposals to mutualize debts (through the so called "Eurobonds") or to create a federal fund to alleviate the social costs of the crisis appear to be politically unfeasible, due to the firm opposition from Northern European countries. In such a bleak context, different scenarios are possible: the continuation of a prolonged phase of stagnation or even recession and depression; the restructuring of the debts of the Mediterranean countries; or the disorderly breakup of the Eurozone, with some countries being forced to exit the monetary union and the ruinous fall of the Eurosystem following suit.

Given the circumstances, it is highly unlikely that negotiating wider margins of fiscal flexibility with Brussels and Berlin would be sufficient for the crisis-hit countries to revamp domestic demand, since this would not address the real issues affecting the Eurozone. Besides, for countries like Italy, greater flexibility, even if granted, would imply even larger levels of indebtedness.

A number of economists propose abandoning the single currency as a way for crisis-hit economies to avoid being further subjected to penalizing conditions. Yet returning from the euro to domestic currencies would be far more problematic than exiting a semi-fixed exchange rate system (such as the old European Monetary System). A disorderly breakup of the euro – the second world reserve currency – would likely produce economic and geopolitical shocks of incalculable consequences.

How then to resolve such an ominous crisis that Europe has inflicted upon herself? It is by now clear that the founding treaties of the Eurosystem will have to be revised radically, but this requires political will and time, neither of which is currently available. Facing the crisis requires that, even within the context of the euro, every national state urgently take sovereign initiatives to revitalize domestic demand, output and employment. Unlike the unelected EU executive bodies, the democratically elected governments of the European countries have the right and the obligation to make the future of their citizens a better one and to implement courageous reforms to preserve the prosperity of their national communities. Citizens rightly expect their elected governments to enact growth-enhancing policy measures without being imposed excessive and unjustifiable constraints by other countries and without asking for concessions.

## The Tax Credit Certificate Proposal

Urgent and effective measures are necessary. Our proposal features a feasible alternative option to other solutions that appear to be more complex and less practicable.

**We propose to adopt a solution that in economics is commonly known as "helicopter money", i.e., money that the state issues and distributes free of charge to individual agents (in our case, self-employed, salaried and unemployed workers, enterprises, and pensioners).**

However, since under current Eurosystem rules money creation is a monopoly of the ECB, we propose that the Eurozone governments issue and distribute a form of quasi-money, that is, special non-debt government bonds called Tax Credit Certificates. The TCC would be used to settle any financial obligations to the national public administrations (e.g., state and local taxes, social contributions, pecuniary sanction, etc) two years after their issuance, but would be immediately convertible in euro. The major feature of the TCC, therefore, is that they would grant households and enterprises immediate access to additional purchasing power.

Governments would issue TCC in the order of 5% of GDP for the first year and would increase their issuance in subsequent years, if necessary, up to an annual ceiling of 10% of GDP and until recovery in output and employment is observed.

The TCC solution is legally sound and uncontestable at the EU level and from the European monetary authorities: **while the ECB is the exclusive issuer of the euro, each sovereign state retains the legal right to offer fiscal rebates, such as the TCC.** Moreover, while the ECB has the monopoly over the single currency, it does not exercise control over the creation of "quasi" money instruments (such as, for instance bank deposits, government bonds, etc.). As the TCC is a financial instrument with a "quasi" monetary nature (it is a non-debt store of value that can be transformed into legal tender), it would not be subject to the ECB monopoly.

The new instrument issued by the state for the purpose of lowering the fiscal burden would directly flow into the pockets of people without raising new debt. TCC issuance would counteract the austerity imposed by the EU and resolve the liquidity scarcity problem that is currently affecting the economy of the weakest countries in the Eurozone, which the banking system has proven unable to address: while largely refinanced by the ECB, banks have mostly invested the new funds available in financial assets while continuing to limit the extension of credit to the real economy.

Based on its nature of legal tender to settle obligations to the state, the TCC would be exchanged for euros in the financial market similarly to any zero-coupon government bond. It could also be accepted as a means of payment (to be used, for instance, in combination with credit or debit cards). The TCC would become a new financial product, which the state would commit to issuing on a permanent basis. Additional amounts of TCC issues would vary over time depending on the economy's response. This would contribute to improving expectations and would induce people to consume a large share of their TCC-generated income. A virtuous circle would emerge with multiplier effects on demand and output.

## The advantages of the new quasi-money

Large and persistent allocations of TCC would stimulate demand and help close the output gap, while having a limited effect on inflation and yet countering the risk of chronic deflation and reducing public debt burdens.

**As a result of the income multiplier effect, the fiscal revenue shortfalls caused by the TCC deferred tax rebates would be offset by the increased fiscal revenues driven by GDP growth.** In fact, with the current real resource slack and interest rates close to zero, the income multiplier would be greater than one*. GDP and employment would grow rapidly.

As a consequence of revived growth, state budget deficits would be reduced and public debts would become better sustainable. Moreover, the share of TCC allocated to enterprises in proportion to their labor cost would drastically lower production costs. This would replicate the effects of currency devaluation: it would trigger export growth and offset the impact that the resumption of GDP growth would have on the trade balance via larger imports.

Taking Italy as an example, assume that over 2015-16 a TCC issue of €70bn is allocated to employees in inverse proportion to their taxable income, and that €80bn are similarly allocated to private-sector employers. The latter allocation would cut labor cost by 18%, broadly equivalent to Italy's competitiveness gap vis-à-vis Germany. Some additional €50bn TCC could be used further stimulate demand, for instance, through new public investment, guaranteed income schemes, support to private-sector initiatives in depressed areas, and the like. The idea would be to give preference to easy-to-implement social utility projects.

At operating speed, an annual issuance of €200bn could be effected, which would bring the stock of circulating TCC to €400bn (taking into account the annual reflow of deferred TCC used to pay taxes). This amount would compare to Italy's total fiscal revenues of €800bn. Assuming an income multiplier of 1.3*, GDP would recover by 15% over three years, with a 5-point drop in unemployment, and the trade balance holding in substantial equilibrium. The public deficit – defined as the difference between fiscal revenues and expenditures in euros – would be reduced to zero already from end-2015, and public debt would start falling in percent of GDP.

## Exiting the debt trap with the Tax-Backed Bonds

While the TCC would allow an economy to exit the "liquidity trap", largely indebted countries also need to escape the "debt trap". From the 1980s onwards, and certainly in preparation for the entry in the monetary union, central banks in many European countries have stopped issuing money to purchase public debt obligations in the primary market. Public deficits could only be covered through new debt issuances, and interest rates started to rise as a result. Attracted by high returns, institutional investors absorbed an increasing share of the new debts. **Eventually, the corresponding debt burdens subjected taxpayers to increasing levels of fiscal pressure, which in some cases has become unsustainable.** Reducing such pressure is now a priority, but this should not be achieved at the expense of social welfare (which has to be improved, but definitely not dismantled or indiscriminately reduced). The objective must be one of reducing the outstanding debt and the interest payments on it.

In this regard, a major obstacle is that public debts in largely indebted Eurozone countries are denominated in a currency that the individual countries neither issue nor control. This exposes them to high real rates of interest and to speculative behavior from investors, especially international ones, who are most reactive to negative outlooks and ready to download their debt holdings or to demand higher premia. **The public debts denominated in euro must thus be reduced rapidly and, where feasible, they should be "nationalized".**

To this purpose, in addition to introducing TCC, governments should refinance their maturing debt obligations with Tax-Backed Bonds (TBB), **which (like the TCC) would not be reimbursed at maturity with euro but would be accepted by the state for tax payments.** In practice, a public debt-swap offer could be launched at the same time that TCC are issued whereby every government bond would be exchanged for a TBB carrying a longer maturity and a premium on the original bond's interest rate. The debt-swap option would remain open for all the residual life of the outstanding public debt. The premium on rates is intended to cause a large proportion of the existing debt to be tendered, notwithstanding the longer maturity. It should be noticed that TBB could be more attractive than "traditional" bonds regardless of the premium, as no default risk is associated with them.

This conversion would i) prevent market turbulences from affecting bond prices, and ii) reduce the level of the "real" public debt (that is, debt obligations to be repaid in euro), transforming it in "national deferred money". Such process would amount to "renationalizing" the debt; it would substantially reduce the risk of default on sovereign debts, and would make the financial stability of largely indebted countries less dependent on the erratic mood of international capital markets.

The TBB will become increasingly attractive as the supply of traditional government bonds decreases. National institutional investors need a "domestic" liquidity management instrument, especially in view of an overall reduction in traditional bond offers. In particular, such entities as banks and insurance companies have large liquidity needs not just to pay their own taxes, but also to make payments of taxes and social contributions on behalf of their employees.

## Conclusions

The proposed issuance of TCC and TBB does not involve default risk for the issuers: issuing governments commit to accepting them for tax payments, but are under no obligation to reimburse them at future dates.

The issuance of TCC aims at revamping demand, output and employment. The resulting recovery of GDP raises the fiscal revenues needed to compensate for the deferred tax rebates made possible by the TCC, and thus keeps euro expenses and incomes on balance. In turn, the TBB accelerate the reduction of gross public debt (to be reimbursed in euro) as a ratio of GDP ratio.

The possibility becomes real that the debt/GDP ratio may rapidly trend downward toward the 60% Fiscal Compact objective, which would otherwise remain totally unrealistic. The protraction of austerity measures would in fact condemn the weak economies of the Eurozone to permanent stagnation or depression, and inhibit the objective of debt consolidation.

We believe that the creation by sovereign states of quasi-money national instruments can provide weak countries with a feasible way out of economic depression. The economies of the Eurozone that have been hit by the crisis most badly may exit the tunnel of depression and debt by putting their own act together, without asking competitor countries to inflate their economies, worsen their trade balance, or provide financial aid.

Notwithstanding the difficulties that our proposal may raise, we believe it offers a concrete way out of the current dramatic situation avoiding traumatic solutions, which could inflict large losses to workers, savers, firms and financial institutions.

**We believe that this can be the way to set up the best conditions for Europe to survive the current serious crisis and lay down the bases for a different**

**monetary system, which would finally be stable, sustainable and conducive to economic well being and full employment**.

* Note on the Income Multiplier

Recent studies (some of them reported below) provide a broad range of estimates of the income multiplier. Our proposal is based on the assumption that the income multiplier is greater than 1. Specifically, we have conservatively assumed a value of 1.3, based on a number of considerations:

- The demand stimulus following the issuance of TCC would be intense and persistent; it would taper only when a strong response from output and employment would be observed
- TCC would be allocated to individuals featuring a higher propensity to consume
- Interest rates are low and will likely remain so due to the accommodative monetary policy stance from the ECB
- Leakage effects from demand through the external channel (i.e., higher imports from abroad) would be offset by the export growth made possible by competitiveness gains following the reduction in labor costs
- The negative impact that the issuances of TCC might have on the value of the multiplier if they were to cause higher interest rate spreads on public debt would be neutralized by the issuance of TBB, which would stabilize the price of debt.

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