



Policy Note

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THE CONTINUED RELEVANCE OF TAX-BACKED BONDS IN A POST-OMT EUROZONE

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Introduction

In a policy note published last year by the Levy Institute, the present author and Warren Mosler argued that the eurozone sovereign debt crisis could be solved by national governments without the assistance of the European Central Bank (ECB) and without leaving the currency union. We argued that this could be done through the issuance of a proposed financial innovation called “tax-backed bonds.” We laid out the basic premise as follows:

Tax-backed bonds would be similar to standard government bonds except that they would contain a clause stating that if the country issuing the bonds does not make its payments—and *only if the country does not make its payments*—the tax-backed bonds would be acceptable to make tax payments within the country in question, and would continue to earn interest. (Pilkington and Mosler 2012, 1)

Since that time, the tax-backed bond has been considered and rejected by the Irish finance minister (Houses of the Oireachtas 2012), while the ECB has engaged in providing extensive guarantees that indebted countries in the eurozone will not default.

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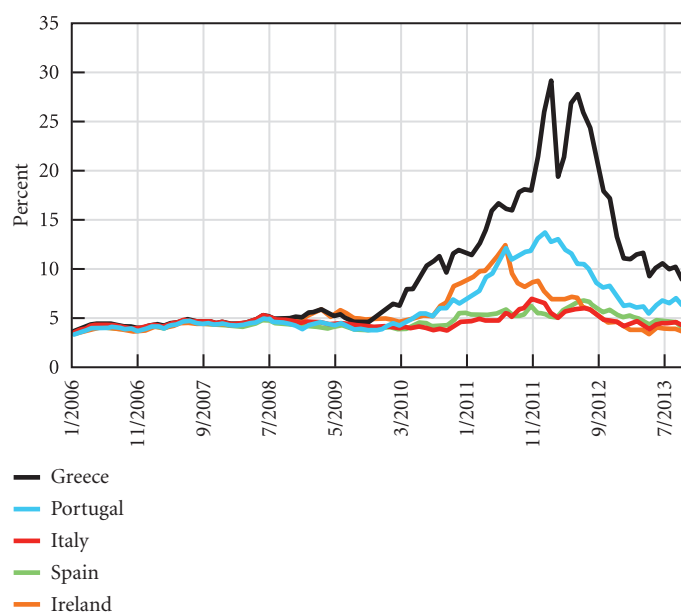
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In what follows, we will examine the continued relevance of the proposal in light of the changes that have taken place with respect to ECB policy since the original proposal was made. We will also examine the case made by Ireland’s finance minister that tax-backed bonds would violate current Irish law (and, by implication, the law in other eurozone countries). Finally, we will examine some innovations made to the initial proposal in response to constructive criticisms that we have received since its publication, and will briefly note another area in which the proposal might be utilized.

Contemporary Relevance of Tax-backed Bonds in a Changing Eurozone

Since the original tax-backed bond proposal was published in March 2012, much has changed in the eurozone. As can be seen in Figure 1, the eurozone was in its second major phase of the sovereign debt crisis around the first quarter of 2012, with yields on Greek and Portuguese 10-year bonds hitting their greatest heights: namely, 29 percent and 13 percent, respectively. By that stage, the worst phase of Ireland’s crisis had already passed, but many commentators remained worried that Irish sovereign yields might rise once more if there were more bad economic news.

Figure 1 Eurozone Periphery 10-Year Government Bond Yields



Sources: ECB and European Commission

The falls in the sovereign yields of the peripheral countries seen across the board after this point can be attributed to two major, interconnected causes. The first is that in this period it was becoming increasingly clear that the ECB would do “whatever it takes” to ensure that no peripheral country defaulted, as ECB President Mario Draghi put it in a historic speech at the Global Investment Conference in London on July 26, 2012 (Draghi 2012). Although this speech marked a turning point in the crisis, many in the markets were already anticipating that the ECB would take such a position prior to the speech, as can be seen in the fact that sovereign yields were already declining prior to July 2012.

The second reason why the sovereign debt yields of the peripheral countries fell so precipitously is that on August 2, 2012, just days after Draghi’s speech, the ECB announced it was putting in place a program called Outright Monetary Transactions (OMT). The OMT program guaranteed unlimited financing in the form of newly created money to suppress sovereign debt yields in the eurozone should they ever again reach a crisis point. Tied to this support, however, were stringent conditions that those countries wishing to avail themselves of the program must continue to engage in strong-arm austerity programs, despite any negative economic consequences these might have. In a September 2013 speech, ECB Executive Board Member Benoît Cœuré summarized this succinctly:

[Policy conditionality] distinguishes [the OMT program] from other historical episodes of central bank intervention in government bond markets. And it renders the argument on incentive incompatibility invalid. This is because conditionality removes the privilege of governments to choose between economic adjustment and central bank intervention. Even if the ECB were to decide—at its full discretion—to buy bonds via OMTs, governments would have to continue their reform efforts as required by the respective ESM programme and by IMF involvement. Otherwise, they would simply become ineligible for OMTs. Hence, no reforms, no OMTs. (Cœuré 2013)

The fall in sovereign debt yields can then be read as the outcome of a perception on the part of the markets that (1) the ECB would backstop the sovereign debt of eurozone members, and that (2) these members would adhere to any program the

ECB deemed necessary as a condition of this support, no matter the consequences of such programs for the economies of these countries. With these two assumptions in place, investors could assure themselves of safe returns on eurozone sovereign bonds that, when compared with yields in other financial markets in the post-2008 low-yield environment, would continue to be rather attractive.

Considered superficially, this fall in yields on eurozone sovereign debt would appear to negate the need for the implementation of tax-backed bonds. However, this is simply not the case, for two reasons. The first is that yields on the sovereign debt of some countries like Greece and Portugal have not come down to what might be called their “equilibrium” or “trend” level, as can be seen in Figure 1. We attribute this to the perception among investors of higher political risk in these countries. By putting tax-backed bonds in place, these countries may be able to bring down yields even further than has already been the case after the ECB intervention.

The second reason why tax-backed bonds remain relevant is even more important. As already stated, the OMT program only provides guarantees to investors if the member country implements austerity programs. Yet the consensus today is that such austerity programs are counterproductive and only lead to stagnant or even negative GDP growth and growing debt-to-GDP ratios. Tax-backed bonds, on the other hand, would give eurozone member countries back their fiscal independence. If eurozone member countries issued tax-backed bonds and succeeded in stabilizing the markets, these countries would no longer have to rely on European Union bailouts or backstops from the ECB, and thus would no longer have to engage in counterproductive austerity programs. With their newly found fiscal independence, these countries would have the choice to slow or reverse the austerity programs, or perhaps even engage in fiscal stimulus.

Objections and Responses to Tax-backed Bonds

Since the initial publication of the tax-backed bond proposal, there has been much discussion of its potential problems or pitfalls. In what follows, we will try to respond to some of these objections by both examining potential flaws and clarifying certain details.

The most significant of the objections raised came from the Irish finance ministry, under the direction of the National Treasury Management Agency (NTMA). The argument made

was that the issuance of tax-backed bonds would mean that those holding these bonds would have a privilege over and above those holding bonds that were not tax backed, and that this would violate the “*pari passu*” clause embedded in said bonds. Irish Minister of Finance Michael Noonan put it as follows:

Turning to the Deputy’s question, I am informed by the NTMA that investors in Irish Government bonds legitimately expect that tax receipts form a substantial part of the revenue stream to meet Ireland’s debt obligations as they fall due. Such investors rank “*pari passu*” (i.e. equally amongst themselves) and would not expect investors in tax backed bonds to be granted a preference in terms of payment obligations, particularly if any significant volume were to be issued. (Houses of the Oireachtas 2012)

The response to this is rather simple. Governments issuing the tax-backed bonds would have two options to avoid violating the *pari passu* clause. Either they could rewrite the clauses of all bonds retroactively and ensure that all investors had access to the tax-backed clause, or they could open up a swap program where concerned investors could exchange their non-tax-backed sovereign debt for new tax-backed sovereign debt with the treasury at par. Beyond this, we would point out that governments make their own laws in this regard and these laws are flexible; plus, given the two options above, there is ample scope to negotiate with creditors, since tax-backed bonds could increase the value of their investments by driving down the risks associated with them.

Others objected that, while the proposal itself seemed sound, the bonds issued would likely be denominated far in excess of the amounts needed by those paying tax. For this reason, we believe that intermediation should be a key component of the plan. In the original proposal we note that bond investors who do not have outstanding tax liabilities with the issuing government—for example, foreign investors—could, in the case of a failure to receive payment, sell the bonds to a bank within the issuing country. The bank could then act as an intermediary between depositors and the government in order to extinguish the former’s outstanding tax liabilities. The same would be true for residents of the country in question, who could use banks as an intermediary to pay their taxes using the defaulted-on bonds, should such a case arise.

The key issue here would be the spread that the intermediary would charge the original bondholder to engage in such a transaction. Here, two options are available. Either the issuing government could simply let the market decide such spreads, which would then presumably drive them down through competition; or they could actively intervene in the banking system to ensure that national banks, many of which are receiving large amounts of bailout funding, partake in the plan as part of a mutually self-interested public service program—after all, some of the funds raised by sales of sovereign bonds are being pumped directly into these banks. If the issuing government were to engage in the latter solution, it would have the added advantage that it could build this infrastructure prior to issuing the bonds, which would give investors added surety of the liquidity of their investment.

Some have raised the objection that the proposal might not work in eurozone countries like Greece where the collection of tax liabilities is known to be problematic. These criticisms are well grounded. If Greece or other countries with tax collection issues did decide to try to initiate the program, the first step would be to engage in meaningful, well-publicized tax reform that would aim at assuring investors there would always be adequate collectible tax liabilities, and thus ensure demand for the tax-backed bonds in case of nonpayment by the government. We must stress that this is an absolutely essential prerequisite, and we make no guarantees that the tax-backed bonds would work in countries such as Greece without said reforms.

It has also recently become clear that tax-backed bonds might be applicable to problems faced outside of the eurozone. Recently, commentators responding to proposed plans by the Scottish National Party to achieve Scottish independence have stressed the fact that if they were to keep the sterling as their currency they would potentially be subject to the same fiscal constraints as eurozone member countries. Thus, in the case of a serious recession and a large increase in the budget deficit, Scotland would face the possibility of a European-style fiscal crisis, and would have to comply with whatever dictates the Bank of England, or possibly even the British government, made in order to have the central bank suppress yields (Wolf 2013). We propose, however, that the Scottish government could instead keep the sterling and issue tax-backed bonds. In this way, they would retain all the political and economic advantages of the sterling while at the same time preserving their fiscal sovereignty and avoiding any potential sovereign debt crises that might arise in the future.

Conclusion

The problems faced by the eurozone continue to be as pressing today as they were when the original proposal for tax-backed bonds was published by the present author and Warren Mosler. In the meantime, the consensus against austerity policies has become ever larger, while the European political infrastructure proves itself time and again to be unable to respond to the changed economic realities in Europe. For these reasons, we argue that tax-backed bonds remain a valid policy tool that can be implemented at the national rather than the federal level, and a stepping stone to solving the eurozone's economic problems. The case for the implementation of tax-backed bonds remains as strong as ever in a Europe that risks years, even decades, of economic stagnation and unemployment should conditions and policy not fundamentally change course.

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