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TAX-BACKED BONDS—A NATIONAL SOLUTION TO THE EUROPEAN DEBT CRISIS

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Introduction

The purpose of this paper is to offer a brief introduction to a new approach to the burgeoning European debt crisis: tax-backed bonds.

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.

Background

The key problem facing Europe is the sovereign debt crisis. The crisis has caused enormous damage to Europe, politically, socially, and economically. As recent polls have shown, confidence in the European Union and its institutions is at its lowest point, with many citizens questioning the direction that the European project is taking.

The key issues raised on both sides of the debate are those of sovereignty and responsibility. The populations of the wealthier European countries insist that distressed peripheral countries

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must take responsibility for their debt burdens and stop relying on bailouts from Europe as a whole.

Meanwhile, citizens in the periphery are growing distressed at the loss of fiscal sovereignty that has resulted from the bailouts and subsequent austerity measures. In more extreme cases, this has manifested itself in calls for countries to exit the single currency, an action that would be catastrophic for the European project as a whole.

The ideal solution would satisfy both parties. Such a solution would allow individual countries to maintain their sovereignty and return to the markets so that they no longer have to rely on the rest of Europe for bailouts. At the same time, we must also ensure that the single currency remains intact. In what follows, we introduce a financial innovation that could provide such a solution.

Cause of the Present Crisis

The root of the debt crisis can be found in the fact that investors are currently concerned about the government debt of countries in the eurozone periphery. They are concerned that these countries might default and that investors would consequently lose their money. This causes investors to demand a higher "yield," or interest rate, on such government bonds. But when interest rates rise too high, the country in question suffers under the burden of hefty interest payments, which may push that country into a situation in which it is unable to repay its creditors. In such a case, the debtor country may then ask its neighbors for a bailout, either through a fund set up especially for such a bailout or by requesting that the central bank buy up some of their debt in the secondary market. Both of the above scenarios have already occurred and have caused tension and strife across Europe.

We wish to call attention to the fact that member-nations are not issuers of the euro, and that countries that issue their own currency do not have such problems. Japan, whose debt-to-GDP ratio is the highest in the developed world at over 220 percent yet whose interest payments on that debt are among the lowest in the world (1.04 percent on 10-year bonds, at time of writing), is a good example.

As prominent figures such as Alan Greenspan and Paul Krugman have noted, the reason countries that issue their own currency have such low debt-servicing costs is that these countries can always make debt repayments; they can always create money to meet contractual obligations. And the fact that they have this option on the table allows their bond yields to remain low even as their debt burden reaches relatively high levels.

The problem, of course, is that if any of the peripheral countries wished to issue their own currency they would have to exit the euro, a policy option for which there is no political support.

The Key Elements of the Tax-backed Bond Approach

What investors seek is assurance that they will be paid back. In the markets, this is referred to as "creditworthiness." Investors seek out safe assets that they believe to be "money good." Therefore, what we must do is give peripheral debt a high degree of safety while (1) allowing peripheral countries to remain users of the euro and (2) ensuring that the European Central Bank does not need to step in as lender of last resort.

We propose that a simple solution to this problem would be to have the peripheral countries begin issuing a new type of government debt. We call this type of debt a "tax-backed bond." Tax-backed bonds would be similar to current government bonds except that they would contain a clause stating that if the country failed to make its payments when due—and *only if this happens*—the tax-backed bonds would be acceptable to make tax payments within the country in question.

How the Tax-backed Bond Would Work

If an investor holds an Irish government bond, for example, worth 1,000 euros and the Irish government misses a payment of interest or principal, the investor can simply use the bond to make tax payments to the Irish government in the amount of 1,000 euros.

If the investor is a foreign holder of debt and the government misses a payment, he or she may simply sell the defaulted-on debt to an Irish bank (perhaps at a tiny markdown; say, 5 euros) that could then use the bonds to pay the taxes of their customers in exchange for their customers' euros.

The key point here, however, is that since this tax backing would set an absolute floor below which the value of the asset could not fall, and because the bonds pay a fair rate of interest, there would be no risk of actual loss and no reason to part with them—and, hence, the bonds might never be used to repay taxes.

The tax-backed bonds assure investors that the bond is always "money good" no matter what the circumstances. This would lead to lower interest rates on the bonds, and this, in turn, would ensure that peripheral countries would not be driven to default.

The question has been raised, by economists and by money managers, as to why a defaulting government could not simply refuse to accept the defaulted-on bonds in the payment of tax. For this to happen, however, someone would have to attempt to use his or her bonds for tax payment and the government would have to claim that no payment had been made and prosecute that taxpayer for nonpayment of taxes. To ensure this does not occur, we advocate that bonds be written under United Kingdom (international) law. That would mean the government would have no legal standing to make such a claim.

The yields on the new bonds would then be set by markets. We believe that these yields would reflect the low risk associated with the new bonds and would be significantly below the yields currently being demanded by the markets. (We advise issuing the bonds with an interest rate set at the Euro Interbank Offered Rate plus 3 percent on a floating basis, and then letting the market adjust the price from there.)

Conclusion

We contend that this is the cleanest and most efficient solution to our current debt crisis. Yet it is a solution that has received minimal media or political attention. Our tax-backed bonds plan could provide the gateway to a fresh approach to sovereign debt in Europe, one in which the desire for sovereignty is balanced by the need for countries to take responsibility for their actions and not rely on the assistance of others.