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Legal aspects of a debt-financed EU transformation fund

Brief legal opinion on behalf of the German Trade Union Confederation

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Summary

The aim of this brief legal opinion is to update the findings on the legal possibilities of a debt-financed EU transformation fund in light of the judgement of the German Federal Constitutional Court (BVerfG) on the Climate and Transformation Fund. The focus of the analysis is therefore:

I. the assessment of the judgement of 15 November 2023 with regard to the creation of a debt-financed EU transformation fund;

II. analysing the European legal requirements and implementation paths, in which both implementation through replication of the tried-and-tested NGEU model and the creation of debt-financed own resources in the regular EU budget will be examined;

III. analysing EU bonds as "safe assets" and the legal classification of the monetary policy relevance of EU bonds.

I. The BVerfG ruling of 15 November 2023 and the implications for a climate transformation fund

The judgement of the German Federal Constitutional Court on the Climate and Transformation Fund 2023 does not create any insurmountable hurdles for the establishment of an EU transformation fund. The judgement relates exclusively to German budget planning and does not provide a restrictive and certainly not a binding interpretation of European primary law. Specifically, the court agrees that the consequences of crises that were foreseeable for a long time should not be financed with emergency loans. It could be argued that climate change and the necessary countermeasures should be categorised as a phenomenon that was foreseeable for a long time.

However, even if climate change is recognised as a constant and predictable phenomenon, it cannot be concluded from this that a transformation fund the resources of which are to be used to specifically avert and mitigate the climate catastrophe would be inadmissible. Firstly, existing but worsening crises can also get out of government control, which is the case with the climate crisis with its worsening burden and more frequent climate change-related environmental disasters. Secondly, climate change – although undoubtedly man-made – cannot be understood as a controllable event. Even if Germany has its share of man-made climate change, climate change would have occurred even if the German economy had undergone an extremely climate-friendly transformation. For Germany, the event of climate change, i.e. the cause of the emergency, is not controllable on its own. The German Federal Constitutional Court itself clearly spelt out this inability to influence and combat climate change in its climate judgement. There, it not only assumed an obligation on Germany to protect the climate, even "if it were not possible to formalise international cooperation in a legal agreement." The court states even more explicitly in the climate judgement: "Either way, you cannot counter the obligation to take national climate protection measures arguing that they cannot stop climate change. It is true that Germany would not be able to stop climate change on its own. Germany's isolated action is obviously not comprehensively causal for climate change and climate protection."[1] The court itself therefore assumes that Germany cannot control climate change. Climate change is an uncontrollable event within the meaning of Article 109 of the German Basic Law (GG).

As a result, for reasons of the primacy of European law over national law, no interpretation of Art. 109 GG can be extended to the effect that binding guidance or even binding force could be derived from it for the interpretation of the European law norm in Art. 122 TFEU. Furthermore, there are no recognisable conflicts between the Federal Constitutional Court's interpretation of Art. 109 GG and European law.

1 BVerfG, Order of the First Senate of 24 March 2021 – 1 BvR 2656/18 –, para. 202.

II. European law considerations on a debt-financed EU climate transformation fund

Borrowing by the EU is not explicitly excluded by the treaties and there are indications that **the Union has the power to incur debt**. Of particular relevance here are Art. 318 TFEU, which obliges the Commission to provide information on the Union's debt, and Art. 311 TFEU, which allows the EU to openly handle raising funds to fulfil its tasks. Borrowing has already been used in the past, but to a limited extent. With the Next Generation EU (NGEU) Fund, which was set up during the COVID-19 pandemic, the EU has taken this power to incur debt to a new level by issuing bonds worth around 750 billion euros. In its judgement on the NGEU, the German Federal Constitutional Court stated that the treaties do not contain an absolute ban on debt and that borrowing is possible under certain conditions.

Against this background, two alternative models for financing a debt-based EU transformation fund are conceivable: Firstly, a NGEU 2.0 model in which debt is categorised as "other revenue", i.e. outside the regular EU budget. Secondly, proceeds from the issue of bonds could be included in the budget as a new category of own resources.

In the first option, the issuance of EU bonds outside the general budget as "other revenue" under Art. 311 II TFEU is implemented by a new own-resources decision. However, as is clear from the Treaties, the opinion of the Council's legal service and the decision of the German Federal Constitutional Court, other revenue may only be used to supplement the regular budget and may not replace the normal budgetary procedure. Re-using the NGEU model for a transformation fund would be problematic both from a legal and financial standpoint, as the revenue generated by NGEU accounts for almost two thirds of the EU budget for 2021 – 2027, which undermines the exceptional nature of this revenue. A renewed use of this model with significant amounts could probably only be considered after 2028, when the share of other revenue is reduced again with the start of the repayment of NGEU bonds.

Alternatively, the proceeds of the bond issue could be anchored in the budget as new own resources, as Art. 311 III 2 TFEU authorises the creation of new categories of own resources. The introduction of debt as a new category of own resources would undoubtedly represent a significant step in the development of the EU budget. This option would have some advantages over the NGEU model. The introduction of debt as an own resource would restore the balance between own resources and other revenue and strengthen the democratic legitimacy of the EU, as the European Parliament would be fully involved and the European Court of Auditors would be responsible for auditing. The main criticism levelled at EU debt as own resources is that it is not a resource definitively allocated to the EU, but a liability. However, this criticism is considered too short-sighted, as the concept of own resources is openly formulated in the treaties and such a distinction is justified more by practice than by primary law. The decisive factor is that the repayment of debt is always secured by genuine own resources of the Member States, as was also legally required for borrowing from NGEU. The possibility of issuing debt on a revolving basis depends on the payment guarantee created by the Member States, as the EU itself has no tax collection powers. In principle, debt can also be introduced as own resources in the regular budget. Their amount must be determined in the own resources decision and the repayment must be secured in this amount by guaranteed (i.e. not borrowed) own resources. There is no mandatory time limit in the sense of a fixed repayment obligation, whereby a limitation on the permanent use of debt already results from the succession of the own-resource decisions, which are the basis for the debt. A model in which liabilities are financed exclusively through debt would only be possible through a treaty amendment, which would significantly expand the EU's scope for debt.

So *borrowing* is therefore possible in principle. The next step then is the question of the *utilisation of funds*. The relevant legal basis for the utilisation of funds determines the purposes for which the borrowed funds may be used. The first relevant legal basis for the use of funds is **Art. 122 TFEU**, the solidarity clause, which has already played a central role in financing the common response to the economic emergencies triggered by the COVID-19 pandemic. However, whether Art. 122 TFEU is generally applicable is highly controversial, in particular due to the lack of detail of the norm, the lack of ECJ case law and the collision with Art. 125 TFEU, the no-bailout clause. Nevertheless, it may be

possible, given appropriate justification and a strict earmarking of the resources of the EU Transformation Fund to such measures that serve to combat climate change. It could be disputed whether climate change is a foreseeable phenomenon and whether Member States could possibly be (partially) responsible for climate change – such an interpretation is hinted at in the most recent judgement of the German Federal Constitutional Court, but is ultimately not convincing (see above). In addition, an "exceptional event" within the meaning of Art. 122 TFEU should also include intensifying developments, in particular "rapidly worsening crises which are unforeseeable in terms of their nature and scale", which includes the climate crisis. However, Art. 122 TFEU does not authorise unconditional aid. As with NGEU, where financial assistance was conditional on remedying the macroeconomic disruption caused by the COVID-19 pandemic, an EU transformation fund, at least if it is structured like NGEU (i.e. debt as "other revenue" within the meaning of Art. 311 TFEU), would also have to implement strict earmarking.

Whether **primary law standards other than Art. 122 TFEU** can be used for the utilisation of debt-financed other revenue or own resources is controversial, but can be affirmed, even if the respective primary law standards have a different scope with regard to permissible measures. The competences of the EU in the area of cohesion and structural policy (Art. 174 to 178 TFEU) as well as in the area of environment and energy (Art. 192 and Art. 194 TFEU) appear to be particularly relevant for an EU transformation fund. A central question here is whether Art. 175 TFEU as an independent standard (without Art. 122 TFEU) can be a legal basis for the use of funds. At least the current application practice of the norm seems to suggest this: the various funds based on this norm have linked very different policy areas in cohesion policy (e.g. social affairs, globalisation, natural disaster management, strategic investments). Art. 192 TFEU could be the relevant legal basis for climate transformation, but generally does not provide for centralised funding, which means that the norm could most likely be used in conjunction with Art. 175 et seq. TFEU.

The use of EU funds is generally linked to the fulfilment of certain conditions (policy conditionality). NGEU loans and grants were also subject to conditions, even if the focus has shifted from economic and financial conditionality to ensuring the rule of law, thereby softening the relatively strict ESM case law. Like NGEU, an EU transformation fund would probably not have the objective of providing a Member State with bridging loans or grants to overcome a financial crisis. Rather, it is about the long-term promotion of climate-relevant agendas and projects. Even if this could possibly reduce the financing needs of Member States on the capital market, it cannot be assumed that the principles of market logic will be eliminated as a result. However, the liability of individual Member States would have to be proportionate and not joint and several in order to be compatible with Art. 125 TFEU. Strict conditionality in the sense of ESM conditionality is probably not necessary. On the one hand, EU structural and cohesion funds are linked to fundamental preconditions (ex-ante conditionality) and macroeconomic conditionality. In addition, since 2020, the rule of law mechanism must also be observed, according to which a Member State must in particular ensure the rule of law within the meaning of Art. 2 TEU and violations can ultimately lead to a loss of entitlement.

III. The analysis of EU bonds as "safe assets" and the legal categorisation of the monetary policy relevance of EU bonds

"Safe assets" are financial instruments with a low default risk that enjoy a special status on the financial market. EU bonds are generally classified as safe assets due to their high credit rating (AA+ by Standard & Poor's, AAA by Fitch Ratings). However, they differ from traditional government bonds in certain aspects, such as their regulatory treatment and their temporary nature, which leads to slightly higher interest costs compared to European sovereign bonds with the highest ratings, such as German ones. A key point in favour of the status of EU bonds as safe assets is the unconditional payment guarantee given by the EU Member States. In addition, although the liability of the Member States is proportional, the Commission can provisionally call for additional funds from other Member States in the event of defaults. Joint and several liability could further strengthen the safe assets character of EU bonds by allowing creditors to assert their claims directly and in full against states with the highest creditworthiness and payment potential. However, such joint and several

liability would be problematic due to the no-bailout clause and constitutional requirements, particularly in Germany. The introduction of Eurobonds that include joint and several liability would require a treaty amendment and could give the EU more financial autonomy. Whether this is necessary for the development of a European capital markets union remains unclear. However, the EU bonds issued in the wake of the COVID-19 pandemic have already taken a strong position as safe assets, even if structural differences to government bonds continue to influence the liquidity and rating of these bonds.

EU bonds play an important role in the **implementation of the eurozone's monetary policy**. They are accepted by the ECB as eligible collateral and are categorised as marketable assets, which makes them usable for monetary policy operations. While they were initially subject to higher valuation haircuts, they were recently included in the highest collateral category (L1A), which further strengthens their safe asset status. The ECB has carried out several bond purchase programmes in the past, in which EU bonds also played a role. These programmes served to stabilise the monetary policy transmission mechanism and to combat deflationary tendencies. Although the ECB acts independently in the fulfilment of its monetary policy mandate, its actions are always aimed at ensuring price stability. Purchases of EU bonds could therefore theoretically be justified if they are necessary to ensure a uniform monetary policy, especially in deflationary times. The creation of new bond purchase programmes that include EU bonds to a greater extent is not ruled out, provided they serve the ECB's monetary policy objectives.

Introduction

This report examines the legal possibilities of a debt-financed EU transformation fund in the light of the Federal Constitutional Court (BVerfG) ruling of 15 November 2023 on the Climate Transformation Fund ("KTF ruling"). In general, the assessment of the legality of financing such a fund by taking on new debt raises both European law and constitutional law issues. From a European law perspective, it must be examined whether the borrowing is to be treated as "other revenue" or as "own resources" under budgetary law and which primary law standards could be considered for the utilisation of funds. The constitutional assessment of an EU transformation fund must be carried out in particular against the background of the decision of the German Federal Constitutional Court of 15 November 2023 on the Second Supplementary Budget Act 2021, which deals in particular with the utilization of the emergency margin. Previous decisions of the BVerfG on the Union's debt competence and the principle of limited individual authorisation are also relevant.

The report is structured as follows: Section I) analyses the ruling of the BVerfG and possible consequences for a climate transformation fund at European level. Section II) turns to the aspects of European law and discusses in particular the Union's debt competence, the borrowing and utilisation of funds in the context of debt. The final section focuses on the status of EU bonds as safe assets and their role within the framework of conventional and unconventional monetary policy in the European Monetary Union.

I. The BVerfG ruling of 15 November 2023 and the implications for a climate transformation fund

The statements of the German Federal Constitutional Court in its judgement of 15 November 2023 relate to the utilization of the emergency margin on the basis of the provisions on emergencies enshrined in the German Basic Law and are limited to this (a). No further requirements for the interpretation of the relevant provisions of European law can be derived from this. No interpretation of the court can be inferred from them that would stand in the way of the creation of a transformation fund geared towards the consequences of climate change (b). The judgement does not provide any clues as to the other functions of the transformation fund because only those aspects of the transformation fund that are based on Art. 122 TFEU (as a parallel provision to Art. 109 para. 3 GG) could be affected by the judgement of the BVerfG.

The budget judgement is limited to the emergency margin under Art. 109 para. 3 GG (German Basic Law)

In its judgement of 15 November 2023 on the Second Supplementary Budget Act 2021, the Federal Constitutional Court handed down basic clarifications on issues relating to the application of the debt rule under Art. 109 para. 3 and Art. 115 para. 2 of the Basic Law, in particular its exemption under Art. 109 para. 3 sentence 2 and Art. 115 para. 2 sentences 6 to 8 of the Basic Law. The key message of the BVerfG relates to the system of public borrowing enshrined in Art. 109 para. 3 GG. The BVerfG clarifies that the budgetary principles of "Jährlichkeit" (annuality, i.e. the obligation to issue a budged annually) and "Jährigkeit" (validity of the budget for

one fiscal year) must be applied to emergency borrowing.[2] As a consequence, a budget act that includes loan-based funding of supra-annual spending infringes upon the constitutional-law principles of "Jährlichkeit" and "Jährigkeit". This is intended to prevent a practice that ignores the simultaneity of emergency and loan-based expenditure by creating special assets through current loans "as a reserve" for later financial years. According to the judgement, there is scope for supra-annual spending if the emergency situation is repeatedly determined[3] and borrowing takes place in the year of determination of an emergency.[4]

Compatibility with Art. 115 para. 2 sentence 6 GG presupposes that it is an "extraordinary emergency situation" that is covered by the identical term in constitutional law. The "extraordinary emergency situation" within the meaning of Art. 115 para. 2 sentence 6 GG is characterized by an undeterminate fact.[5] This definition continues to apply following the ruling of the BVerfG. In it, the BVerfG emphasises that the question of whether an "extraordinary emergency situation" exists is fully subject to constitutional court review.[6] The substantive details of and requirements for an "extraordinary emergency situation" remain unclear even after the BVerfG's judgement. The factual existence of an "extraordinary emergency situation" alone is not sufficient to justify an exception to the obligation of presenting a balanced budget. The legislator must not only make it plausible that the situation is exceptional, but must also show that it is beyond the control of the state and significantly impairs the state's financial situation. In addition, the scope for judgement, which narrows over time, requires the legislator to make clear in its emergency resolution that it intends to avert or overcome this emergency by increasing borrowing and that it provides a justified and plausible forecast that and how this objective can be achieved by increasing borrowing.[7] However, the BVerfG does not subject the aforementioned conditions to a full review. With regard to the "impairment of the financial situation" within the meaning of Art. 115 para. 2 sentence 6 GG, the court rather limits itself to examining whether the emergency situation was "fundamentally capable of significantly impairing the state's financial situation".[8]

Furthermore, the BVerfG specified that the causal context must be taken into account when selecting the appropriate and necessary measures. The BVerfG has concretised the burden of justification to the effect that the forecast must show that and how this objective can be achieved through increased borrowing. However, the BVerfG has also emphasised the legislator's scope for assessment and judgement in this context. The legislator has this scope not only "with regard to the diagnosis, nature and extent of the emergency situation", but "also for the design of measures to combat, adapt and, if necessary, provide aftercare".[9] It is also significant to note that the court does not see the need to "restrict emergency-related borrowing to the elimination of the direct consequences of any emergency situation" because a "clear distinction between direct and indirect consequences of a crisis [...] is, moreover, practically unfeasible".[10] Thus the legislator is provided freedom in the selection of its measures, their objectives and regarding the question of what it considers to be the appropriate approach to overcoming the emergency situation. It must be clear from this that the measure to eliminate the emergency situation appears to be "suitable" at best to overcome the emergency situation – if this should be disputed, constitutional court review would be limited to this aspect and would not extend to additional purpose and plausibility checks that are carried out by the legislator.

Another limit to judicial reviewability of the emergency-financed measures is important for the legislative forecast on the suitability of the bundle of measures: The BVerfG emphasises that this suitability test is limited to the "totality of the measures and not to each

2 BVerfG of 15 November 2023, 2 BvF 1/22, para. 155.
3 BVerfG of 15 November 2023, 2 BvF 1/22, para. 172, 207.
4 BVerfG of 15 November 2023, 2 BvF 1/22, para. 173.
5 Jarass/Pieroth/Jarass, 17th ed. 2022, GG Art. 115 para. 13f.
6 BVerfG of 15 November 2023, 2 BvF 1/22, para. 116.
7 BVerfG of 15 November 2023, 2 BvF 1/22, para. 150.
8 BVerfG of 15 November 2023, 2 BvF 1/22, para. 122.
9 BVerfG of 15 November 2023, 2 BvF 1/22, para. 137.
10 BVerfG of 15 November 2023, 2 BvF 1/22, para. 136.

individual measure, because the individual measures can reinforce each other, support each other or bring about their effect in the first place". What is more, it also means that "individual expenditure approaches should not be taken out of the overall context, isolated and subjected to a suitability check".[11] The consequence of this restriction is that the measures taken do not all have to appear equally suitable. Rather, the decisive factor is whether the package of measures as a whole can be viewed to be suitable.

Statements cannot be applied to the European Law context

The aim here is to consider whether the restrictive attitude to the use of an emergency situation for climate change indicated in the judgement of the German Federal Constitutional Court could also restrict the possibilities of using the legal bases under European law. This must be denied in principle: firstly, for systematic reasons because of the primacy of European law over national law. No matter what a provision of European law looks like – even if it is identical to the national provision – no national court can interpret it as having a binding effect under European law. Specifically, the BVerfG cannot offer a "correct" interpretation of a European law provision. Only the European Court of Justice is authorised to provide a binding interpretation of European law. It already follows from this widely accepted and undisputed principle that you cannot derive findings from the BVerfG ruling regarding the permissibility of a transformation fund under European law. The BVerfG interpreted a German constitutional law provision, Art. 109 GG, not a European provision. Insofar as the German Basic Law can be used for the admissibility of a debt-financed transformation fund, its admissibility does not result from Article 109 of the Basic Law, but from the general standards that the court has developed for the review of European Union measures.

However, even if this fundamental hurdle were to be set aside for a moment and the parallels between the constitutional and European law norms were to be considered in material terms, the case law of the German Federal Constitutional Court cannot be construed to prohibit the argument of climate change to be an emergency situation – not even according to German constitutional law standards.

The starting point for this is the correct reference by the BVerfG to the parallel between the emergency provisions in Art. 109 GG and Art. 122 (2) TFEU in that both provisions contain the restriction that the emergency situation must be beyond the control of the state.[12] In fact, as will be explained under II, Art. 122 (2) TFEU stipulates that the European Union may provide financial assistance to a Member State in the event of difficulties caused by natural disasters or exceptional occurrences beyond its control. The BVerfG deduces from this wording that there must be a moment of uncontrollability of the event, "whereby medium or longer-term developments, such as a creeping accumulation of sovereign debt, are to be ruled out".[13] This statement – is actually controversial in the literature[14] – has no binding effect in the present case, as the creation of a transformation fund is by no means about providing financial assistance to benefit a Member State in financial distress (in this respect, the situation is different from the corresponding support programmes such as the ESM or EFSF). Resources from the transformation fund are utilised regardless of the fiscal situation of a member state. Therefore, no concerns can arise from the no-bailout provision in Art. 125 TFEU (see II below).

It is also worth discussing that the BVerfG states: "The consequences of crises that were foreseeable for a long time or were even caused by the public sector may not be financed with emergency loans."[15] One could argue here that climate change and the necessary countermeasures should be categorised as a phenomenon that was foreseeable for a long time. In fact, climate change is not a sudden event, but has been on the horizon for some time. However, there are two reasons why it can-

11 BVerfG of 15 November 2023, 2 BvF 1/22, para. 134.

12 BVerfG of 15 November 2023, 2 BvF 1/22, para. 109.

13 BVerfG of 15 November 2023, 2 BvF 1/22, para. 109.

14 Häde, in: Calliess/Ruffert, Art. 125 TFEU, para. 8 et seq.

15 BVerfG of 15 November 2023, 2 BvF 1/22, para. 109.

not be concluded from this that a transformation fund whose resources are to be used to specifically avert and mitigate the climate catastrophe is inadmissible.

Firstly, the court itself refers at one point in the judgement to the legislative history of the provision and the legislative intention according to which a "sudden impairment of economic processes to an extreme extent due to an exogenous shock" also justifies the emergency situation.[16] This must also include events which, although they have been occurring for some time, suddenly worsen. In this sense, the characteristic of this provision is concretised in the literature as a "suddenly occurring or in any case rapidly worsening crisis that is unforeseeable in terms of its nature and extent".[17] The worsening climate crisis in recent years, with its increasing stress and more frequent climate change-related environmental disasters, can be understood as such an aggravation.

Secondly, climate change – although undoubtedly man-made – cannot be understood as a controllable event. Even if Germany contributes its share to man-made climate change, climate change would have occurred even if the German economy had behaved in an extremely climate-friendly manner. For Germany, the event of climate change, i.e. the cause of the emergency, is not controllable on its own. The Federal Constitutional Court itself clearly spelt out this lack of influence on climate change and the fight against it in its climate judgement. There, it not only assumed an obligation on Germany to protect the climate, even "if it were not possible to formalise international cooperation in a legal agreement."[18] The court states even more explicitly in the climate judgement: "Either way, it cannot be argued against the requirement to take national climate protection measures that they cannot stop climate change. It is true that Germany would not be able to stop climate change on its own. Germany's isolated action is obviously not comprehensively causal for climate change and climate protection."[19] The court itself therefore assumes that Germany cannot control climate change. Climate change is an uncontrollable event within the meaning of Article 109 of the Basic Law.

As a result, for reasons of the primacy of European law over national law, no interpretation of Art. 109 GG can be extended to the effect that any guidance or even binding force could be derived from it for the interpretation of the European law norm in Art. 122 TFEU. Moreover, Art. 109 GG is not the standard for a possible violation of the Basic Law by a debt-financed European transformation fund (the ultra vires review comes into consideration here, the concretisation of which took place in the BVerfG ruling on NGEU and is discussed below). However, even if one were to accept the analysis in material terms, climate change cannot be categorised as a foreseeable and controllable event within the meaning of Art. 122 TFEU. Furthermore, climate change is also not excluded as an emergency event within the meaning of Art. 109 GG. Climate change has worsened in a way that justifies considering this worsening to be a sudden event. Furthermore, according to the Federal Constitutional Court's own standards, climate change cannot be understood as a controllable event within the meaning of the provision – the court itself considers climate change to be a phenomenon that cannot be controlled by Germany.

16 BVerfG of 15 November 2023, 2 BvF 1/22, para. 136.

17 BeckOK GG/Reimer, 56th ed. 15.08.2023, GG Art. 109 para. 66.

18 BVerfG, Order of the First Senate of 24 March 2021 – 1 BvR 2656/18 –, para. 201.

19 BVerfG, Order of the First Senate of 24 March 2021 – 1 BvR 2656/18 –, para. 202.

II. European law considerations on a debt-financed EU climate transformation fund

In the following we will explain that neither the principle of budget neutrality or balanced budget enshrined in Art. 310 TFEU nor the no-bailout clause in Art. 125 TFEU stand in the way of a debt-financed fund solution. The principle of budget neutrality in Art. 310 TFEU, which essentially aims to prevent the EU from being unable to fulfil its payment obligations, is upheld if the repayment of the Union's liabilities is guaranteed within the own resources ceilings and the Member States undertake to provide the funds necessary for repayment up to the maximum amount of borrowing specified in the own-resources decision. The no-bailout clause is particularly relevant in the event of an immediate and urgent liquidity and solvency crisis of a state. It is less relevant in cases in which financial transfers are not used to avert payment difficulties but to finance European priorities such as the Green Deal.

The Union's debt competence and its limits

The assumption of debt by the EU has not been excluded per se by the treaties. This can be distilled both from scattered hints in primary law and from the case law of the German Federal Constitutional Court. In addition to Art. 318 TFEU, which obliges the Commission to provide information on the "debt of the Union", budgetary management is open-ended in accordance with Art. 311 TFEU ("The Union shall provide itself with the means necessary to attain its objectives and carry through its policies"). In addition, the ban on "borrowing within the framework of the budget" enshrined in Art. 17 II of the Financial Regulation would not make sense as an option. In fact, the EU has financed itself on the international capital market through bond issues since the 1970s, albeit to a financially manageable extent. With the Next Generation EU (NGEU) fund put together during the COVID-19 pandemic, which not only required a unanimous Council decision but also eclipses all previous EU debt programmes at almost 750 billion euros, the EU Member States have also recognised such debt competence for large-volume financing. Even the Second Senate of the BVerfG did not attest to an "absolute" prohibition on debt in its NGEU ruling and affirmed the possibility that the own resources decision based on Art. 311 III 1 TFEU could constitute an implicit authorisation basis for earmarked credit debt.[20] Admittedly, such debt authorisation is not absolute and both EU law and national constitutional law impose clear limits on the European legislator.

Two alternative funding models for a debt-based EU transformation fund are conceivable: Firstly, one could follow the NGEU model and issue EU bonds bypassing the general budget as "other revenue" within the meaning of Art. 311 II TFEU through a new own-resources decision ("off-budget").[21] Alternatively, it is possible to anchor the proceeds of the bond issue as new own resources in the budget; Art. 311 III 2 TFEU allows for the creation of new categories of own resources and the treaties do not standardise a material concept of own resources or, as discussed above, a ban on loan financing.

Both options must comply with the same primary law guardrails. Firstly, as discussed below, any borrowing must be exclusively earmarked for a specific authorisation allocated to the EU; the borrowing must be limited in time and volume and specified; its repayment must be backed by sufficient genuine own resources.

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20 COVuR 2022, 707 BVerfG: EU Corona Fund judgement of 6 December 2022 – 2 BvR 547/21, 2 BvR 798/21, para. 163.

21 Grund, S. and A. Steinbach (2023) 'European Union debt financing: leeway and barriers from a legal perspective', Working Paper 15/2023, Bruegel.

Legal considerations for borrowing according to EU primary law

NGEU 2.0 and debt as "other revenue"

NGEU has led to a fundamental European financial constitution and has been characterised by many as Europe's "Hamiltonian moment". In legal terms, the innovation lies in the fact that, in the opinion of the EU institutions, the Member States and later also the German Federal Constitutional Court, the balanced-budget principles under Art. 310 I and III TFEU were satisfied by the NGEU construction. This was achieved by guaranteeing the repayment of the Union's liabilities within the own resources ceilings and by the Member States committing to provide the necessary funds up to the maximum amount of borrowing specified in the own-resources decision. This "irrevocable, definitive and enforceable" payment guarantee creates an asset for the Union that covers all possible liabilities (debts) in a budget-neutral manner. A few years earlier, the Commission had rejected such a construction as legally problematic.

At the same time, it should be noted that the financial resources raised through NGEU were largely added to the Union budget as external earmarked revenue or "other revenue" (Art. 311 II TFEU). The Council Legal Service stated in its opinion on NGEU that earmarked revenue "constitutes an addition or complement to the funds entered in the budget and cannot become a generalised means of meeting the Union's financing needs which would circumvent and replace the usual budgetary procedures". In particular, Article 311(2) TFEU stipulates that the budget shall be financed entirely from own resources, without prejudice to other revenue, thus emphasising the secondary nature of 'other revenue'. The NGEU judgement of the BVerfG comes to the same conclusion and only accepts the financing aspect of the NGEU construction with considerable reservations.

A renewed recourse to the "NGEU model" therefore appears to be both legally and financially problematic. While other revenue averaged 1 % of the budget, the volume of NGEU (750 billion euros) reached almost two thirds of the EU budget between 2021 and 2027 (1,075 billion euros).[22] A further increase in other revenue before 2027 through a new borrowing programme to finance an EU transformation fund would further undermine its exceptional nature compared to own resources and would therefore probably not stand up to any constitutional court review. This results from the quantitative restriction imposed by the German Federal Constitutional Court, according to which the funds raised as "other revenue" may not exceed the own resources. Only when NGEU's debt repayment begins in 2028 will the proportion of other revenue be reduced and the leeway under the quantitative restriction formulated by the BVerfG be expanded.[23] Then – with appropriate justification and legal basis – borrowing through "other revenue" could again be considered to a considerable extent, provided that it is still ensured that the funds are smaller than the remaining EU budget financed by own resources.

Union loans as a new category of own resources

There is no doubt that the creation of "loans" (or "debt") as a new category of own resources would represent a significant and controversial step in the fiscal evolution of the EU budget. In terms of primary law, however, there are comparatively few objections as long as you move within a certain margin, which is explained below.

Since the 1970s, the EU has been borrowing on the capital market and then immediately passing these funds on to the Member States as (low-) interest-bearing loans ("back-to-back" lending). The NGEU differs in that debt is taken on and then passed on to the EU countries as (non-repayable) grants. Firstly, it is undisputed that the inclusion of debt as own resources in the EU budget has several legal, financial and institutional advantages. On the one hand, the relationship between own resources and other revenue stipulated by the treaties is restored. The creation of debt as a "new category of own resources" is also superior to the alternative in terms of legitimisation – it fully involves the European Parliament, thus creating the dual legitimation of national ratification of the own resources

22 Ruffert, NVwZ 2020, p. 1777 <1779>.

23 COVuR 2022, 707 BVerfG: EU Corona Fund judgement of 06.12.2022 – 2 BvR 547/21, 2 BvR 798/21.

decision and EU parliamentary budgetary control. The European Court of Auditors would also be formally responsible for auditing the revenue and expenditure associated with the EU Transformation Fund.[24]

The main criticism of debt as an own resource is probably based on the fact that it is not an own resource in the traditional sense because it is not definitively assigned to the EU but represents a liability of the Union.[25] In our opinion, however, this is too shortsighted. The Treaties undoubtedly give rise to an open concept of own resources, which is why such a distinction must be justified not by primary law but by practice. From a financial point of view, it is evident that the repayment of Union debt can ultimately only be made using funds that have been definitively allocated to it. From a legal point of view, however, there is no explicit prohibition on using debt as own resources as long as the principle of a balanced budget in Art. 310 TFEU is complied with.

As discussed above, NGEU has led to a reinterpretation of the balanced budget principle, which we believe is also crucial for taking out Union loans as new own resources.[26] In particular, Member States must ensure that the Union has the necessary own resources to repay current liabilities at all times. As with NGEU, this collateralisation is to be achieved by raising the own resources ceiling in a new own resources decision (Art. 310 III TFEU).[27] The "irrevocable, final and enforceable" payment guarantee thus created[28] would, as with NGEU, also secure those liabilities that have arisen through the inclusion of debts as own resources in the budget. Whether this payment guarantee should be classified as "genuine own resources" is a terminological question; it is clear that all EU liabilities must be collateralised by the own-resources decision in accordance with Art. 310 TFEU and that the repayment of debt is always sufficiently guaranteed by the Member States.

A related question that arises with the own-resources variant is whether Community debt may be issued on a revolving basis, i.e. whether the debt service can be covered by taking on new debt, as is common practice in most national budgets. Once again, the crucial point here is that the Member States have agreed to provide the EU with sufficient funds to repay the existing debt burden by raising the own resources ceiling. In this respect, the possibility and amount of revolving EU debt remains a function of the payment guarantee created by the Member States. Even if old liabilities can be paid back using new debt, there must always be sufficient collateral from the Member States in the background due to the Union's inability to generate revenue, particularly because there is no fiscal competence. A model in which EU budget liabilities are financed solely by taking on debt can only be achieved by amending the treaties. This goes hand in hand with a considerable restriction of the EU's scope for debt: it can only ever take place in sync with securing debt repayment through future genuine own resources of the Member States – this restriction illustrates the ultimately still derivative status of the European Union vis-à-vis the Member States.

Primary law aspects of the use of funds

Art. 122 TFEU

As explained in the previous section, the BVerfG judgement on the Climate and Transformation Fund does not prevent the European legislator from using Art. 122 TFEU as the substantive competence for the use of

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24 As noted by the Council's legal service, borrowing as miscellaneous revenue is subject to "extensive restrictions [...] aimed in particular at preserving the interinstitutional balance by protecting the prerogatives, including budgetary prerogatives, of the European Parliament and the Council". Many of these restrictions do not exist in the alternative option. *Council Legal Service*, Proposals on Next Generation EU, Opinion, Council document 9062/20 of 24 June 2020, para. 62.

25 The Council Legal Service stated that such borrowed funds "are in fact liabilities that must be repaid and are therefore not genuine revenue that can be definitively and finally allocated to the Union, as is the case with genuine own resources." *Council Legal Service*, Proposals on Next Generation EU, Opinion, Council document 9062/20 of 24 June 2020, para. 57.

26 Grund, S. and Steinbach, A. (2023) 'European Union debt financing: leeway and barriers from a legal perspective', Working Paper 15/2023, Bruegel.

27 This decision can only be amended unanimously by the Member States in accordance with their respective constitutional provisions, which usually requires the involvement of national parliaments.

28 *Council Legal Service*, Proposals on Next Generation EU, Opinion, Council document 9062/20 of 24 June 2020, para. 46.

funds for a possible EU transformation fund if the relevant conditions are met. Art. 122 TFEU was the basis for both NGEU and SURE[29]. Whether Art. 122 TFEU is generally applicable is highly controversial. The lack of detail in Art. 122 TFEU makes subsumption difficult; there is no guiding case law from the ECJ, apart from "financial assistance" in the context of the euro crisis[30]. The solidarity character of Art. 122 TFEU lies in its exceptional nature. Economically and legally, a collision with Art. 125 TFEU, the bail-out prohibition, is unavoidable, which is why Art. 122 TFEU is therefore ruled out as a legal basis for permanent transfer mechanisms, as well as for assistance payments that are primarily intended to influence the fiscal situation of the state.[31]

It may be possible that, given appropriate justification and a strict earmarking of the resources of the EU Transformation Fund to such measures that serve to directly combat climate change, Art. 122 TFEU could be considered as a legal basis for such a fund.[32] Climate change is an "exceptional occurrence" within the meaning of Art. 122 TFEU. All EU Member States are exposed to the consequences, so that – comparable to NGEU – mutual support from the EU Member States could be considered as a solidarity measure. An argument against this could be that climate change is a foreseeable phenomenon and that the Member States could possibly be considered as (partially) responsible for climate change – such an interpretation can be taken from the most recent judgement of the German Federal Constitutional Court (see above). However, the effects of climate change go far beyond the individual contributions of the EU Member States. Rejecting an "exceptional event" with the argument that the Member States should have been more active long ago may not be wrong in terms of substance, but it cannot be denied that climate transformation would be no less urgent even if the consequences of climate change had been counteracted more vehemently. Firstly, the consequences of climate change remain acute in view of its global dimension, even if the EU had taken countermeasures earlier. Secondly, from a European law perspective, the same reasons can be cited here that have already been mentioned above in relation to the constitutional law assessment. An "exceptional event" within the meaning of Art. 122 TFEU should therefore also include exacerbating developments, in particular "rapidly worsening crises of an unforeseeable nature and scale"[33], which includes the climate crisis.

As far as the catalogue of instruments and measures of an EU transformation fund is concerned, the earmarking to the climate emergency also means that no measures may be financed from it that are outside of this scope, such as those that serve to increase general competitiveness. The measures must be related to the climate emergency and they should contribute to addressing it. Climate transformation measures cannot generally be denied this relation and contribution. On the other hand, it should be noted that the German Federal Constitutional Court viewed those NGEU measures to be particularly problematic where a pandemic reference wasn't clear – such as climate and digital spending.[34] It also follows that Art. 122 TFEU does not permit unconditional aid. As with NGEU, where the financial aid was conditional on remedying the macroeconomic disruption caused by the COVID-19 pandemic, an EU transformation fund would also have to implement strict earmarking.

Authorisation to use funds in the area of cohesion and structural policy

Whether primary law norms other than Art. 122 TFEU can be used for the utilisation of debt-financed other revenue or own resources is controversial, but can be affirmed, even if the respective primary law norms have a different scope with regard to permissible measures. The competences of the EU in the area of cohesion and structural policy (Art. 174 to 178 TFEU) as well as in the area of environment and energy (Art. 192 and Art. 194

29 Council Regulation (EU) 2020/672 of 19 May 2020 establishing a European instrument for temporary support to mitigate unemployment risks in an emergency (SURE) following the COVID-19 outbreak, OJ 2020 L 159, 1.

30 ECJ ECLI:EU:C:2012:756 = NJW 2013, 29 – Pringle.

31 ECJ ECLI:EU:C:2012:756 = NJW 2013, 29 – Pringle, para. 116.

32 See also Abraham, L., M. O'Connell and I. Arruga Oleaga (2023) 'The legal and institutional feasibility of an EU Climate and Energy Security Fund', Occasional Paper Series No 313, European Central Bank.

33 BeckOK GG/Reimer, 56th ed. 15.08.2023, GG Art. 109 para. 66.

34 BVerfG, Judgment of the Second Senate of 6 December 2022 – 2 BvR 547/21 –, para. 178.

TFEU) seem particularly relevant for an EU transformation fund:[35]

- Articles 174 to 178 TFEU already provide the legal basis for various structural funds such as the European Social Fund Plus (ESF Plus), the Just Transition Fund (JTF), the Cohesion Fund and the European Regional Development Fund (ERDF). As part of the ERDF, for example, around 226 billion euros will be made available in the aforementioned funding period. Of this amount, regions and Member States must already use 30 % of their allocations for the transition to a climate-neutral economy. In the case of NGEU, Art. 175 TFEU was a key implementation standard (in conjunction with Art. 122 TFEU) for the national resilience plans. The financial resources generated via the emergency stipulation in Art. 122 TFEU were allocated to the individual Member States according to a cohesion policy yardstick. In this sense, Art. 175 TFEU could also be used for an EU transformation fund as a standard that determines the regional allocation requirements for climate protection funds. There would then be an interplay of the norms set out in Art. 122 TFEU and Art. 175 TFEU, as with NGEU. A distinction must be made between this and the question of whether Art. 175 TFEU as an independent standard (without Art. 122 TFEU) can be a legal basis for the use of funds. At least the current application practice of the legal standard seems to suggest this: The diverse funds based on this standard have linked very different policy areas in cohesion policy (e.g. social affairs, globalisation, natural disaster management, strategic investments). The Just Transition Fund also serves the just transition to mitigate the negative side effects of the energy transition and is therefore directly linked to climate change.

- Art. 192 para. 1 TFEU enables the Union to take legal action to achieve the objectives set out in Art. 191 para. 1 TFEU, which include "preserving, protecting and improving the quality of the environment" and "promoting measures at international level to deal with regional or global environmental problems, in particular to combat climate change". The Social Climate Fund (CSF) is the EU's most prominent financing instrument to date, which is based on Art. 192 (1) TFEU (alongside Art. 194 (2) and Art. 322 (1) TFEU). According to legislators' plans, the KSF will be financed from the auctioning of greenhouse gas emission allowances. What is interesting in this context, however, is that these allowances are treated as earmarked revenue and thus exceptionally deviate from the non-appropriation principle or overall coverage principle, according to which revenue may not be earmarked and all revenue must be kept available to cover all payment obligations.[36] The EU has already put together climate packages based on this legal standard in the past, which oblige the Member States to take measures in the areas of renewable energies, energy efficiency and emissions reduction, most recently through the European Climate Law resulting from the European Green Deal. With regard to the EU Transformation Fund, however, it must be taken into account that the implementation of European environmental protection measures – including their financing – must generally be borne by the Member States (Art. 191 para. 4 TFEU). Art. 191 para. 5 TFEU stipulates an exception to this principle of Member State financing. If a Member State incurs disproportionate costs when implementing climate measures, financial support from the Cohesion Fund should be made possible. There is no doubt that the measures to ambitiously combat climate change come with a very high cost, which is significant in relation to other items in national budgets. The literature also argues that the costs in para. 5 can only be those that burden public budgets, so that costs for industry are ruled out (e.g. adaptation costs for industry).[37] In the present context, this means that Art. 192 TFEU is the relevant legal basis for climate transformation, but does not provide for centralised financing. It also takes second place to the Cohesion Fund under Art. 177 TFEU, which has priority in this respect, for the coverage of disproportionate costs. Consequently, Art. 192 TFEU

35 See Abraham et al, op. cit.

36 See Regulation (EU) 2023/955. In contrast, revenue for the German Energy and Climate Fund is not earmarked. See Schumacher et al, Der Klima-Sozialfonds im Fit-for-55-Paket der Europäischen Kommission – Definition und Quantifizierung vulnerabler Haushalte und notwendige Investitionsbedarf, 2022. Politically, such earmarking could also be attractive for an EU transformation fund, even if it is not legally mandatory.

37 Calliess in Calliess/Ruffert, Art. 192, para. 47.

is most likely to be used for an EU transformation fund in conjunction with Art. 175 et seq. TFEU.

Conditionality and earmarking

In recent years, the principle of policy conditionality has become the focus of EU funds distribution. Probably the most prominent, albeit most controversial, were the strict conditions under which the European Stability Mechanism was allowed to grant loans to financially distressed countries during the euro crisis. As emphasised in the Pringle decision of the ECJ, strict conditions are necessary to maintain a sound budgetary policy in the Member State receiving financial assistance and thus to comply with the no-bailout clause of Art. 125 TFEU. NGEU loans and grants were also subject to conditions, even if the focus has shifted from economic and financial conditionality to ensuring the rule of law, thereby softening the relatively strict ESM case law. In this context, the German Federal Constitutional Court's St. Nicholas judgement on NGEU stated that "Art. 125 para. 1 TFEU does not preclude the allocation of funds within the framework of NGEU on the basis of the primary law spending authorisation in Art. 122 TFEU"[38], meaning that Art. 122 TFEU is *lex specialis*. Although Art. 122 TFEU requires a close earmarking between the exceptional event and the use of the funds, strict conditions for maintaining budgetary discipline were not necessary as, unlike the ESM, market financing was not replaced.[39]

An EU transformation fund would also not aim to provide a Member State with bridging loans or grants to overcome a financial crisis. Rather, it is about the long-term promotion of climate-relevant agendas and projects.[40] Even if this could possibly reduce the financing needs of Member States on the capital market, it cannot be assumed that the principles of market logic will be eliminated as a result. It was only with NGEU that such a narrow interpretation of the no-bailout clause became established, as can be seen in the opinion of the Council Legal Service and the BVerfG judgement. Nevertheless, Member State liability for any Community debt to finance an EU transformation fund must be subject to clear limits, as is also the case with NGEU. In particular, there should be no assumption of liability by individual Member States for payment obligations of other Member States towards the EU if such liability would exceed the respective Member State's contribution to the EU's own resources.[41] To ensure conformity with Art. 125 TFEU, national liability must remain *pro rata* and not become joint and several.[42]

Although concerns in connection with the no-bailout clause can probably be dispelled, this does not mean that resources from the EU transformation fund can be allocated entirely without conditions. On the one hand, EU structural and cohesion funds are linked to fundamental prerequisites (ex-ante conditionality) and macroeconomic conditionality. In addition, since 2020 the rule of law mechanism, which was created to protect the EU budget and is stipulated under secondary law in the EU regulation on a general conditionality regime to protect the Union budget, must also be observed.[43] Accordingly, a Member State must in particular ensure the rule of law within the meaning of Art. 2 TEU and violations can ultimately lead to a loss of entitlement. Whether and to what extent the obligation to allocate EU funds subject to conditions arises from primary law has not been conclusively clarified. If Art. 122 TFEU is utilised, financial assistance can only be provided "under certain conditions". Furthermore, the EU can impose conditions so that funds are used more effectively to fulfil their purpose.

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38 COVuR 2022, 707 BVerfG: EU Corona Fund judgement of 6 December 2022 – 2 BvR 547/21, 2 BvR 798/21, para. 210.

39 Geiersbach, GRZ 2/2021: 112–119.

40 The Council Legal Service notes that "[...] funding for the implementation of EU policies, and in particular its cohesion policy, is by its very nature compatible with Article 125(1) TFEU." Council Legal Service, Proposals on Next Generation EU, Opinion, Council document 9062/20 of 24 June 2020.

41 As noted by the Council Legal Service, "[...] it does not follow from the commitments entered into by Member States under the Own Resources Decision proposal that they are liable for the commitments of other Member States within the meaning of Article 125(1) TFEU." *Council Legal Service*, Proposals on Next Generation EU, Opinion, Council document 9062/20 of 24 June 2020, para. 158.

42 NGEU provides for a subsidiary obligation to provide additional funding, which, according to the BVerfG, only represents temporary interim financing and therefore does not violate Art. 125 TFEU. COVuR 2022, 707 BVerfG: EU Corona Fund judgement of 6 December 2022 – 2 BvR 547/21, 2 BvR 798/21, para. 209.

43 Regulation (EU, Euroatom) 2020/2092.

Another important question concerns the earmarking of funds when loans are taken out as "other revenue". Other revenue is not provided for in the budget and therefore cannot affect the balance of the budget. The flip side of the complementary nature of other revenue is the earmarking of such funds; in contrast to own resources, they are not subject to the principle of overall coverage (Nonaffektionsprinzip: non-affection principle), according to which earmarking of revenue and expenditure is prohibited.[44] As the BVerfG states, the earmarking of other revenue ensures that it is only used for expenditure that is covered by the principle of conferral within the meaning of Art. 5 (1) sentence 1, (2) TEU, according to which the EU can only act within the limits of the competences conferred on it by the EU Treaties. It could therefore be argued, with some backing from literature, that other legal bases can also be used for the utilisation of funds in the sense of an EU transformation fund.[45]

In contrast to the method of raising Union debt as "other revenue", the earmarking of loans obtained as own resources is not mandatory under primary law.[46] The earmarking of other revenue provided for in the NGEU and confirmed by the BVerfG serves to ensure the integrity of the system of own resources and the budget.[47] By contrast, own resources entered in the EU budget are generally subject to the principle of universality (also known as the nonaffection principle), which is stipulated in Art. 20 of the Financial Regulation[48]. Accordingly, all revenue should serve to cover all expenditure and there is no provision for own resources to be tied to specific purposes.

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44 See above point II) for the analysis of the non-affection principle in connection with debt as a new category of own resources.

45 In this respect, similar considerations must be made when utilising the funds as when creating Union loans as own resources; see point II) above.

46 Grund, S. and Steinbach, A. (2023) 'European Union debt financing: leeway and barriers from a legal perspective', Working Paper 15/2023, Bruegel.

47 *Council Legal Service*, Proposals on Next Generation EU, Opinion, Council document 9062/20 of 24 June 2020, para. 59.

48 Regulation (EU, Euroatom) 2018/1046.

Table 1: Legal options for a debt-financed EU transformation fund

	NGEU 2.0	Union loans as own resources
Legal aspects	• New own resources decision (unanimity in the Council and ratification by Member States in accordance with constitutional rules, Art. 311 TFEU) • Member States must ensure that the repayment of liabilities is secured by raising the upper limit for own resources.	• New own resources decision (unanimity in the Council and ratification by Member States in accordance with constitutional rules, Art. 311 TFEU) • Member States must ensure that the repayment of current liabilities is covered by the necessary own resources at all times. • The annual budget that mandates the use of funds, is determined by the European Parliament and the Council through a special legislative procedure.
Restrictions on the use of resources	Use of funds is limited depending on the legal basis: • Art. 122 TFEU: limited in time, scope and volume to appropriate measures to combat the emergency situation • Art. 175/192 TFEU: insofar as the substantive requirements for the applicability of the rules are met, there are no additional restrictions.	Use of funds is limited depending on the legal basis: • Art. 122 TFEU: limited in time, scope and volume to appropriate measures to combat the emergency situation • Art. 175/192 TFEU: insofar as the substantive requirements for the applicability of the rules are met, there are no additional restrictions.
Earmarking	Yes, funds must always be earmarked due to their nature as “other revenue”	No, no earmarking, the non-affection principle applies.
Conditionality	Kann sich aus der primärrechtlichen Norm ergeben (z. B. Art. 122 AEUV). Im Sekundärrecht und der Praxis wird die Verwendung von EU-Mitteln an Auflagen geknüpft.	Kann sich aus der primärrechtlichen Norm ergeben (z. B. Art. 122 AEUV). Im Sekundärrecht und der Praxis wird die Verwendung von EU-Mitteln an Auflagen geknüpft.
Other		Effective involvement of both the European Parliament both in the decision on the use of resources in the annual budget.

III. EU bonds as "safe assets" – monetary policy considerations

The "safe asset" character of EU bonds

"Safe assets" describe financial instruments that have a low default risk and therefore enjoy a special status on the financial market. Union bonds consistently demonstrate a high credit rating (AA+ from Standard & Poors and AAA from Fitch Ratings) and can generally be categorised as safe assets. At the same time, EU bonds differ from the most traditional form of safe asset government bonds in several aspects, such as regulatory treatment, inclusion in bond indices and their hitherto temporary nature.[49] These differences largely explain the slightly higher interest costs compared to the most creditworthy countries in the eurozone.[50]

From a legal perspective, the direct and unconditional payment guarantee that Member States have given to the Union, as discussed above, is particularly decisive for the safe asset status. Although Member States are only liable *pro rata* for the amount budgeted for them, the Commission can nevertheless provisionally and proportionally call on additional funds from other Member States if one or more Member States are in default.[51] Joint and several liability could further strengthen the safe asset character of EU bonds, as it would enable bondholders to assert any claims arising from the EU bonds against the most financially strong states, i.e. Germany in particular, in full. As indicated by some in the literature[52], such joint and several liability would collide with the no-bailout clause, as individual Member States would then be fully responsible for Community debts externally towards bond creditors or towards the Union. Also, any recourse claim against defaulting Member States could only be asserted internally. In addition, joint and several liability would probably not be compatible with German constitutional law at the very least.[53]

The creation of "Eurobonds" in the strictest sense, in which joint and several liability would give the Union financial autonomy, can only be achieved by amending the treaties.[54] Whether such a step would be necessary for the creation and success of a European capital markets union cannot be answered conclusively. What is clear is that European and international financial market participants have recognised the EU bonds issued on a large scale since the COVID-19 pandemic as robust, safe assets, even if various structural differences to government bonds will continue to have a negative impact on both the liquidity and rating of Community debt.[55]

Monetary policy considerations on EU bonds

EU bonds already play an important role in the implementation of the common monetary policy in the Economic and Monetary Union. According to the treaties, the primary objective is ensuring price stability. General economic policy in the Union can only be supported by monetary policy if this is possible without jeopardising the objective of price stability (Art. 127 para. 1 TFEU). Union bonds are relevant in both conventional and

49 Bletzinger/Greif/Schwaab, ECB Working Paper Series WP No 2712 (August 2022).

50 Mack, S. (2021). Don't change horses in midstream, Hertie School Jacques Delors Centre Policy Paper.

51 Art. 9 Council Decision (EU, Euroatom) 2020/2053 of 14 December 2020.

52 Waibel, Eurobonds: Legal Design Features, Review of Law & Economics 2016.

53 This was already indicated by the BVerfG in the NGEU judgement: COVuR 2022, 707 BVerfG: EU Corona Fund judgement of 06.12.2022 – 2 BvR 547/21, 2 BvR 798/21.

54 Grund, The Quest for a European Safe Asset, (2020) 6(2) Journal of Financial Regulation 233.

55 Alexandra Born, Claudia Lambert, Luis Molestina Vivar, Andrzej Sowiński, Josep Maria Vendrell Simon, Do EU SURE and NGEU bonds contribute to financial integration?, European Central Bank 2024, available at https://www.ecb.europa.eu/press/fie/box/html/ecb.fiebox202406_06.en.html

unconventional monetary policy operations, in particular as eligible collateral accepted by the ECB and the national central banks.

Conventional monetary policy transactions

Guideline (EU) 2015/510 of the ECB defines, among other things, the various categories of monetary policy operations and the collateral that can be provided for credit operations within the meaning of Article 18.1 of the Statute of the ESCB. The common collateral framework has expanded since the introduction of the single currency. EU bonds fall into the category of marketable collateral, which includes, for example, uncovered and covered bonds, asset backed securities or other securities.[56] Bonds issued by supranational institutions, such as the EU Commission, have also long been included in the list of marketable assets.[57] Eligible assets are subject to haircuts and fluctuation margins imposed by the Eurosystem for risk control purposes, which in turn are influenced by various characteristics of the assets.[58]

Supranational bonds are assigned to haircut category L1B in the list of marketable assets and are therefore subject to higher haircuts than government bonds. On the recommendation of some experts in the literature, the ECB has now also included EU bonds in the highest category (L1A) and thus equated them with government bonds in terms of monetary policy.[59] This should further strengthen the safe asset character of EU bonds and secure their status as attractive collateral for monetary policy transactions.

EU bonds as part of ECB bond purchase programmes

The first important aspect of the purchase of Union bonds as part of bond purchase programmes is whether this is required in terms of monetary policy. The ECB and the national central banks of the Eurosystem are completely independent in the fulfilment of their monetary policy mandate (Art. 130 TFEU). Accordingly, every monetary policy decision, including the purchase of debt instruments as part of open market operations[60], must be taken solely by the Governing Council of the ECB in order to achieve the objectives of the European System of Central Banks.

Since 2010, the ECB Governing Council has deemed several bond purchase programmes necessary to achieve its monetary policy objectives.[61] While the main focus during the euro crisis was on maintaining and stabilising the monetary policy transmission mechanism, the programmes running between 2015 and 2022 were aimed at combating deflationary trends in the eurozone economy through quantitative easing.[62] In the summer

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56 Deutsche Bundesbank, Eligible collateral, available at https://www.bundesbank.de/de/aufgaben/geldpolitik/notenbankfaehige-sicherheiten/notenbankfaehige-sicherheiten-602254. The valuation haircuts differ by type of collateral, residual term, credit rating and interest rate.

57 The supranational issuers of bonds the Eurosystem buys include all EU institutions, such as the Commission, the EIB or the ESM, but also some international financial organisations, such as the World Bank or the Inter-American Development Bank.

58 Deutsche Bundesbank, eligible collateral, available at https://www.bundesbank.de/de/aufgaben/geldpolitik/notenbankfaehige-sicherheiten/notenbankfaehige-sicherheiten-602254. The valuation haircuts differ according to collateral type, residual term, credit rating and interest rate.

59 This re-categorisation was previously proposed by some voices, see for example Rebecca Christie, Gregory Claeys, Pauline Weil, The EU borrowing strategy for Next Generation EU: design, challenges and opportunities, European Parliament, available at https://www.europarl.europa.eu/cmsdata/241434/Brochure%20WS%20BORROWING%20STRATEGY%20FINAL.pdf

60 According to Art. 18.1 of the Statute of the ESCB, the national central banks of the Member States whose currency is the euro and the ECB may operate in the financial markets by, inter alia, buying and selling marketable securities outright. See Art. 18 Protocol (No. 4), C 202/230.

61 The following bond purchase programmes for public debt instruments have been adopted to date, even if purchases have not necessarily been made: the Securities Markets Programme-SMP (2010), the Outright Monetary Transactions-OMT (2012), the Public Sector Purchase Programme-PSPP (2015), the Pandemic Emergency Programme-PEPP (2020) and then the Transmission Protection Instrument-TPI (2022).

62 For example, the decision on the "Public Sector Purchase Programme-PSPP" set the following objectives: to improve the transmission of monetary policy, to facilitate the supply of credit to the euro area economy, to ease credit conditions for households and companies and to support the sustained convergence of the inflation rate to a level below, but close to, 2 % in the medium term in line with the ECB's primary objective of maintaining price stability. DECISION (EU) 2020/188 OF THE EUROPEAN CENTRAL BANK of 3 February 2020 on a secondary markets public sector securities purchase programme (ECB/2020/9).

of 2022, the ECB then heralded a turnaround in interest rates in view of rising inflation and suspended all ongoing bond purchase programmes.[63]

The Governing Council of the ECB is also independent in its choice of eligible collateral to be purchased as part of a bond purchase programme. Although the majority of the debt instruments purchased were government bonds, supranational bonds also played an important role in the bond purchase programmes. At the start of the PSPP in March 2015, the ECB Governing Council determined that the share of all debt instruments purchased should be 12 %, which was reduced to 10 % just under a year later. At the same time, the ECB Governing Council decided to set the purchase limit for supranational debt instruments eligible for central bank borrowing at 50 % per issuer and 50 % per ISIN, i.e. per bond series issued.[64] The aim of these upper limits is to ensure the proper functioning of the markets and adequate pricing as well as to limit risk concentration.[65] These limits differ from government bonds, where the purchase limit is 33 % both per issuer and per ISIN. The Eurosystem has thus given itself additional flexibility in the purchase of supranational bonds and could, in extreme cases, purchase up to 50 % of all bonds issued by the EU under the legal basis of the expired bond purchase programmes.

A further increase in the ceilings would probably be controversial in light of the ban on monetary government financing (Art. 123 TFEU). In the 2020 PSPP ruling, the German Federal Constitutional Court stated that the purchase limits for government bonds "are the decisive 'guarantees' that can be used to establish the lack of obviousness of a violation of the prohibition of circumvention under Art. 123 TFEU."[66] Although this judgement is not directly applicable to supranational bonds, higher purchase limits, coupled with a larger actual total volume of supranational purchases, could be problematic under both European law and German federal constitutional law. In light of the relevant ECJ case law, there would then have to be other sufficient guarantees to ensure that the bond purchase programme does not lend itself to removing the incentive created by Art. 123 TFEU for the Member States to pursue a sound budgetary policy.[67]

In general, it should be noted that ECB bond purchase programmes are still considered unconventional monetary policy instruments that are only used if the ECB Governing Council deems them justified. Since the interest rate turnaround was heralded in 2022, bond purchase programmes, which are generally used as part of quantitative easing to combat deflationary dynamics, have lost their relevance, at least temporarily. Although the ECB Governing Council acts independently, the ECB's primary objective is to ensure price stability, which is defined as a medium-term inflation rate of 2 % in the eurozone.[68] Only insofar as this is possible without compromising the price stability objective does the Eurosystem support the general economic policy in the Union in order to contribute to the realisation of the Union's objectives, which are enshrined in Article 3 TEU.[69]

This means that primary law prohibits purchases whose primary objective is to strengthen the European capital market or reduce the interest burden on the Union. Nevertheless, the bond purchase programmes of the last decade have expanded the scope for monetary policy and recognised the safeguarding of the monetary pol-

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63 When the Russian invasion led to an increase in refinancing costs for some member states of the Monetary Union in 2022, the Governing Council of the ECB launched the Transmission Protection Instrument-TPI, the aim of which is to ensure the transmission of monetary policy by purchasing government bonds from individual Member States. To date, however, the ECB Governing Council has not made any purchases under the TPI.

64 European Central Bank, FAQ on the public sector purchase programme, 9 August 2023, available at https://www.ecb.europa.eu/mopo/implement/app/html/ecb.faq_pspp.en.html#:~:text=The%2050%25%20issuer%20and%20issue,located%20in%20the%20euro%20area%E2%80%9D.

65 Decision (EU) 2020/188 of the ECB of 3 February 2020.

66 BVerfG, Judgment of the Second Senate of 5 May 2020 – 2 BvR 859/15, para. 217.

67 CJEU judgment of 11 December 2018, Case C-493/17, ECLI:EU:C:2018:1000 (Weiss), para. 107.

68 According to Art. 127 (1) TFEU, "the primary objective of the European System of Central Banks (hereinafter referred to as the "ESCB") shall be to maintain price stability".

69 Art. 127 (1) TFEU.

icy transmission mechanism as an essential element for achieving price stability.[70] Although the TPI launched in 2022 only provides for purchases of securities issued by eurozone countries, purchases of EU bonds could also be justified, at least in theory, if the transmission of a uniform monetary policy is disrupted across the entire monetary union. However, as disruptions to the transmission mechanism are typically caused by a fragmentation of interest costs between individual Member States, purchases of EU bonds are probably an adequate monetary policy instrument, particularly if deflationary conditions arise throughout the Monetary Union. In conclusion, it should be noted that the ECJ has granted the Governing Council of the ECB considerable discretion in the development and implementation of a programme for open market operations.[71] This means that the creation of new bond purchase programmes that focus on EU bonds cannot be ruled out, although these must always serve to achieve the monetary policy objectives of the ESCB.

70 ECJ, judgement of 16 June 2015, Case C-62/14, EU:C:2015:400 (Gauweiler).

71 ECJ, judgment of 16 June 2015, Case C-62/14, EU:C:2015:400 (Gauweiler); ECJ, judgment of 11 December 2018, Case C-493/17, EU:C:2018:1000 (Weiss).

DGB Deutscher Gewerkschaftsbund

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Stark in Arbeit.