The functions of money and proposals for 'fiscal money'

Overview

- In recent years a number of economic observers have proposed that governments issue so-called 'fiscal money'. According to its advocates, this new form of public financial liability could be used to finance several kinds of expenditure (for example, to pay suppliers or employees) and would remove existing obstacles to increasing the deficit or the public debt; since it would not be legal tender, it would not violate the provisions of the European treaties regarding money issuance.
- In order to encourage its acceptance in private transactions and accordingly guarantee its liquidity, in some circumstances (for example, after a certain amount of time had elapsed since its issue), 'fiscal money' could be used by its holders to pay taxes.
- Based on the statistical rules in force these liabilities (as already happens for coins) would be included among the instruments that comprise the public debt and would be subject to the rules of the Stability and Growth Pact.
- Instruments of this kind have been issued only very rarely, generally following acute state liquidity crises (as happened in California on a number of occasions, most recently in 2009, and in Germany in 1933). These cases were characterized by the poor liquidity of the transactions using these forms of 'money' without legal tender status.

What are the functions of money?

From an economic standpoint, money has three functions. It is a: **unit of account**, **store of value** and **medium of exchange**.

- **Unit of account**. Money is used as a standard means of differentiating between the value of very different products and services, thereby facilitating economic decisions and contractual agreements.
- **Store of value**. Money allows us to preserve the share of income that is not used for the immediate consumption of goods and services for later use. In other words, it enables a share of current income to be kept (saved) for spending in the future.
- **Medium of exchange**. Money can be exchanged instantly for goods and services. The purchaser gives money to the seller and is accordingly freed from all obligations with respect to the latter, who, on accepting it, recognizes its value.

From a legal point of view, currency (i.e. banknotes and coins) is the only money with legal tender status used by households and firms nationwide or, as in the case of the euro, within several nations that have committed to use a common currency on the basis of a treaty. Currency in circulation is accordingly the only means of payment that has the following characteristics:

- **Mandatory acceptance**: the creditor of a payment obligation cannot refuse banknotes and coins that have legal tender (Article 1277 of the Italian Civil Code), unless the parties have agreed on other means of payment;

- **Acceptance at full face value**: the monetary value of the banknotes and coins is equal to the amount indicated on the banknotes and coins;

- **Power to discharge from payment obligations**: a debtor can discharge himself from a payment obligation by tendering banknotes and coins to the creditor.[1]

When concluding a payment transaction households and firms may, in addition to money having legal tender status, also employ private means of payment, defined and regulated by agreements between the parties. Bank sight deposits, for example, though without any legal tender status, are nonetheless a very common means of payment since the depositor can request their conversion into legal tender at full face value at any time.[2] ATM cards, cheques, credit cards and bank transfers are commonly used instruments for transferring deposits in payment transactions which, when this occurs between customers of different commercial banks, is made possible by movements of reserves on accounts held by credit institutions with the central bank.

In the monetary union only the European Central Bank (ECB) and national central Banks (NCBs) of the participating Member States, subject to authorization by the ECB, are empowered to issue euro banknotes. Member States may issue euro coins subject to approval by the ECB of the volume of the issue.

What is 'fiscal money'?

'Fiscal money' cannot be legal tender. Article 128 of the Treaty on the Functioning of the European Union (TFEU) and Articles 2, 10 and 11 of Council Regulation (EC) No 974/98 stipulate that euro banknotes and coins are the sole legal tender in the monetary union. If issued, 'fiscal money' could only play the role of store of value and, in this regard, would closely resemble a government security. Based on current legislation, this 'money' could only be used as a means of payment with the consent of the creditor. Accordingly it would only be certain to be accepted by a State that had pledged to do so against its own tax credits vis-à-vis the holder.

If, instead, the State unilaterally decided to pay down its own debts using money other than the legal tender, this would violate the provisions of the TFEU and of Council Regulation (EC) No 974/98, with a high probability of litigation and negative repercussions of a reputational nature among the potential subscribers of its public debt securities.

Has 'fiscal money' ever been issued?

Issues of this kind of instrument have occurred very rarely, when there have been acute national liquidity problems, leading to the inability of the State to raise funds on the markets. The most frequently cited cases are Germany in 1933 and California (several times, most recently in 2009). Both are very particular cases and ought to be assessed against a specific historical and economic background.

In 1933 the German government was unable to raise funds on the markets owing to the block imposed by the creditor countries that controlled the central bank (the victors of the First World War). In response, the government set up a company (the MEFO or Metallurgical Research Corporation) that issued bills of exchange underwritten by the State to pay its suppliers. These bills

[1] Italian Anti-money-laundering legislation provides that cash payments exceeding certain amounts cannot be made directly between the parties but must be executed through banks, Poste Italiane, e-money or payment institutions.

[2] Without prejudice to compliance with any notice period agreed on pursuant to the provisions of Article 1852 of the Civil Code.

could be converted at the German central bank into legal tender at below face value.[3] Although this money did not constitute a State debt *per se*, it was clearly a debt of a public subsidiary company.

In 2009, following the liquidity crisis triggered by the failure to approve the federal budget, the State of California used actual IOUs as a means of payment for public-sector employees and suppliers. These were securities with 3-month maturities and a rate of return equal to more than 15 per cent.[4] In the first week of issue, the banks converted these bills into deposits (withholding the interest); subsequently they refused to accept them.[5] From that moment up until the approval of the budget, and therefore until it became possible to redeem the bills early, a secondary market was created in which they were exchanged at a much lower price than the face value (owing to their poor liquidity and issuer default risk).[6]

How liquid is this kind of instrument?

If, notwithstanding the legal and reputational risks highlighted above, it became possible for a State to free itself in part or in full from its pecuniary obligations by making payments in 'fiscal money', it is likely that this kind of instrument, given that it would not enjoy legal tender status, would have a lower degree of liquidity in transactions other than tax payments. As happened in California, 'fiscal money' would probably be accepted as a means of payment between private parties only in exchange for a liquidity premium, equivalent to a discount on the face value (at least equal to the return on a government security with a maturity equal to the period that must elapse between the issue of the instrument and the time when it can be used to pay taxes).

In transactions, instead, between the State and its creditors (for example, suppliers and employees), if obliged to accept 'fiscal money' as payment, creditors would witness a reduction in their income, given that they would be paid with an instrument of lesser value compared to the legal tender used in subsequent transactions. This would presumably lead to the adoption of mechanisms to safeguard the value of their income (for example, amendments to collective bargaining contracts and higher prices of goods and services in calls to tender).

Could these instruments be issued without increasing the national debt?

No, given that just like government securities, 'fiscal money' would be a liability incurred by the State from the moment of issue. Even coins issued by the State, which are also legal tender, are considered liabilities and counted towards the public debt.[7]

---

[3] A. Ritschl, 'Reparations, Deficits, and Debt Default: the Great Depression in Germany', Centre for Economic Performance Discussion paper, 1149, 2012; D. Silverman, 'Fantasy and Reality in Nazi Work-Creation Programs, 1933-1936', *The Journal of Modern History*, 65(1), 1993.

[4] In the case of California the Securities and Exchange Commission (SEC), the equivalent of Consob in Italy, issued an investor alert to safeguard those who had received payments through these IOUs, declaring that for the purposes of the federal securities laws they could be considered in all respects securities (https://www.sec.gov/investor/pubs/californiaiou-alert.htm).

[5] http://money.cnn.com/2009/07/09/news/economy/california_ious/

[6] https://www.theguardian.com/world/2009/jul/12/california-issues-iou

[7] See the section, 'The Public Finances: Borrowing Requirement and Debt' (http://www.bancaditalia.it/pubblicazioni/finanza-pubblica/index.html?com.dotmarketing.htmlpage.language=1).

Could the issue of these instruments help to sidestep European restrictions?

No, given that to all intents and purposes they would be government liabilities, these instruments could be issued only by complying with the limits on the deficit and public debt imposed by the Stability and Growth Pact.

Would the issue of these instruments cost the State less than regular government securities?

No, similarly to what happens when the government issues public debt securities, by issuing 'fiscal money' the government would pay a 'risk premium' (defined by the market) to compensate the holders both for the lower degree of liquidity of the instrument, which can generate uncertainties about its acceptance as a means of payment among private parties, and for the risk of subsequent legislative changes that could reduce or eliminate the possibility for the State to accept 'fiscal money' for the payment of taxes.

Issuing 'fiscal money' would also require the establishment of an *ad hoc* payments system with built-in anti-counterfeiting measures (to enable firms and households to consider such money as trustworthy as banknotes), entailing future additional costs compared with those incurred for issuing Government securities.