Partial Fiscalization: Some Historical Lessons on Europe's Unfinished Business

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The recent Eurozone crisis of 2010-2013 has brought to the fore the argument that a successful monetary union needs to be combined with a fiscal union. The history of the U.S. monetary/fiscal union is often given as a template for Europe. In this paper we describe how the push towards creation of the American fiscal union was long and arduous—it took from 1790 to the mid-1930s. In the European case, unlike the U.S. story, there is strong opposition to creating a fiscal union because members fear the loss of sovereignty that is entailed.

As a compromise between the status quo and a U.S. style fiscal union we highlight a series of measures which amount to partial fiscalization. These include: a banking union; a tax union; a capital markets union; a social security union; an energy union; and a military union. These fiscalizations can be viewed as a variety of insurance mechanisms in which different risks for different participants are covered. Each taken by itself may produce substantial objections from those who fear that someone else's risks are being covered at their expense. The answer to such objections may be to think not in terms of partial but comprehensive reform packages as are often negotiated in the sphere of international trade.

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A. Introduction/Overview

The British referendum on EU membership, combined with the discussion of a partial Greek exit from the euro has raised in a suddenly acute form the question of the relationship of the EU and the eurozone. The new acute crisis demands some innovative thinking to preserve – and extend – the central benefits of European integration, while thinking about additional areas that demand a cooperative rather than a confrontational solution.

The Maastricht treaty basically assumes that all EU member countries will satisfy the membership criteria for the currency union and stipulates that they are then obliged to join. The opt-outs only relate to the UK and Denmark. The UK has been in a paradoxical position of championing the rather abstract case (with which probably a majority of economists agree) that a currency union requires a greater measure of fiscal integration than the EU or the eurozone currently possesses. US policymakers made very similar points. But, on the other hand, the UK made it clear that it did not want to participate in that greater fiscal integration; and (with the Czech Republic) voted in January 2012 not to accept the fiscal compact treaty (on "legal grounds").

Brexit may thus in theory make a move to greater fiscal integration easier. At the time of the Maastricht discussions, many European policymakers, like the influential commission president Jacques Delors, simply assumed that the EU budget's share of the budget would rise to about three percent of GDP (by coincidence, that was about the share in peacetime of the US federal budget during the 19th century). Instead, the figure remained stuck at just over one percent (it has actually declined slightly since the 1990s). Denmark on its own is unlikely to want to remain an outlier, especially since the management of the currency since the global financial crisis of 2008 has been rather precarious. There is a similarly strong case why Sweden might want to end its anomalous "out" position – for the same kind of reasons as Norway and Switzerland are finding it very hard to live with an independent currency and to devise an appropriate set of monetary and exchange rate policies. But, at the same time, the contemporary Greek experience should be a warning against thinking that there might be a new political equilibrium that shifts towards an obvious acceptance of greater fiscal federalism.

Bordo and James (2010) identified three key problems facing the euro after 10 years; a) the lack of a fiscal union (the architects of the euro had assumed that the European budget would rise as a share of GDP from about 1 percent to at least around 3 percent; b) the absence of a banking union (the architects of the euro believed that some common banking supervision was needed to meet the financial stability requirements that followed from an integrated capital market with large cross-

border financial institutions); c) slow economic growth (the architects of the euro had had a naïve belief that market integration would set off a surge of economic growth).

We believe that we were prescient in that all three elements contributed to the Eurozone debt crisis although at the time our views were greeted with considerable skepticism. Our analysis however raises the question of how can the EZ get around these obstacles, and of where will the EZ project go in the aftermath of the debt crisis. Can lessons from history help? It is by no means clear that fiscal union on its own solves adjustment problems: the existence for instance of an integrated monetary and fiscal regime in Italy after Italian unification did not promote equal growth throughout the new state, and for most of the next 150 years (with the exception of the 1950s and 1960s, and partially also of the 2000s) regional differences in wealth and income increased rather than decreased (Toniolo 2013). So there is a legitimate question about the circumstances in which a commitment to greater fiscal integration has a growth enhancing effect that builds rather than erodes integration.

In this paper, after looking at the historical record of fiscalization (which is mixed), we highlight a series of measures which amount to partial fiscalizations, and some of which are currently being discussed. These fiscalizations are all understandable as a variety of insurance mechanisms, in which different risks for different participants are covered. Each taken by itself is likely to produce substantial objections from those who fear that somebody else's risks are being covered at their expense. The answer to such objections may be to think not of partial but of comprehensive reform packages.

B. The Historical Analogy between the EU and the US

The creation of a monetary and fiscal union in the US is often presented as the outstanding model for Europe (Sargent 2011). Successive Presidents of the ECB seem to endorse this advice. Accepting the Charlemagne Prize in Aachen, Jean-Claude Trichet (2011) said: "In a long term historical perspective, Europe – which has invented the concept and the word of democracy – is called to complete the design of what it already calls a "Union". His successor, Mario Draghi (2012), has been even more dramatic, demanding "the collective commitment of all governments to reform the governance of the euro area. This means completing economic and monetary union along four key pillars: (i) a financial union with a single supervisor at its heart, to re-unify the banking system; (ii) a fiscal union with enforceable rules to restore fiscal capacity; (iii) an economic union that fosters sustained growth and employment; and (iv) a political union, where the exercise of shared sovereignty is rooted in political legitimacy." This advice seems appallingly radical to many, since almost every politician denies that there is any real possibility of creating a European state, and almost every citizen recoils at the prospect.

A great deal of the discussion of how European integration might operate – both in the past and in the future - has been driven by thoughts of how precedents on the other side of the Atlantic have worked. At the highest political level, such reflection concerns the constitution, where the U.S. precedent has driven European leaders to contemplate (up to now rather unproductively) the possibility of realizing a European constitution. At the time of independence in 1776, the thirteen former colonies were widely thought of as independent and sovereign entities, and Americans did not want the United States simply to be another conventional state like France or Britain. The constitution was only drawn up in 1787, and really only completed in 1791 with the Bill of Rights. Modern European attempts to follow the eighteenth century U.S. constitutional path were suspended after the proposed constitutional treaty was rejected in referenda in France and the Netherlands in the summer of 2005. That was not, however, the end of the discussion. In the wake of the financial crisis, some – including Chancellor Merkel – suggested that in the long run, a new constitutional settlement is the only acceptable way of defining the claims and obligations of member states. This argumentation is convincing. If the path laid out in this section is taken, in which monetary union is followed by the development of some measure of fiscal federalism, a constitutional solution laying out clearly the extent and limits of states commitment would be an essential condition.

The aftermath of the recent financial crisis has driven another sort of European reflection on how a workable federal fiscal system arose in the United States: that came, again with a considerable lag after the Declaration of Independence, in 1790. Fiscal federalism actually took much longer to work its nation-building magic. It was not until the middle of the nineteenth century that "the United States is" became the accepted grammatical form (rather than "the United States are"). The federal state expanded beyond a rather modest peacetime share of 3 percent of GDP only in the middle of the twentieth century. Strikingly, that ratio of 3 percent was the size of the European Union budget envisaged by European Commission President Jacques Delors at the time of the Maastricht Treaty, at a moment when the actual size of the budget was the 1 percent where it still lies (James 2012).

Those who (like Jacques Delors) would like to see Europe moving in a federal direction see the long (and often tumultuous) development of the United States as a precedent. But is it a helpful example or rather a grim warning? There are many episodes in the creation of a modern federal U.S. state that hold analogies in the painful and politically contentious road to European integration.

Alexander Hamilton in 1790 created a currency union based on specie convertibility, created a fiscal union based on the consolidation of state debt into US bonds serviced by excise taxes collected by the Federal government and created a prototype central bank , the First Bank of the United States, that closely resembled the Bank of England (ten years later Napoleon similarly imitated the British example when he established the Banque de France).

Hamilton's eventually successful proposal for the assumption of state debt arising out of the war of independence was certainly a decisive initial step in the creation of a real Union – and it accompanied the constitutionalization of the American experiment. But assumption did not produce a responsible system of state finance, and within the subsequent half century there were numerous state-level defaults and a debate about new debt assumptions and/or new ways of blocking state indebtedness. The irresponsibility of states also gravely damaged the reputation of the federal government and made external borrowing prohibitively expensive.

Hamilton argued – against James Madison and Thomas Jefferson - that the war debt accumulated by the states in the War of Independence should be assumed by the federation. There were two sides to his case, one practical, the other philosophical. Initially the most appealing argument was that a federal takeover of war-related state debt was an exercise in providing greater security and thus reducing interest rates, from the 6 percent at which the states funded their debt to 4 percent. Hamilton emphasized the importance of a commitment to sound finance as a prerequisite to public economy. "When the credit of a country is in any degree questionable, it never fails to give an extravagant premium upon all the loans it has occasion to make." Reduced borrowing costs and a lower drain on resources by the need to service debt would allow the state governments to "furnish new resources," to uphold public order and protect the security of the union against foreign attacks. There would be concrete benefits, accruing "to every member of the community." Land values would increase from their postwar lows. The historical case looks like an attractive precedent for the Europeans of today, where proponents need to sell a solution as holding out gains for both debtors and creditors.

Hamilton also insisted on a stronger reason for following good principles than merely the pursuit of expediency. There existed, he stated, "an intimate connection between public virtue and public happiness." That virtue was considered in honoring commitments. Extended in a political body, it would build solidarity. Those principles made the fiscal union what he called "the powerful cement of our union." (Hamilton 1790) The promise to honor obligations had already been clearly set out during the War of Independence as a foundation of a new American identity: in Congress's address to the states of April 18, 1781, it had stated that: "A bankrupt, faithless Republic would be a novelty in the political world, and appear, among reputable nations, like a common prostitute among chaste and reputable matrons."

The state debt (estimated at $25 m.) at this time was smaller than the federal debt (also incurred almost entirely as a result of the war), with $11.7 m. foreign-owed federal debt (on which at that time default was unthinkable) and $40.4 m. domestically owned (for comparison, a modern estimate of 1790 GDP is $158 m.: Mitchell 1983).

The condition for success in the American case was that the Union raised its own revenue, initially mostly through new excises and federally administered customs houses that generated an amount equivalent to 10 percent of imports or around 2 percent of GDP (Perkins 1994; Bordo and Végh 2002). The logic of a need for specific revenue applies also in modern Europe, where the sources of funding for bank rescues or for a recapitalization fund should be clearly spelled out. This consideration has produced an initiative to impose a small levy or tax on financial transactions. In the longer horizon, the analogy with Hamilton's system would require a more extensively reformed fiscal system that might include a common administration of customs or of value added tax (with the additional benefit in both cases of eliminating a great deal of cross-border fraud).

Would an expansion of European federal fiscal capacity represent a massive transfer of power from member states to EU authorities? It is significant that the 1790 assumption of state debt occurred in the context of an understanding that federal powers should be few and limited. In Federalist paper 46, James Madison had made clear that central authority should be carefully circumscribed, and had concluded that "the powers proposed to be lodged in the federal government are as little formidable to those reserved to the individual States, as they are indispensably necessary to accomplish the purposes of the Union." (Madison 1788)

There were two problems with the Hamilton proposals, both of which gave rise to immediate and violent political controversy. First, state debt had been extensively traded on a secondary market at a deep discount. Relatively few of the original purchasers, who had acted out of patriotism, still held the debt; instead, the debt had been bought up by speculators – financial intermediaries – who hoped that something like the Hamilton scheme might be realized. A settlement that imposed no haircut and treated the debt at nominal value would in effect be a reward for speculation. James Madison disliked the idea of what would be in effect a subsidy for northern financiers. But Hamilton argued that any discrimination between creditors based on the moment when they had bought debt would be a breach of contract.

Second, some states had already made great efforts to pay down their wartime debt and would not benefit from the federal bailout. Virginia and Maryland in particular had largely paid off their debt, and the Virginian representatives in Congress consequently pressed for a precise calculation of the level of state debt outstanding (Mitchell 1962, 70). Madison in particular pressed for a compensation for states that had already discharged their debt. Politically, a straight forward debt assumption was unworkable.

Initially, assumption was rejected by Congress, with potentially catastrophic consequences. Thomas Jefferson, who was opposed to the Hamilton proposal, wrote to his fellow Virginian James Monroe about the possibility of failure as Congress was split. "Unless they can be reconciled by some

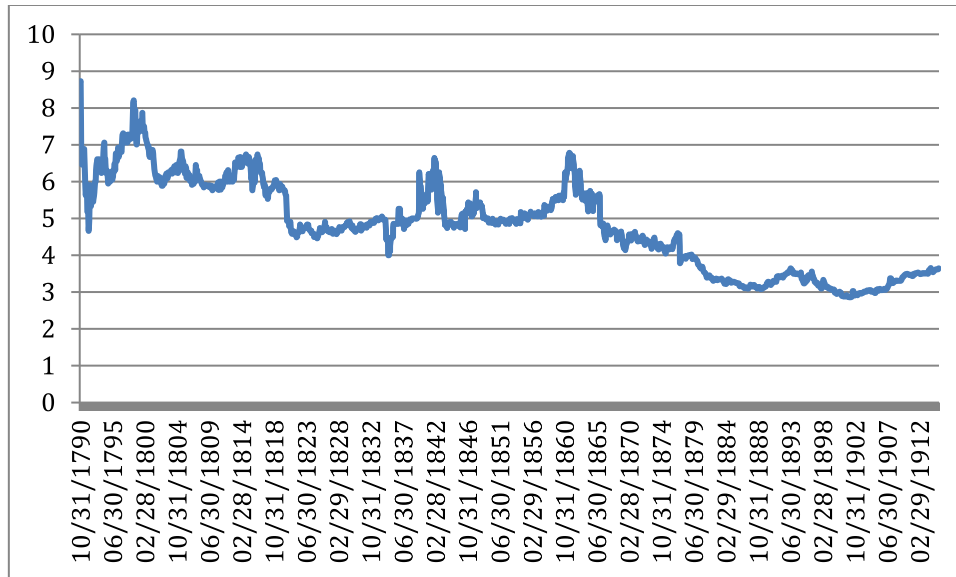
compromise, there will be no funding bill agreed to, our credit will burst and vanish, and the States separate." (Mitchell 1962, 81)

Eventually the Union was bought, at a price, and there was a compromise. Since the financial arrangement favored the northern states, the south and its landed elite needed a symbolic but also practical compensation. There were financial clauses that limited the liability of the southern states. The exposure to the common liability of Virginia, the most politically powerful state in the Union, was limited with a ceiling. Only this inducement moved Madison to drop his opposition and agree to assumption. But there was also a symbolic and political concession. The historic compromise also led to the capital being moved to the new site of Washington, on the border of Virginia and Maryland, rather than staying in Philadelphia. Some states, such as Georgia, opted out of the assumption.

The U.S. experiment in federalized finance was not immediately successful from the point of view of driving economic growth in the young republic. Two important parts of Hamilton's financial architecture were not realized, or only realized imperfectly. He proposed a model of joint stock banking on a national scale, which ran into immediate opposition, and which curiously was much more influential in Canada than in the U.S. Secondly, the proposal for a national central bank, based on the model of the Bank of England, was eventually blocked by political opposition. The charter of the First Bank of the United States was allowed to lapse in 1811; then, one generation later, the charter of the Second Bank of the United States was successfully opposed by Andrew Jackson after 1832.

The fiscal side did not bring long-lasting relief, either. Yields on U.S. government debt fell immediately, showing the new confidence produced by the debt arrangement. By the beginning of 1792, they had fallen to 4.6 percent; but after that the cost of borrowing rose sharply again.

Figure 1: Yield of Ten Year U.S. Federal Bonds 1790-1914



Source: Global Financial Data

Neither did the Hamiltonian scheme of federal finance guarantee a peaceful commonwealth in the longer term. The immediate consequence of the new excise was a revolt in Pennsylvania (the Whiskey Rebellion of 1794 and four years later the Fries Rebellion). States were in the longer run divided over the shape of tariffs, which southern states saw as disadvantageous to them since they relied on cotton exports and the import of British manufactures. In fact, the fiscal union proved to be explosive rather than cement, because the tariff dispute by the 1830s was turned into a constitutional struggle in which southern states claimed that the constitution was merely a treaty between states and that the south could resist federal laws that they deemed to be unconstitutional. The fiscal mechanism designed to allow servicing of a common liability raises inherently explosive distributional issues.

The distributional consequences between states of a fiscal mechanism would also be a potentially divisive mechanism in contemporary Europe. The most popular suggestions in discussion today are a general financial transactions tax, which would fall heavily on major financial centers (and for this reason is resolutely blocked by the U.K.); or a European payroll tax, which would raise problems of different implementation and coverage in the various European states.

The fiscal union was also dangerous because it allowed states to recommence their borrowing. As with the dispute over the tariff, the problem became very apparent in the 1830s. As international capital markets developed in the first decades of the nineteenth century, American states used their new-found reputation to borrow on a large scale, and quite soon ruined their creditor status. The states borrowed to finance infrastructure projects, canals and railroads. It was assumed that these improvements would lead to economic growth and would generate the tax

revenues to service and amortize the debt. (Wallis, Sylla and Grinath 2004). It also may have been assumed that the federal government would bail out the states in the event of a default, as they did after the Revolution (Sargent 2014).

At first, the North American states looked to British banks and investors as more appealing debtors than the newly independent South American republics, which just wanted to borrow in order to buy weapons. Agents of the American states swarmed over Europe in order to sell their debt. A key part of the argument for the foreign investors was that the American state borrowing was sanctioned and approved by the United States government. A characteristic statement was that of the London Morning Chronicle in 1839 and 1840 that "persons desirous of investing money in any of the principal American securities will find on inquiry that we have never over-rated the honor and good faith which have always been shown by the United States government." Even "the newest and smallest states" were satisfactory for Washington (McGrane 1933, 677).

In addition, the difficulties of the states became acute because of banking issues. In the long-standing conflict about the Hamiltonian concept, President Andrew Jackson launched a Bank War, in the course of which he vetoed the rechartering of the Second Bank of the United States, but also encouraged other banks to seek charters. The result was successful in achieving Jackson's immediate objective, in that it decentralized credit. But then the new banks immediately started to expand their lending, above all to the states and the political elites that had facilitated their establishment. The upshot was an orgy of bank credit to individual states, often structured in a complex way so that debt securities could be repackaged and sold on foreign markets.

When in 1841 the first state, Mississippi, reneged on its debt, disingenuously claiming that its law allowing state bond issuance had been unconstitutional, the major British bank involved in the issuance of American state debt in London, Barings, counseled against a panic response: "Is it wise for this single instance of dishonesty in a remote and unimportant state to endeavor to brand the whole of the United States as wanting in good faith? We think not." (McGrane 1933, 683) But the foreign creditors also tried to push the U.S. government into a new federal assumption of state debts, and the case was actively pushed by the Whigs (while Jacksonian Democrats saw the campaign as a conspiracy to get the American taxpayer to bail out individual states but above all the foreign creditors).

The practice of default spread in 1841-2, with Florida, Michigan, Pennsylvania, Maryland, Indiana, Illinois, Arkansas and Louisiana all announcing their unwillingness or inability to pay. At this time, a whole palate of responses was contemplated, ranging from the expulsion of defaulters from the Union to the repetition of the Hamiltonian assumption. The situation was so precarious because of the international consequences: not just exclusion from the European capital markets needed to finance American development but also a real security threat. The federal government

could not even sell bonds yielding six percent, while – as the U.S. Treasury bitterly complained, 'nations with not a tithe of our resources, and with large public debts, have been able to effect loans at three per cent per annum." (Bolles 1885, 580) But the consequences of default also included the risk of international conflict, as Britain was widely thought to be willing to use naval and military power to enforce credit claims. As a response to the danger of military conflict with the principle creditor country, Congressman John Quincy Adams even introduced a proposal to make the repudiation of any debt to foreigners "a violation of the Constitution of the United States" and that any state involved in a war as a consequence of repudiation should cease to be a state of the Union (Scott 1893, 248-249).

Inevitably, the Hamiltonian option was floated again. In 1843, a congressional committee recommended a new assumption, on the grounds that the debts incurred had been mostly for infrastructure which was "calculated to strengthen the bonds of union, multiply the avenues of commerce, and augment the defenses from foreign aggression." (Scott 1893, 251) But this proposal was rejected, primarily on moral hazard grounds: if states were freed of present debt, they would only be likely to get into debt very quickly again. The measure also would have imposed a clear and heavy cost on the non-indebted states. The outcome of the 1840s debate was laissez-faire: no federal intervention to punish defaulters, but also no bailout.

The fiscal space of the US federal government in the nineteenth century was very small, about 1-3 percent of GDP in peacetime, in other words somewhere between the actual size of the EU budget today and the size envisaged by the visionaries of the late 1980s. The big innovation that led to the creation of a real fiscal union occurred in the aftermath of the Great Depression, but there were two parts of this story: one an expansion of general fiscal activity, aimed at public goods that pulled the union together (water and dam projects; and federal highways); and second, a social security system that collected payments from individuals and created benefits for individuals, but where the resulting surpluses or deficits in strongly expanding or contracting states amounted to a fiscal stabilizer.

The Great Depression also produced the beginning of a banking union, with FDIC in 1934. Like the European banking union, it started in a modest and perhaps even disappointing way. In 1934, a relatively small share of deposits was protected by FDIC which had a limit of $10000 per account. The Federal Reserve's Gold Settlement account, which provided reserves to deficit Reserve banks on the collateral of gold certificates, also protected member banks from asymmetric shocks to the extent that they had access to the Reserve bank's discount window. This differed between Reserve Bank districts (Richardson and Troost 2009). This arrangement financed inter

regional payments imbalances (Rockoff 2004) In many ways it was a predecessor to the use of the Target II facility of the ECB (Bordo 2014).

It was the legacy of the 1930s more than that of Alexander Hamilton that made the late twentieth century US more resilient, and in the aftermath of the housing bust and the Global Financial Crisis, US states did not go through the severe traumas of the EU members.

The implication taken from the US story was that Europe needed to imitate the American example. Europeans had already done that by creating integrated goods, capital and labor markets, as well as in establishing the ECB and the euro. But they didn't go all the way and create a fiscal union at the same time because of fears over loss of sovereignty and one way fiscal transfers (art. 122 of the Maastricht Treaty). They also believed that following the discipline of the no bail out clause (art. 125 of the Maastricht Treaty) and market reforms would be enough. This omission came to haunt the framers during the 2007-2008 global financial crisis when many countries ran large fiscal deficits which threatened their fiscal stability. The crisis came to fruition in 2010 after Greece revealed that its deficits and debt were much higher than originally stated. Despite the evidence that a fiscal union like the U.S. would have prevented much of the eurozone's distress, going very far in this direction is vehemently opposed by most member states because it would involve a perceived surrender of sovereignty and because it would lead to permanent one way fiscal transfers. That said we ask whether there are alternative paths to greater integration and stability.

C. Improvements in Fiscal/Governance Integration

There are many reforms – some of them being actively debated at present – that would make the EU work more effectively without requiring full fiscal integration. But at the heart of Europe's contemporary paradox is that it either needs more moves to establish a wider field of common areas of activity (implicitly or explicitly mechanisms for sharing public goods subject to certain conditions, in a manner anaologous to insurance) , or alternatively greater monetary flexibility.

1. Currency Innovation: The Meaning of Currency Union

The debate about currencies within the EU should include a greater willingness to think about alternatives. In 1992-3, the EMS crises almost destroyed the path to the Euro, but the crisis was resolved by instituting greater flexibility: through wider (15 percent) margins in the exchange rate bands. The modern equivalent to the band widening of 1993 would be keeping the Euro for all members of the Eurozone but also allowing some of them (in principle all of them) to issue – if they needed it – national currencies. The countries that did that would find that their new currencies

immediately traded at what would probably be a heavy discount. California adopted a similar approach at the height of the recent financial crisis, issuing IOUs when faced by the impossibility of access to funding. The success of stabilization efforts could then be read off from the price of the new currency. If the objectives were met, and fiscal stabilization occurred and growth resumed, the discount would disappear. In the same way, after 1993, in a good policy setting, the French franc initially diverged from its old level in the band but then converged back within the band. Such a course would not require the redenomination of bank assets or liabilities, and hence would not be subject to the multiple legal challenges that a more radical alternative would encounter. There would also be the possibility that the convergence did not occur. The two parallel currencies could then coexist for a very much longer time period. This is not a novel thought. It was one of the possibilities that was raised in the discussions on monetary union in the early 1990s, that there might be a common currency but not necessarily a single currency.

2. Minimizing Financial Vulnerability: Banking Union

The debate on banking union also needs to be recast. What is now termed a banking union – that is common European regulation with some fiscal capacity for resolution in the case of failed banks – is a very belated but necessary completion of the monetary union. Even this step is only partial, and has excited a great deal of opposition from Germans who do not want to bail out south European banks. Thus while there is European supervision, the resolution process is predominantly national. Critics have correctly identified the problem, that some sort of permanent fiscal mechanism is required in order to pay for the bailouts and thus in fact implies a move to a real political union which regularly redistributes resources. But there is also a legitimate worry that the creation of an extended banking union would involve very large insurance commitments, that Europe's citizens are not necessarily already willing to take on. The current discussion – as set out for instance in the very helpful Four Presidents' Report of December 2012 and extended in June 2015 in the Five Presidents' Report - is set out very much in terms of an "insurance type mechanism": but it is important to remember that insurance mechanisms are not suited to make long term one way transfers, rather they have to represent a genuine sharing of risk (ie of conditions which at the time of making the insurance contract cannot be anticipated).

In a recent extended analysis of political economy trilemmas (Bordo and James 2015), financial vulnerability provided the key linkage by which instability is transferred from the primarily technical domain of currency arrangements to the large fundamentally political problems of democracy and the international order. Taking the fangs out of a dangerous financial system – for instance moving along the path from a bank-based system to a greater orientation toward capital

markets – is thus an important element in rectifying flaws. The critical issue is to find innovative institutional paths to allow small and medium sized enterprises – that are traditionally at the core of economic dynamism in Mediterranean countries, but also in German and in Baltic Europe.

Securitization, which is often especially in the US presented as the villain of the 2008 crisis because of the centrality of problems in the securitized mortgage market, may be the most hopeful solution. Combining and repackaging small enterprise loans – from different regions and from different kinds of economic activity – is an obvious step to risk diversification. Of course, there can still be shocks that produce coordinated and generalized slowdowns, and that require macro-economic responses; One of the problems of bank lending in many countries (in the US but also in Europe) has been that it was increasingly directed toward property lending – and just served in consequence to drive up real estate prices leading to a boom and eventual bust. It may also have been a source of increased wealth inequality in modern societies (Ronglie 2013).

3. Becoming more American: The Capital Markets Union

Part of the transformation of Europe's economy consequently should lie in a reduction of the role of banks in financing business activity and an increase in the access to capital markets, especially for small and medium sized enterprises (SMEs). This has become part of the official European agenda for the capital markets union, sketched out in the green paper. Creating a genuine capital union will also require steps to ensure compatibility for products across national frontier, and provisions for greater transparency, including credit registries and credit ratings for SMEs. Up to now, small enterprise credit rating is handled in a very different manner in different countries: by private providers in some cases while in others central banks still play a major role in maintaining. The Banque de France created its major credit register in 1946; Germany has had a tradition of private associations, such as Credit reform established in 1879, and which then internationalized their activity. There is also a requirement for convergence on legal procedures, notably bankruptcy: the idea of integrating capital markets thus requires really quite considerable steps in political and legal integration.

4. Shifting the Tax Base: Tax Union

Fourth, the debate about fiscal consolidation is in need of rethinking. One of the great controversies of the nineteenth century U.S. revolved around Henry George's proposal for a land tax. In Progress and Poverty (1873), he explained that a great part of the gains from productivity were captured through rents of monopolists or land-owners. Competition policy – the limiting of

monopoly power – has from the beginning been a core task of the European Economic Community / European Union. But the land-owning issue has not been the subject of thought or debate – until very recently.

The recent story of Europe has been a process of learning lessons about the appropriate character of the tax base. In the 1970s, with increased capital integration, many European countries discovered that they could not tax capital highly – as large companies would otherwise move their operations. Capital was too mobile, and especially smaller European countries adopted low rates of corporate taxation which contributed to stronger and more dynamic economic performance. With increased mobility of people, the same limits are being reached for personal tax: as President Hollande found when he introduced a tax on the super-rich (over one million euros), which brought unexpectedly little revenue, and which he was obliged to scrap. The threat of the tax just precipitated the move of high-earning French residents to other countries, with lower tax environments. One solution – a common European tax rate – is hardly likely to lead to greater dynamism, and is incompatible with the principle of national democratic choice.

Taxing land more effectively has many obvious advantages. It isn't easy to conceal land, and it's impossible to move it. Taxing under-utilized land (empty, neglected and decaying houses) imposes a cost on the owners that they will try to avoid by selling their property to others who can make better use of it. Taxing urban land is an effective counter to the substantial rents that are created by planning restrictions in densely populated urban settings. Like any new tax, however, such a innovation would produce a politically powerful coalition of those property holders fearing the costs of the scheme; it could only be realized with a broad coalition of other tax payers (those on wages and salaries) who would look favorably on the consequences of tax relief.

5. Transfers without Politics: Welfare Union

Problems of transfers in a large unit are at the heart of the political process of building federations or federalism. The better way of discussing transfers within a large and diverse political order is to think of them as individualized or personalized. In particular, a European-wide social security system would not only be a logical completion of the labor mobility requirements of the single European market. It would indicate that the insurance principle is not just one which it is appropriate to apply to financial institutions. It would provide an important buffer in that booming areas would pay in more, and shrinking areas would draw out more – without these payments going through government bodies and appearing as transfers from North to South – whether in a country such as Italy or in the whole of the European area. Defusing the political problem requires less statehood, rather than necessarily requiring the erection of a European super-state. But like the

problem of designing better bank insurance, it also depends on making more adaptable labor markets so that the threat of large-scale unemployment swamping and destroying the insurance system is minimized.

6. Common Projects: Energy Union

The argument in favour of a European energy union – a genuine common energy market with common regulation – may even be stronger than the case that was successfully made in the 1980s and 1990s for a monetary union. Security concerns and worries about the extent of risk generate considerable pressure to implement dirigiste measures that may be counter-productive and harmful.

A coordinated approach to energy needs to address equally obvious problems that are often not recognised explicitly. Just as in the case of the European Union's overall "growth, stability, and cohesion" objectives, the 1996 Internal Energy Market directive's goals of (1) secure, (2) environmentally compatible, and (3) competitive energy sources are in conflict with each other: renewable energy may be environmentally sound, but is neither secure nor inexpensive; foreign supplies of oil and gas may be inexpensive at a point in time, but are subject to geo-political risks. Policy choices need to provide a framework to guide the myriad choices of market participants, producers and consumers, through a pricing mechanism that is accepted as fair and transparent. An economic argument can be made for security-oriented policies like renewable energy subsidies that increase both current costs and self-sufficiency.

The difficulty in formulating a forward-looking energy policy arises from the difficulty in comparing different types of risk and drawing appropriate policy lessons. There are at least four different perceptions of risk, and while all are clearly present, they tend to be seen in quite contrasting ways in different European countries, and consequently produce varied and mutually incompatible responses from national political authorities: in CO2 emissions and global warming; in nuclear energy; in security dependence on imported gas and oil; and in the vulnerability of grid delivery systems to periodic breakdown. Each of these threats is treated in very different ways. Since public debate is often driven by single headlines, a nuclear accident such as Fukushima produces a greater sense of danger than the vaguer (but more certain) long-term threat of climate change. The risk of system breakdown only enters the political debate after a concrete instance. Politics thus tends to respond too late to threats.

A fundamental philosophical division is discernible in energy discussions, around the choice between long-term planning or fixing of prices in order to generate certainty about future signals on the one hand, and a response to short-term and noisy market signals on the other. The debate is

most pronounced in the case of the two environmentally and politically most sensitive issues: gas pricing, and nuclear energy. The greater the diversity of supply, and the more market alternatives exist (including different forms of energy), the more resilient the energy economy becomes against unanticipated events, including attempts to blackmail energy users. In other words, diversity of supply limits the power of the resource providers. Marketization can thus also provide a substantial impetus to improve political conditions in other parts of the world, and reduce the monopoly rents that corrupt politicians extract in resource-rich countries.

There is a geographical divide in Europe between those countries that rely on spot markets and those that use long-term oil-indexed contracts to purchase and receive their natural gas supplies. Northwest Europe has spot markets, with LNG import facilities and hubs. Oil-indexed contract markets predominate in Central, Eastern, and Southern European countries, where only one or two suppliers provide gas to domestic markets and there is little gas supply diversification. The geopolitical strategy of President Putin is based around a pipeline view of the world, rather than a LNG vision. One result of the Ukraine-Russia crisis of 2014 may be a greater awareness of the security threat, an enhanced willingness to construct LNG facilities, and an expansion of the market principle of spot pricing as a result, rather than long-term indexation to other energy products.

Flexibilisation is an important principle in wholesale markets; but it can also play a major part in promoting domestic energy efficiency. From a consumer point of view, a move to flexible pricing may be an increasingly attractive way of steering demand away from peak times, at which the production costs/marginal costs are high. Reducing extreme peaks of demand (and consequently of pricing) in an energy supply network that is pushing against capacity restraints requires a better linkage of supply systems that are still not fully integrated. The same is true for the potentially even bigger problem of smoothing peaks in green energy supply. If the national smoothing capacity becomes exhausted thanks to the closure of conventional power plants, as is regularly the case in Germany, there is a case for selling the excess electricity to other national energy markets and use their smoothing capacity.

Further improving the linkage requires a substantial investment in transmission systems. One response to the financial and debt crisis, which is also a crisis of European growth, is to demand higher levels of investment – both public and private – in Europe. The problem is that in the past, much public sector investment has been misdirected as a result of the political bargaining processes. However, private investment has also been misdirected (above all in large construction booms). Investment in energy networks may offer appropriate incentives to private producers looking at innovative ways of producing new clean energy sources. Since the search for funding also coincides with a widespread sentiment that Europe should investigate large infrastructure investment projects, it may be conceivable to fund the new energy transmission channels, both electricity gridlines and gas

pipelines, with public or a mixture of public and private funding. A security levy on energy supply might be an appropriate way of ensuring the fiscal sustainability of such investment.

7. Common Projects: People Union

One of the gravest security crises currently facing Europe is the outcome of the disintegration of neighboring regions: North Africa and the Middle East in the wake of the so-called Arab Spring; and more recently the crisis in eastern Ukraine. Europe is confronting a humanitarian crisis as a consequence of the flight of refugees from civil war in Libya and Syria. ISIS is indeed trying to use the threat of further expulsions as a weapon against Europe.

The countries that are today on the front line of Europe's humanitarian struggle are by chance also the worst affected by the financial crisis: Greece, Italy, Spain. Responding to the distress of refugees is a European task, and the financial consequences of the refugee crisis cannot be left to the crisis-struck states, in which there is an inevitable political feeling that resources devoted to accommodating and even potentially integrating refugee populations can only come at the expense of citizens. Any adequate solution to the refugee challenge involves including or integrating them in a constructive way, at least for some time, into the host societies. It would necessarily involve substantial financial injections from Europe as a whole into the countries at the forefront of the refugee crisis. That could also be a source of new dynamism, and an answer to the problem of European ageing and decline.

At the same time, ensuring that people can move with dignity also requires the elaboration of a precise political program to stabilize the neighborhood of Europe. Europe cannot be an island in a sea of a humanitarian disaster. It needs to act effectively to end the chaos that is driving despairing people by the millions to a European safe haven.

8. Common Projects: Military Union

At the outset of the 1990s, many European leaders in the face of the new security challenge created by the collapse of communism and the Soviet Union emphasized that they needed to find a way to permanently secure European peace. Even at the time, it was not quite obvious that a currency union was the best way to do this (it was rather a question of the central bankers having plans for a currency union in their drawers). Would not a common European army be a better course? In the nineteenth century, many people made the argument that universal military service was a central part of the project of nation-building. Jean-Claude Juncker recently triggered a storm of controversy when he made this suggestion, and critics emphasized the difficulty of expecting

military sacrifice without a much further deepening of political community. On the other hand, common defense organization and procurement would certainly involve major savings, generate a more effective capacity to project power, and might well indeed make a wider group of young people realize that they are Europeans.

9. Common Projects: Youth Union

But a similar argument could be made for encouraging other sorts of organized movement: a common social year (in a different country), but also cross-national apprenticeship schemes: indeed this is an area that some German companies have tried, with considerable success. Fostering youth mobility is probably a better way of moving to an integration of outlooks and attitudes, but also to a dissemination of best practice across Europe. Countries with high levels of out-migration at some point in the last century (Ireland and Poland are the most striking examples) found that the return of young migrants who had increased their skill levels represented a major source of dynamism. In that sense, if the current crisis is promoting higher migration, it should not simply be a source of worry: in the long-run, it may have a strengthening effect.

10. Thinking Globally: Global Union

The management of cross-national problems and the containment of nationalistic quarrels certainly require technical fixes. But it also needs more. The fatal loops that tie badly managed currencies to the destruction of the international economic and political order inevitably conjure up memories of the disasters of the 1930s, the Great Depression and the drive to war. Currency wars are now making their reappearance. Some observers believe that the rise in the exchange rate risks choking off an incipient strong US recovery. Unusually, Federal Reserve officials now sound worried about the currency. The unpleasantness created by the strong dollar additionally interacts with the vulnerabilities of the political system with a President committed to a significant trade agenda faced by a hostile and increasingly obstructionist Congress. The fierce debates about dispute settlement in the Trans Pacific Partnership as well as in the Transatlantic Trade and Investment Partnership play into the hands of trade skeptics. We should remember that there can be global disaster, as well as merely European disaster.

A politically legitimate mechanism for solving the problem of international adjustment was the unsolved problem of the twentieth century. In Europe and elsewhere it generated enormous conflict. There is an urgent need for ways of constructing currency stability that go beyond the narrow framework suggested by the OCA literature. Fixing this issue is a European but also a global agenda for the twenty-first century.

All of these areas of potential cooperation raise classic issues associated with the provision of public goods: the (many) gainers can often not see precisely how they will gain, while the (relatively few) well organized losers know quite well what their losses would be and have powerful lobby activities dedicated to stopping the realization of the public good. The obstacles to change are multiple:

1. There is a great deal of worry associated with the prospect of temporary or longer term replacement of the euro by a new secondary currency (as evidenced by the debate in Greece on possible "Grexit").

2. Countries with small public sector banks that are heavily engaged in regional economies fear the consequences of a Europeanization of banking.

3. The promotion of a better functioning capital market raises fears in the banking sector as a whole.

4. A Europeanization of some part of tax revenue raises fears in national parliaments, whose competences would be somewhat eroded by such a move.

5. A welfare union arouses fears of abuse and long-term one way transfers: the US dealt with this fear in the 1930s by constructing a social security system that made benefits largely dependent on the amount of in payments.

6. National energy providers with partial or complete monopolies would see their positions eroded by a more complete energy union.

7. The perception that refugees are being settled locally raises numerous fears and concerns.

8. A military union worried the providers of goods and services for national armies, even when there are clear efficiency gains to be realized.

9. Actions that try to engage young people in the labor force more actively encounter opposition from older workers who fear that employment protection is being eroded.

10. Trade openness on a global level worried those who fear that they will have to compete with cheaply produced imported goods and services.

Realizing any of the potential gains from any of these partial fiscalizations thus requires some mechanism for negotiation in which potential losers are either compensated by other insurance measures, or convinced that there are substantial potential gains that also make them beneficiaries.

D. The Trade Analogy

We suggest that the analogy from trade negotiations may be a useful way to think of solving the political side of some of Europe's problems. Trade negotiations have been a largely successful exercise in the second half of the twentieth century, in which large welfare gains were realized in many areas. How did they work?

First, the breakthrough occurred in the 1930s with the conceptual realization that negotiating fora that were too open to the assertion of particular interests stood in the way of the realization of generally beneficial outcomes. The landmark study (Schattschneider 1935) examined the contribution of Congress to an unintended snowballing effect, in which thousands of extra positions were added to the Smoot Hawley tariff, which was thus transformed from its original intention of providing some agricultural support into an extensive and complex industrial tariff. After the 1934 Reciprocal Trade Agreement Act, and after Second World War, the authority to act in trade negotiations in the US was delegated to the President (Irwin 1998). In an analogous manner, European countries delegated trade authority at an early stage to a supranational institution in the European Economic Community. In all the controversies over European policy after 2010, no one has ever cast doubt on the effectiveness of the Commission as the voice of Europe in trade. Trade is an instance in which framing in terms of an over-arching interest (Olson 1971) is required in order to realize potential gains.

Secondly, though, the appeal to an over-arching interest may not be enough. In practice, trade is often accompanied by auxiliary measures (Germans speak of "flankierende Massnahmen"). In trade negotiations going back to the nineteenth century domestic policy packages were put together where all players gain something but some lose more than others, so a compensation mechanism has to be created to make the deal go through. The Bismarkian welfare state is an early example, and can be understood as a compensation for the grain tariff, which raised food prices and thus hit workers who wanted some measure that would protect them. The same logic was the heart of many compromises made on a national level in the aftermath of the Great Depression: during the New Deal, where trade negotiations conducted through the RTA were compensated by deals that favored unions in the Wagner Act, but also especially in some smaller European states (the Swedish and Swiss examples are often discussed as examples: Gourevitch 1984). After the Second World War, the major surges of trade liberalization also occurred at the same time as social reform packages: the Kennedy Round at the same time as the Great Society.

The lesson from trade reform is in part a story of political framing, and in part a story of compensatory deals.

Conclusion

There is a possibility for a large variety of overall gains through partial fiscalization that would make the Eurozone operate more effectively, and which would in practice produce a logic that would increase cross-border ties and thus represent a "strong cement of the union". We first identify greater currency flexibility as a potential way of easing the problem of whether reforms need to be accomplished at the EU or the Eurozone level. We then briefly discuss banking union, capital markets union , a Europe-wide tax, possibly on property, a Europeanization of social security, an energy union, a Europe-wide response to the refugee crisis, common defense, a common approach to youth employment, and acting on a broader international stage to realize a global compact. Some of these proposals are already being partly implemented; others are the subject of an intensive debate.

The obstacles to the realization lie in political rather than economic logic. All measures represent some variant of a common insurance, but taken individually, they insure only particular sectors. That is why they are more likely to be realized as a grand compact rather than as a series of incremental measures, each produced in response to a particular crisis (an approach that has been characteristic of the European process so far, and was identified by Jean Monnet as working to integration through crises). They also require for their realization a negotiation method that identifies overarching or general interests rather than sectional preferences.

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