Whither the Euro: Some Lessons from the History of Fiscal Unions

Michael D. Bordo. Rutgers University, NBER and Hoover Institution, Stanford University

Remarks Prepared for CIGI-INET conference “ Sovereign Debtors in Distress”

Waterloo, Ontario. February 25 2012

The Euro area is still struggling through its debt crisis. The Greek Crisis may be temporarily on hold with the structured default that is currently being concluded. Continued forced austerity in that country and a political backlash to it may end in a real disorderly default in the not too distant future and a possible exit from the euro. Portugal may follow with a structured default. The crisis for the rest of the euro area is being presently (temporarily?) alleviated by generous ECB liquidity to the banks, a modest fiscal compact, some bank recapitalization and moves toward moderate structural reforms.

Many of Europe’s woes could have been predicted from what is known about the history of monetary and fiscal unions and the theory of optimum currency areas. The creation of successful national monetary unions in the past always coincided with the set up of a fiscal union as part of the creation of a nation state (Bordo and Jonung 2000). The theory of optimum currency areas developed half a century ago posited that a monetary union without full labor mobility required a fiscal authority to make transfers between subnational units (Mundell 1961).

Europe embarked on a unique experiment—for political reasons it created a monetary union without a fiscal union (although the framers of the Maastricht Treaty knew full well about the dangers of their actions [James 2012]). It is not obvious from the perspective of the present crisis as to whether the euro project will succeed. Heeding the lessons from the past should be important in guiding the European authorities in their attempt to move the European integration project forward and implementing the fiscal foundations that should have been laid earlier. It is also possible that the Euro area will devolve into a two speed Europe reflecting the growing divide in unit labor costs between the core and the periphery.

My talk briefly surveys the history of fiscal unions in four countries with the aim of drawing some useful lessons for the current situation in Europe. I focus on two very successful cases: the U.S. and Canada, and two less successful ones : Argentina and Brazil.

The United States

The formation of a fiscal and monetary union in the United States after the American Revolution has been regarded by many as the template for European efforts (Bordo, Jonung and Markiewicz 2011, Henning and Kessler 2011, Sargent 2012). U.S. debt history began with the Revolutionary War which was mostly financed by fiat money (bills of credit) by the Continental Congress and the States. The Congress had virtually no taxing power, while that of the states was too limited to pay for more than a small fraction of total expenditures. Foreign bond finance –deteriorated by uncertainty of the war's outcome—and domestic bond issues were limited by a thin bond market. In 1782, the federal government, unable to raise taxes on its own, both before and after the 1783 Articles of Confederation, had to default on both its domestic debt and debts to France.

The Articles of Confederation which created a loose confederation of states, was based on the principle of a very small, limited central authority. Like the members in the Euro area today, the states had virtually complete fiscal control. It was never possible to muster the unanimous agreement required to transfer fiscal resources to the Congress. The perceived failure of the Confederacy led to the Constitution of 1789 which gave the Federal government expanded powers in monetary and fiscal affairs including the ability to raise tax revenue and the sole right to coin gold and silver currency. The Constitution also mandated free trade between the states.

Alexander Hamilton, the first Secretary of the Treasury, put together a plan in April 1790 to restructure the public debt and create deep financial markets. His package included four elements: consolidating state and federal debt; securing sufficient debt to service the debt; the creation of a sinking fund and ; creation of the First Bank of the United States.

The first key element of the Hamilton plan for creating a viable fiscal union was for the federal government to assume the states' debt at face value and consolidate them with the debts of the Congress into specie denominated securities at the official par of exchange. According to Hamilton, this would help in creating an effective capital market and hence to facilitate government borrowing in wartime. The second key element was to secure the federal government's ability to collect sufficient tax revenue to continuously service the debt. To this end, Hamilton proposed a national tariff as well as excise taxes.

Thomas Sargent (2012) views the assumption of the states debt at par as a bailout justified by the fact that the states' debts had been incurred to win the war against Britain. The institution of the national tariff was crucial to both providing the Federal government an independent source of revenue to fund national defence and other public goods, but also to credibly service the national debt. In the present

European context, Hamilton created an equivalent to a Eurobond which would be serviced by taxes collected directly by the European authorities and not by the member states.

Hamilton also proposed a sinking fund as a way to ensure the credibility of his funding program. The idea was to set aside revenues provided by specific taxes to be used to purchase public securities on the open market. The interest earned by the sinking fund would be used to acquire more public securities and eventually pay off the debt.

The First Bank of the United States which was proposed shortly after the key fiscal provisions was to be a proto central bank, which could issue notes convertible into specie. Its role was to provide medium term government finance, promote economic development and promote a uniform currency for the nation. The proposal to create a national mint to coin U.S. dollar denominated gold and silver coins also followed the fiscal arrangements. Thus , unlike the European case, the U.S. fiscal union preceded the monetary union (Sargent 2012).

In the following half century, the federal government played a minimal role in the U.S. economy's development while the states financed major infrastructure investment (canals and railroads) by issuing debt on the assumption that economic growth would generate the necessary tax revenues to service it. In addition, based on their earlier experience after the Revolution, the states assumed that their debt carried a federal guarantee. The global financial crisis of 1837 and the subsequent depression dashed these hopes making eight states insolvent in 1841. These states then turned to the Congress for a bailout remembering what had happened in 1790. This time the Congress turned them down on the argument that unlike the imperative of winning the war against Britain in the 1780s, the eight states had borrowed in excess to finance local improvements. Thus the federal government sent a costly but clear signal regarding the limits to its commitment to fiscal support to the states.

British and other foreign holders of state debt reacted by cutting off credit to both the states and the federal government. In subsequent years virtually all U.S. states adopted balance budget rules. In the context of the debate in the euro area , the U.S. adopted a no bail out clause. Since the 1840s the federal government has never bailed out states when they defaulted.

The present U.S. fiscal arrangements began with the Great Depression. The states were unable to respond effectively on their own to the slump leading to a major change in federal fiscal arrangements. In 1933 as a major component of the New Deal, Franklin Delano Roosevelt expanded the federal government's role in the domestic economy. The New Deal shifted expenditures from the local to the state and federal levels resulting in the creation of 'big government'. The federal government provided transfers to the states through the federal income tax and programs that fund health, education and transportation administered by the states. Federal transfers and automatic stabilizers such as the progressive income tax also served to mitigate the effects of asymmetric shocks between the states. Thus , although there have been problems, the U.S. fiscal union has been successful.

Canada

The evolution of the federal system in Canada contrasts significantly with that in the U.S. .The British North America Act of 1867 created a federation in which federal government power was more highly concentrated than was the case in the early years of the U.S., Canada's legal system and strong ties to Britain in its early years supported the early development of a national bond market comparable to Hamilton's early efforts. The first Dominion of Canada bonds were issued in 1868. Dominion of Canada bonds and a federal taxing authority financed the federal government.

The Great Depression was a turning point for Canadian economic policies. The federal government became much more interventionist and proposed legislation that paralleled Roosevelt's New Deal agenda. The Rowell Sirois Commission on Dominion-Provincial Relations recommended the payments to the provinces by the federal government of national adjustment grants- -unlimited transfers aimed at equalizing provincial fiscal capacity. In return, the federal government acquired exclusive jurisdiction over personal and corporate income taxes and succession duties. In subsequent years fiscal power has swung back to the provinces.

Unlike the U.S., Canada does not have an explicit bail out clause and the provinces have borrowed extensively on the global capital markets. Market discipline has generally been effective in preventing excessive debt build up. In 1936 the Province of Alberta defaulted on its debt after rejecting the conditions of a proposed federal government bailout. In the 1980s a number of provinces ran large deficits and had high debt ratios. This led to significant risk premia and downgrades by the ratings agencies. In response to the market pressure the provinces reduced their debt exposure. In the 1990s both the federal government and the provinces undertook a major fiscal retrenchment in the face of external market pressure so that today Canada(and its provinces) is the most fiscally prudent of all the G 7 countries.

Argentina

Argentina is a federal republic with 24 provinces. Independence in 1816 revealed strong regional disparities which had been hidden by Spanish rule. It took four decades to establish a national government and a Constitution. The Constitution gave the provinces priority over the central government. Although Argentina adopted the Hamiltonian package very early it was unsuccessful in creating a sustainable fiscal union(Bordo and Vegh 2002). Its fiscal history has been characterized by a pattern of excessive government debts often accompanied by high inflation and ending with defaults.

During the 1980s both levels of government borrowed extensively. In the late 1980s the provinces accounted for roughly 40 % of the public sector's deficit. These deficits were financed by discretionary transfers and loans from the federal government. The provinces borrowed from their provincial banks, who then discounted the debt at the central bank, effectively giving the provinces a share of the inflation tax revenue.By the end of the 1980s this process led to a hyperinflation. Between 1992-1994 the federal government financed special rescue operations for seven provinces.

The Convertibility Law of 1991 created a Currency Board which pegged the peso to the U.S. dollar. It was supposed to end inflationary central bank financing of public sector deficits at all levels. However the federal government was unable to control provincial spending. Provincial debts expanded through the 1990s which ultimately were absorbed by the federal government. The process ended with a national default and exit from the Currency Board in 2002. Argentina never had a no bail out policy nor a well functioning fiscal union.

Brazil

Brazil has a complex federation. Three government levels comprise the Union of 26 states plus the Federal District and more than 500 municipalities. The Brazilian Federation was created along with the Republic in 1889. Its fiscal federal arrangements have undergone substantial changes over Brazil's history. The power of provincial governments was weak until 1889 as they had little control over fiscal revenues. As in other federations, the Great Depression accelerated the expansion and consolidation of the federal government's power. However since World War II there has been a marked shift towards the sub national governments in political power and in the share of aggregate taxes collected.

Brazil's public debt history echoes that of Argentina. Brazil experienced three major state –led debt crises between the end of the 1980s and 2000. In each case high levels of expenditure led to debt servicing crisis ending up with federal government bailouts. Large indebted provinces like Sao Paulo were aware of the fact that the center could not let them default because of negative spillovers into the rest of the economy. This led to increases in the federal debt burden fueling a national debt crisis. The last crisis in 1999 led to a Fiscal Responsibility Law in 2000 which greatly increased federal government controls over sub national borrowing. It remains to be seen how effective this move towards hierarchical control will be and whether Brazil's fiscal union will finally become successful.

Lessons for the Euro Area from the History of Fiscal Unions.

There are several lessons for the Euro area that come from our survey of the history of fiscal unions in four countries.

A first lesson is that a central tax authority is needed to service national debt and national debt is necessary to both smooth taxes and fund necessary government expenditures, especially in wartime emergencies and shocks like the Great Depression. The history of fiscal unions makes a strong case for a Eurobond to be serviced by taxes collected by a pan European fiscal authority. The authority and access to these Eurobonds can be used to transfer revenues between member states in the case of large asymmetric shocks. A fiscal authority and a Eurobond would be able to handle the problems caused today by the debt crisis in the peripheral countries. It would also have considerably more firepower to head off contagion than the temporary European Financial Stability Fund and the proposed European Stability Mechanism. Moreover the euro area would not require outside support from the IMF.

A second lesson is the importance of a credible no bailout clause. The U.S. example is most striking. Since the 1840s the federal government has never bailed out a subnational authority. The balanced budget provisions in state constitutions were instituted by the states themselves and have been largely followed. One of the negative consequences of strict adherence to balanced budgets has been to introduce a procyclical pattern into state finances. This has exacerbated the recent recession. Other institutions such as a credible rainy day fund , in which the states would deposit some percentage of their tax revenues to be administered by an independent federal authority, could alleviate this source of imbalance.

The third lesson is the importance for the monetary union of creating a viable fiscal regime. The discounted present value of future taxes must equal the present value of government expenditures and debt service. When this intertemporal budget constraint is violated public debt becomes explosive. As the Latin American examples show, the monetary authorities were forced to fund the domestic debt creating high inflation. To the extent that debt is denominated in foreign currency default will follow. In a fiscal federal framework excessive debts accumulated by the subnational units will end up being assumed by the central government , also leading to either high inflation or default. Thus a successful monetary union needs a successful fiscal union.

Behind the successful historical experiences of national fiscal and monetary unions lies a deep political commitment by all of the member states to the national state. Whether the euro area will ever move far in the direction of a successful fiscal union depends on the willingness of the member states to commit to the notion of a common European political entity and to subsume substantial sovereignty to it. The future will reveal if this will ever happen.

References

Michael Bordo and Lars Jonung (2000), Lessons for EMU from the History of Monetary Unions. Institute of Economic Affairs. London

Michael Bordo, Lars Jonung and Agnieszka Markiewicz (2011) " A Fiscal Union for the Euro: Some Lessons from History" NBER working Paper 17380. September

Michael Bordo and Carlos Vegh " What if Alexander Hamilton Had been Argentinean? A Comparison of the Early Monetary Experiences of Argentina and the United States" Journal of Monetary Economics. April

C. Randall Henning and Martin Kessler (2011) Fiscal Federalism: U.S.History for Architects of Europe's Fiscal Union. Breugel Essay and Lecture Series. Brussels.

Harold James (2012) Making the Monetary Union . Harvard University Press (forthcoming)

Robert Mundell (1961) "A theory of Optimum Currency Areas" American Economic Review, vol 51 , 509-17.

Thomas Sargent (2012) , " United States Then, Europe Now" Nobel Prize Lecture. NYU Mimeo January