

# The Euro needs a Fiscal Union: Some Lessons from History

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*These papers were originally presented as part of the SOMC symposium on October 12, 2010, sponsored by e21.*

The creation of the euro in 1999 was a bold experiment and now runs the risk of failure. Creating a multinational monetary union with a single central bank and without a fiscal union has a lot to do with the present predicament of the eurozone. The lessons from the history of successful national monetary unions should be heeded (Bordo and Jonung 2000). Federal nations like the United States, Canada, Australia, Germany and Switzerland are examples of monetary unions combined with fiscal unions that have been successful for long periods. However not all monetary unions with fiscal unions have been successful. Two obvious cases of failure are Argentina and Brazil (until quite recently) (Bordo, Jonung and Markiewicz 2010).

There are a number of factors explaining the success of national monetary unions with fiscal unions. These monetary/fiscal unions are in federal states based on common goals and a commitment to political unity. The elements of success include: a) a unified currency area (single currency) in which central banks evolved and learned to provide aggregate price level stability; b) free trade and free factor mobility among the members; c) a common federal fiscal policy with effective long-run constraints; d) member states may have some fiscal independence with fiscal discipline enforced by market forces and above all a” no bailout “rule on state debts by the federal government;

and e) the presence of mechanisms to deal with asymmetric shocks. These include automatic stabilizers like unemployment insurance, a

progressive income tax, transfers from states less hard hit by shocks to other states more hard hit, and equalization payments.

The fiscal history of the U.S. (and Canada) illustrates the evolution of these factors. The framework for U.S. fiscal federalism evolved from the Constitution of 1789 which gave the Congress power over the common public goods of national defense, diplomacy and certain public works. The states had power over the rest. Both levels of government could raise taxes to finance their expenditure and could borrow. Threatened debt defaults in 1840 by a number of states which had financed unsustainable public projects (canals) by foreign debt were not prevented by the Federal government assuming the debt. The subsequent defaults led to a cessation of British capital inflows for decades. This experience eventually led all the states to henceforth follow balanced budgets and effectively established the “no bailout rule” (Rodden 2006).

The hardship of the Great Depression in the 1930s led to an increase in the size of government at all levels but especially for the federal government which began conducting countercyclical fiscal policy and which instituted automatic stabilizers. It also led to the institution of fiscal transfers to the states (Wallis and Oates 1998).

During the 1930s Canada set in place a system of equalization payments between the provinces administered by the federal government. These



arrangements have evolved in the two countries since the 1930s and fiscal transfers effectively attenuated the uneven geographic incidence of shocks across the states and provinces (Krugman 1993). Labor mobility across regions also helped weaken asymmetric shocks in the two countries. (Eichengreen 1997).

Two not- so - successful monetary/fiscal unions were Argentina and Brazil. Both countries were established as federal nations on the US model but the states had considerable power relative to the federal government. In their fiscal histories the "no bailout rule" was not followed. In the late twentieth century the state governments ran large fiscal deficits and when faced with default was bailed out by the federal government. In addition the fiscal deficits of the federal government were often monetized by the central bank. As a consequence, on a number of occasions these countries suffered massive currency and debt crises.

The eurozone arrangements have some elements of both sets of countries. Like the U.S. and Canada the European monetary union is anchored by an independent central bank's (the ECB) commitment to low inflation. But it does not have a fiscal union. The member states of the eurozone have full sovereignty and conduct their own fiscal policy. The EU's budget is 1% of EU GDP and is not used as a fiscal stabilization policy instrument. There are no fiscal transfers between members in the face of asymmetric shocks. Moreover labor (and to a lesser extent capital) is much less mobile than in national federal states like the U.S. and Canada. Thus the eurozone does not satisfy the conditions of an optimum currency area (Bordo 2004).

The Maastricht Treaty contains a no bailout clause which prevents the EU government and the ECB from

rescuing a member state which faces a debt crisis. However recent events have proved this clause to lack credibility. In 2010 Greece's fiscal deficit shot up to 14% of GDP and its debt to GDP ratio increased to above 100%. In the face of rising spreads on Greek sovereign debt and the fear of contagion to other European peripheral countries and ultimately of an attack on the euro itself, a rescue package for Greece of 110 billion euros was arranged by the EU and the IMF. This was followed by the establishment of the European Financial Stability Fund of 750 billion euros to protect other eurozone members from a debt crisis. Moreover the ECB broke its pledge to not purchase the sovereign debt of member countries. In the absence of an effective fiscal union the central bank is conducting fiscal policy. This has threatened its independence. In the absence of an effective central fiscal authority to police the no bail out rule it has been the financial markets that have provided the discipline on the peripheral members which would otherwise have come from the center.

The eurozone has another serious problem which is greatly exacerbated by not having a fiscal union. It contains a mix of countries at different levels of economic development (both financial development and productivity). With a common currency and a monetary policy devoted to price stability across the eurozone, wide current account imbalances have opened up between the advanced countries of northwest Europe at the core and the periphery. In the absence of the monetary union, adjustment would occur via floating exchange rates. In the presence of an effective fiscal federal state, adjustment would occur via labor (and capital) mobility and fiscal transfers. This was the case in eliminating the enormous imbalances between the north and the south in many decades after the U.S. civil war.

The crisis of 2007-2009 would have played out very

differently if the eurozone had a fiscal union in place. The crisis of 2007-2009 was precipitated by events in the U.S. – subprime mortgages etc—it spread to Europe via banks holding U.S. mortgage backed securities and via the U.S. recession reducing the demand for imports from Europe. The European peripheral countries which were already at a competitive disadvantage to the rest of the eurozone were hit hard by the global recession. If an effective fiscal union were in place the recessions would have been less, tax revenues would have declined in the member states but because of transfers their fiscal deficits and debt ratios would have been lower. Moreover if the no bailout rule was credible and the members of the eurozone followed similar balanced budget rules as those followed by U.S. states, Greece may not have had a debt crisis. Finally Ireland and Spain would have had the housing booms and busts that occurred as has been the case in California, Nevada and Florida in the U.S. and they would have had to consolidate their budgets, as has been the case for the U.S. states, but their recessions would have been attenuated somewhat by fiscal transfers from member countries that were less hard hit and hence the impact on their economies would have been milder.

Some authorities (e.g. Jonung 2010) argue that Europe already has a fiscal union in place with the Stability and Growth Pact (SGP) which monitors fiscal deficit and debt ratios by the member states to determine whether they threaten to exceed the Maastricht Treaty limits of 3% and 60% respectively, and which imposes sanctions on members who break the rules. They argue that all that is needed to fix the eurozone is to strengthen the SGP. Proposals that have been proffered include having an independent agency to monitor the economic statistics of the member states to prevent a repeat of the fraudulent numbers reported by Greece; and

establishing independent fiscal councils to enforce the Maastricht rules (Baldwin and Gros 2010).

Others, aware of the strong resistance that would arise to any threatened infringement on the sovereignty of member states, propose a more limited move towards a fiscal federal arrangement including having a eurozone wide unemployment insurance fund and common defense procurement (Munchau 2010).

Such proposals may have some impact but the lessons of history suggest that unless the eurozone moves much more in the direction of the fiscal transfers of successful fiscal federal nations, that the next global crisis may lead to its break up. Moreover if the member states are unwilling to give up fiscal authority to the central EU government and to accept the inevitability that membership in an effective monetary/fiscal union requires adherence to credible eurozone wide fiscal rules such as no bailouts and budget balance over the business cycle, then the euro experiment is doomed to failure.



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