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RIPE commentary

Euro-crisis, American Lessons?

What can and should the European Union learn from the experience of the early United States in order to exit the current euro-crisis? While Benjamin Cohen and I agree on roughly four of any five given points, I argue that the early United States yields few useful positive lessons for the European Union (EU). Moreover, those few positive lessons do not suggest that muddling through is an option. I have five points, of which the first two are historical, the second two are structural, and the final one is monitory. First, the US was not a transfer union until quite late in its history; in fact, state-level developmental efforts supported federal revenue rather than the reverse. Second, the early US states were aggressively developmentalist, creating banks and using targeted finance to build their economies. By contrast EU banking regulation supports a liberal, market oriented, and speculative financial structure while limiting state level developmental and keynesian impulses. Third, contemporary US state level finance is integrated with financial markets differently from EU states. In both cases this flows from the nature of central regulation. Fourth, the US could muddle through its crises in the 19th century because it was a small part of the world market and could externalize the costs of reflation. The EU comprises roughly 30% of global GDP and thus must internalize the costs of reflation. Finally, the United States also generated a long run of shoddy compromises around finance and labor markets (i.e. slavery) throughout the first 70 years of its existence, and we know how that worked out.

Cohen suggests that the Hamiltonians envisioned a transfer union for the United States early on, and that this might serve as a model for Europe (Savage 1988: 86-91 disagrees). In this understanding, the US had an effective and early transfer union with three key elements. First, the federal government absorbed state debts at the time of federation. Second, states faced strong budgetary constraints because of balanced budget amendments, and thus could not give into to moral hazard by using federal debt assumption as an opportunity to dig themselves into a new debt hole. Finally the states could rely on a Hamiltonian federal government to ameliorate emerging regional imbalances through transfers. If Europe had something close to this model, there would be fewer of the regional economic imbalances that underlie the current European crisis. Indeed, proposals for a euro-bond are akin to federal debt assumption, and the agreement to keep budget deficits under 0.5% look akin to US states' balanced budget laws.

Moreover, the current system of federal transfers and the high level of financial and labor market integration the United States clearly has ameliorated regional disparities after the 2007-08 crisis. As Paul Krugman and others have pointed out, Florida's real estate bust approximates Spain's but without any overt political or banking crisis. Federal bailouts of national banks bailed out Florida's banks; automatic Federal transfer payments eased Florida's state budget problems. Krugman (*New York Times* 2 June 2012) estimates that federal transfers equaled at least 4% of Florida's GDP from 2007 to 2010, and perhaps more. By contrast, the EU has few transfer mechanisms. For example, the latest EU transportation infrastructure program will spend half as much money as Florida received over twice as

many years and spread it over the entire EU.¹ But this vision of early America reads contemporary US arrangements much too far back into the past. The US transfer union did not emerge until 150 years after federation, with the expansion of federal income taxation to the majority of the population after World War II. And even this massive, once only increase in federal fiscal might has been eroded by a rough doubling of state and local revenues over the six post-war decades to 15% of GDP, near parity with federal revenue.

State and local fiscal strength is nothing new in the United States. The early United States had nothing like a transfer union; if anything it was the reverse with respect to both income and liabilities. First, under both the Articles of Confederation and the 1789 Constitution the states possessed considerable legal and fiscal sovereignty. Indeed under the Articles their legal sovereignty approximated that of the EU's constituent states. During the first half-century of the post-1789 union, US states had no balanced budget laws, and the Federal government raised much less revenue than the state governments. Rather, local governments – townships and counties – captured the largest share of total government revenue all the way until the early 1930s, and much of this revenue came from property taxes. Limits on states' ability to issue bills of credit made borrowing difficult, but states easily evaded this by creating banks, a point we return to below (Savage 1988: 107-108).

State evasion of limits on borrowing meant that the states also dominated the balance sheet respect to public liabilities in the early United States, despite the once only assumption of state level debt by the federal government in 1790. State level public debt often exceeded federal debt, and was four times as large by 1860 (Savage 1988: 118). Plausibly, the fact that the early federal government had access to customs revenue and also had extinguished its public debt in 1835 meant that it had sufficient credit in global markets to bail out a few states. But any general crisis would overwhelm federal resources. Though it is not clear that foreign investors understood this (Flandreau and Zumer 2004), federal revenues were tightly connected to and driven by state and local revenues. Federal land sales provided, on average, 13 per cent of federal revenue from 1806 until 1846. In the 1830s land sales averaged about 23 per cent of federal revenue, and in 1836 land sale revenue actually exceeded customs revenue (Dewey 1915: 216-217). But land sales were strongly pro-cyclic, which is why they peaked during the 1830s state borrowing boom, and fell off just as the state economies – and thus revenues – nosedived. Federal customs revenues were similarly tied to agricultural exports generated by state level development policies. If exports fell off, so did imports. States thus could not rely on what was essentially a pro-cyclic federal tax base to bail them out. A continental labor market helped states more than explicit fiscal transfers. Labor mobility was extremely high in the US, and boom and bust regions imported and exported considerable volumes of labor, literally in the case of the slave states, and figuratively elsewhere.

Second, this difference between federal and state roles in early America is also reflected in the differences between early American banking and the role of banks in today's EU. One reason the states did the heavy fiscal lifting in the United States was that highly interventionist state level governments turned finance into a developmental and fiscal tool (Callendar 1902; Sylla 1971/72; Savage 1988: 105-118; Bodenhorn 2003). US states lacked both an income tax and customs revenue, but desired a modern transport infrastructure. Thus states chartered banks to solve both problems at once. They took an ownership stake in those banks and used their dividends as a revenue source. And they directed those banks to fund canals and roads. In general the less developed the state, the higher the proportion of state ownership of banks. From 1830 to 1860, states with more banks loans and bank capital per capita grew faster than those where states were more diffident about chartering banks, because state banks were able to issue currency like instruments (Bodenhorn 2003: 3-4).

Meanwhile, the federal role in infrastructure development was heroic in the worst sense of the word, that is, largely mythical. The federal government, to make a metaphor, was more about software development than hardware development. State governments built the overwhelming majority of toll

roads, canals, and early railroads – the hardware for an economic growth model based on agricultural exports. The Federal government’s core contributions to economic growth were about establishing rules of the game for export led development (Balogh 2009). The Northwest Ordinance laid out rules for land development, established a property rights regime for land, and funded public education. The states could then develop land and infrastructure in ways that suited local needs. A more expansive federal role in infrastructure had to wait until the Civil War removed the southern (slave) states that opposed a stronger central government. Even then, the federal government retained a strong “software” orientation, with the Morrill land grant college acts matching the land grant railroad acts.

By contrast, the modern European Union severely restricts the economic room for maneuver of its constituent states and abets speculative rather than developmental finance. The various flavors of growth and stability pact over the years limit member states’ room for fiscal maneuver, as does the European Central Bank’s charter, which theoretically prohibits the monetization of deficits and gives the ECB a monopoly on currency emission. Similarly the single market project and the Basel Accords promoted the consolidation of financial institutions and their delinking from state-level economic policy. In the 19th century United States, Bodenhorn (2003: 9) notes that state-owned banks played a counter-cyclic macro-economic role: “A secondary role of these institutions was to insulate the regional economy from the potentially devastating effects of financial panics, extended recessions, and debt-deflation cycles. In effect, these banks reinflated depressed economies, which slowed or stemmed a rising tide of personal and business bankruptcy.” This is rather the reverse of the role EU banks and the European Central Bank currently play. Put too boldly, banks in early America were creatures of the state, while in modern Europe the state is a creature of the banks. If there are any major positive lessons from the early American experience for the EU, then one might be a reversal of the relationship between banks and the states and a loosening of central budgetary surveillance.

Third: Perhaps the contemporary American experience has positive lessons? I doubt that the EU will suddenly be able to capture the same 60% of general government revenue that the US federal government does today, even if it promised to return much of that revenue as various grants. But more subtle aspects of the way US states manage their fiscal situation are relevant. US states are able to borrow in a highly structured municipal bond market.² These bonds usually finance infrastructure (roads, utilities, industrial parks, etc.) and public amenities (hospitals, schools, etc.). The federal government privileges this market by exempting the interest on municipal bonds from federal income tax. These bonds thus carry interest rates below that on federal bonds (although Treasury bonds still establish the reference rate for any given maturity).

Although predatory high finance has made inroads into this market by replacing simple term bonds with complicated derivatives, much of it remains a vanilla, long-term bond market dominated by individual owners or mutual funds (unit trusts). This facilitates access to developmental finance even when states face budget deficits and must cut spending to meet balanced budget laws. Funding on the capital side of the budget is thus somewhat disconnected from the current account side, limiting the temptation to slash all spending in a downturn. And the ownership structure also limits wholesale flight from the municipal bond market. Individuals are less skittish than professional money managers, particularly as the federal tax privilege can be as high as 35% of earned interest (or 39.6% if rates revert, as scheduled, to pre-2003 levels in 2013). Again, in contrast, the EU’s promulgation of the Basel accord led its banks to accumulate large quantities of public debt because their very low risk weighting allowed banks to have lower levels of tier 1 capital. But banks are considerably more skittish than individual investors.

Fourth, it is not obvious that muddling through is an option for the EU. Here too, the early United States does not provide comfortable parallels. The United States could muddle through its early fiscal and banking crises because it was a small part of the world economy. Angus Maddison’s guestimates put the United States at about 1.8% of global GDP in 1820 and 8.8% in 1870.³ The first data

point is roughly the relative size of Greece in the EU and the second one of Canada relative to the United States. There was no federal response to the 1830s financial and debt crises and its associated state level defaults on foreign loans. Instead, recovery from that crisis waited on a recovery in the British cotton textile industry. External demand for raw materials could reflate the relatively small antebellum US economy, just as robust US growth in the 1990s bailed Canada out of a truly desperate fiscal situation. Renewed external demand reflat the economies of the cotton south, restoring their fiscal base, and allowing defaulting states to re-enter the London capital market, pay much of their arrears, and borrow anew. The same was true for earlier and later depressions in the 1800s and 1870s, although there were fewer public defaults in those crises. Equally, important, state fiscal crises in the 1800s, 1830s, and 1870s did not affect their financial systems. Defaults on foreign bonds in the 1830s and 1840s hurt foreign bondholders, but left the banking infrastructure in place.

By contrast, the EU does not have the option of waiting for the rest of the world to grow. First, the EU, at roughly 25% of global GDP, is too big to rely on external growth for salvation. The rest of the world has to grow about 5 percentage points faster than the EU to pull the EU growth rate up by about 1 percentage point given the EU's current share of global exports. This dimensional issue does not seem to register with the EU export surplus countries who insist that the troubled south emulate them. Nor is it clear that a 1 percentage point increase in the growth rate would be enough to save the indebted south at this point in time. This suggests that self-help is the only way out. Differences in the structure of intermediation also suggest more urgency for the EU. US states' defaults hurt British bondholders but did not directly cause the banking system to fail. As external demand reflat US states economies they could then return to capital markets with growing revenues, and channel funds back into local banks. But EU banks themselves hold big swathes of European public debt. The EU's financial crisis threatens to destroy its financial system in the short run. Can the EU save that financial system?

Cohen suggests that all the actors have a strong desire to preserve the EU, and animated by this will muddle through and win the day. But if I can put this in the harshest terms possible, this is rather like the pre-1914 French Army's attitude that *élan* was an adequate substitute for machine guns and artillery. I grant that most actors would prefer the EU and euro to survive. But those preferences are secondary to more fundamental interests. This crisis is now a conflict over whether 'an' EU or 'the' EU will survive, over who will be in the eurozone, over what kind of EU will persist. In this sense the EU is exactly like the early 19th century United States, which had a succession of crises and shoddy compromises around a similarly intractable issue: slavery. Slavery was a fundamental and constitutive conflict that determined preferences over the nature of labor markets, the size and power of the federal state, the structure of taxation, the kinds of banks permitted, and, ultimately the number of states that would be in the union. The conflicts of interests in the EU today are as much about constitutive issues as the conflicts over slavery in the early United States.

Those conflicts exist at multiple levels: between an imagined north and an imagined south; between banks and indebted governments; between predatory elites and workers in the south; and between labor market insiders and outsiders in both north and south. Those conflicts can be seen in the apparent desire of the European Central Bank (ECB) to rewrite labor market practices and social contracts in the south. They can be seen in the Greek elite's insouciance about taxation. And they can be seen in the above average difficulties women face balancing babies and bosses in southern labor markets, and the unskilled face finding work in the continental north. So the issue is not simply one of bailing out the banks. The banks cannot be put on a solid footing unless public finances are robust. Public finances will not be robust unless more people are working and paying taxes. And more people will not be working if the economy is not growing. The patchwork bailouts Cohen lists do not address these fundamental problems. But they do reflect these conflicts, insofar as it is only banks that have been bailed out so far.⁴

Suppose, instead, that the ECB was determined to bail out people, and took the various funds committed to e.g. the European Financial Stability Fund, divided by population and mailed everyone a check (cheque) that could only be used to pay down their household debts. Suppose, rather than raising policy interest rates as it did in 2008, it offered easy, low interest rate refinancing of mortgages at the same time and thus helped force down mortgage interest rates. By freeing up billions of euros of consumer spending, this would restart growth and restore the troubled tax bases of the south and the north. Of course, it would also sharply circumscribe the profitability of the financial sector for a decade. And it would be inflationary, further eroding creditors' real position.

Instead, the current solutions are deeply deflationary rather than being inflationary. There is no other way to describe the situation in Greece, where unemployment is about 23% and where GDP has fallen by nearly the same amount, 2008-2012, and Spain, where unemployment is 25% and GDP has fallen by only a more modest 6% so far. But this is why there is a fundamental conflict of interests. Simply easing up on Greece, or Spain might mean bringing unemployment down to 20% and might buy a little political peace. But this will not change the fundamentally deflationary dynamic in the European economy. It could be argued that the inflationary solution only fixes things in the medium term. But the changes in fiscal practices and labor markets the ECB (and the Germans?) desires also only have medium term effects. Moreover, creditors are foolish to think that their money is safe in a deflationary scenario. If debtors don't have enough income to service their debts, then the corresponding assets that creditors hold have no value. The mature choice here is to suffer a little inflation rather than deflation.

I don't think that the EU will end up in a civil war like the 19th century United States, or even the near rebellion of the 1832 Nullification Crisis.⁵ But 1930s Europe provides a salutary warning. Then, as now, muddling through in the early years of the depression led to polarized politics, a collapse of legitimacy and then a search for extreme solutions to restore political order and reverse deflation. We know how that ended. If the EU wants to get real about sorting out its problems, immediate reflation is the answer. As in the 1930s, this means big, not little, changes to political institutions. The EU needs to solve its democratic deficits along with, if not before, its fiscal deficits. It needs to have fiscal capacity more like that of the US federal government. But it will be easier to get political acceptance of, and legitimacy for that fiscal capacity if the change happens in an environment of economic growth. That's the real solution: fix the growth problem in the real economy, even if it means radically downsizing the financial part of the economy and shifting it away from speculative finance and towards developmental finance.

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NOTES

1 "Connecting Europe Facility: Commission adopts plan for €50 billion boost to European networks," EU Commission press release, 19 October 2011, <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/1200&format=PDF&aged=1&language=EN&guiLanguage=en>.

2 Municipal here is a term of art that means 'non-central government' rather than 'city.'

3 Angus Maddison, "Statistics on World Population, GDP and per capita GDP, 1-2008AD," http://www.ggdc.net/MADDISON/Historical_Statistics/horizontal-file_02-2010.xls.

4 For example, the summer 2012 bailout of Spanish banks was accomplished by adding to the public debt.

5 In the 1832 Nullification Crisis, South Carolina declared that the federal tariffs of 1828 and 1832 were unconstitutional (thus: null and void) and would not be enforced at South Carolina's ports. South

Carolina raised a militia and prepared to prevent federal enforcement of the tariff. This challenged the fundamental supremacy of the federal government. The federal government responded with an equal show of force and South Carolina conceded federal authority. Things went differently in 1860.

NOTES ON CONTRIBUTOR

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