

# Towards a European Federation?

- Overview
- Macro policy tools in unions
- EU/EZ vs US at a glance
- Limits to monetary policy tools, fiscal union
- Model
- Lessons

# Overview

- EU/EZ at a crossroads
- Recession ending in the majority of the EZ/EU
- Portugal, Ireland, and soon Cyprus, market access. GR?
- Is expansion in the “North” sufficient to pull the “South” along?

# EZ-wide response: Discretionary national macro policy tools

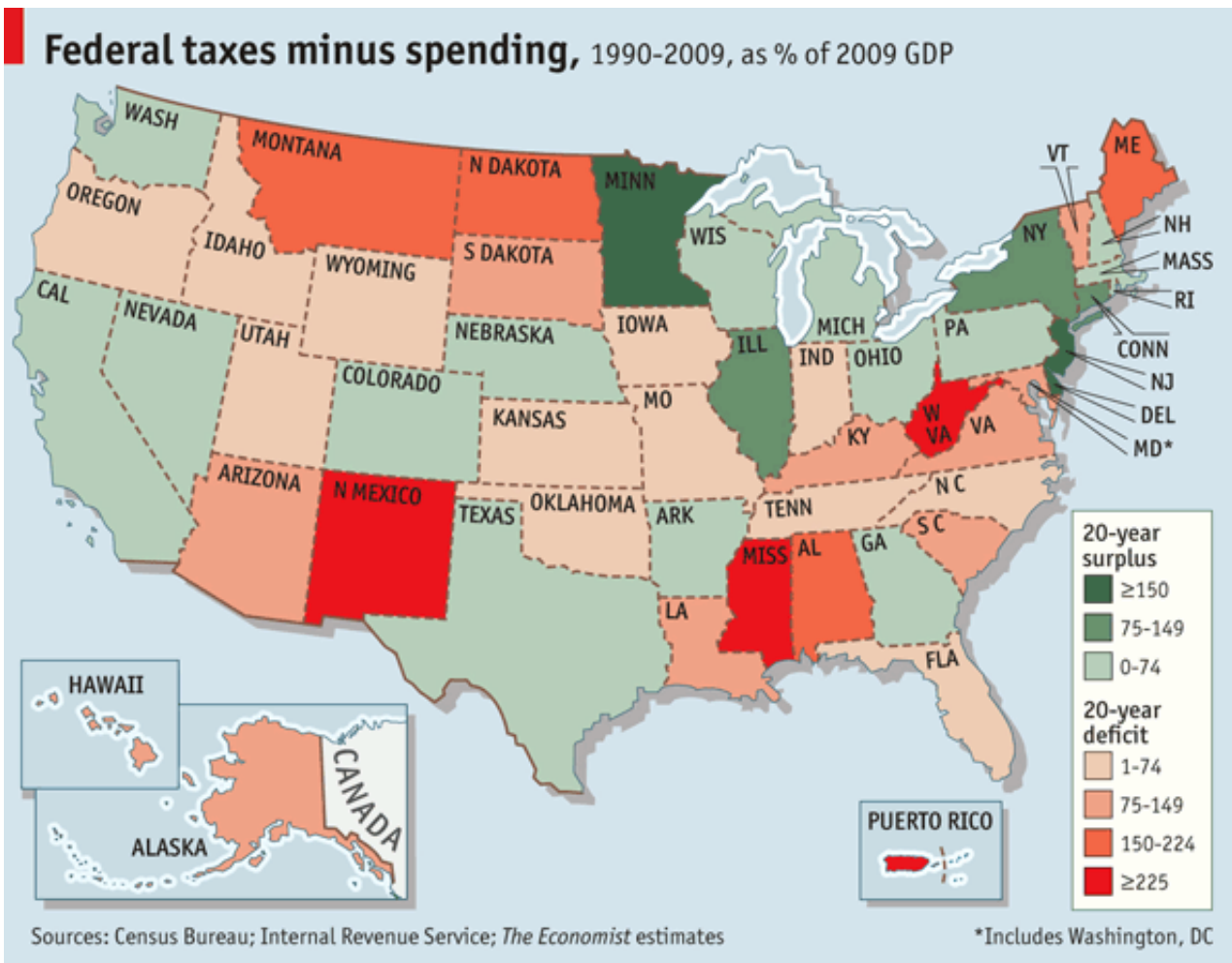
- EZ-wide response: Discretionary macroeconomic stabilization policy tools?
- EU fiscal tools
  - EU budget
  - Fiscal policy: national
  - Monetary policy: EZ-wide
  - Spillovers among EZ/EU/non EZ countries require macro policy coordination
  - Could interpret emergency response as discretionary macro policy  
(Recall US assistance to Detroit)

# EU/EZ vs. US Union at a glance

	US	EU/EZ
Fiscal policy	Federal	National
Federal Budget	24% <i>GDP</i>	1% ( <i>balanced</i> )
countercycl. transfers as automatic stabilizers	e.g., unempl. insurance	?? ??
State/local budgets	23% <i>balanced</i>	can borrow
State/local borrowing subsidized	yes	in crisis
State/local borrowing subsidized	lower interest	higher interest
Total public sector	41%	50%
Monetary policy	Federal	ECB/NCBs

- Transfers in US fiscal union: min: NJ 0.61\$ per \$ of US taxes. max: NM: 2.06\$ per \$ of US taxes.
- Transfers in US fiscal union: federal taxes - federal spending (1990–2009)/2009 state GDP. min: NM: -261%. max: DE: 206%.

Reinhardt/Economist graph



See the full data below:

### US fiscal transfers

	Federal taxes, 1990-2009, \$bn	Federal spending, 1990-2009, \$bn	Taxes minus spending, \$bn	GDP, 2009, \$bn	Federal taxes minus spending, 1990-2009, as % of 2009 GDP
Delaware	211.1	86.4	124.8	60.7	206
Minnesota	1,016.9	503.8	513.2	258.5	199
New Jersey	1,656.2	950.5	705.7	471.9	150
Illinois	2,000.0	1,299.1	700.9	632.0	111
Connecticut	715.2	474.5	240.7	227.6	106
New York	3,320.8	2,364.6	956.2	1,094.1	87
Ohio	1,569.3	1,265.8	303.5	462.0	66
Michigan	1,228.0	1,031.2	196.8	369.7	53
Nebraska	246.5	202.2	44.2	86.4	51
Massachusetts	1,065.5	917.9	147.6	360.5	41
Colorado	606.9	506.2	100.7	250.7	40
Wisconsin	630.1	543.3	86.8	239.6	36
Texas	2,738.6	2,348.8	389.8	1,146.6	34
Georgia	1,018.3	918.8	99.5	394.1	25
Nevada	219.9	197.0	22.9	125.0	18
California	4,249.5	3,913.3	336.2	1,847.0	18

Arkansas	333.3	316.3	17.0	98.8	17
Washington	785.8	739.6	46.2	331.6	14
Rhode Island	145.6	139.7	6.0	47.5	13
New Hampshire	134.2	129.7	4.5	59.1	8
Pennsylvania	1,602.3	1,602.5	-0.3	546.5	0
Indiana	632.0	642.2	-10.2	259.9	-4
North Carolina	863.5	881.3	-17.8	407.0	-4
Oregon	350.0	361.8	-11.8	167.5	-7
Kansas	307.1	331.7	-24.6	122.5	-20
Missouri	723.5	794.3	-70.8	238.0	-30
Tennessee	649.9	731.2	-81.3	243.8	-33
Utah	187.6	225.3	-37.7	111.3	-34
Oklahoma	385.0	434.3	-49.3	142.4	-35
Florida	1,704.0	2,002.7	-298.7	732.8	-41
Idaho	124.3	148.4	-24.1	53.7	-45
Iowa	268.9	332.2	-63.3	136.1	-47
Wyoming	51.3	70.4	-19.1	36.8	-52
Vermont	54.7	73.9	-19.2	24.6	-78
Arizona	424.9	631.7	-206.8	249.7	-83
Louisiana	397.8	601.2	-203.5	205.1	-99
South Dakota	64.7	109.9	-45.3	38.3	-118
South Carolina	302.1	494.5	-192.4	158.8	-121
Kentucky	329.3	536.8	-207.5	155.8	-133
Hawaii	118.9	206.6	-87.7	65.4	-134
Virginia	848.1	1,441.0	-592.9	409.7	-145
Alaska	63.2	131.4	-68.2	45.9	-149
Maryland*	1,030.8	1,604.1	-573.3	384.0	-149
Maine	96.9	172.5	-75.6	50.0	-151
North Dakota	53.9	102.6	-48.7	31.6	-154
Alabama	340.1	630.8	-290.6	166.8	-174
Montana	60.8	125.2	-64.5	35.0	-184
West Virginia	98.6	247.6	-149.0	61.0	-244
Mississippi	164.7	404.6	-239.9	94.4	-254
New Mexico	115.7	316.6	-201.0	76.9	-261
Puerto Rico†	73.7	256.1	-182.4	62.8	-291

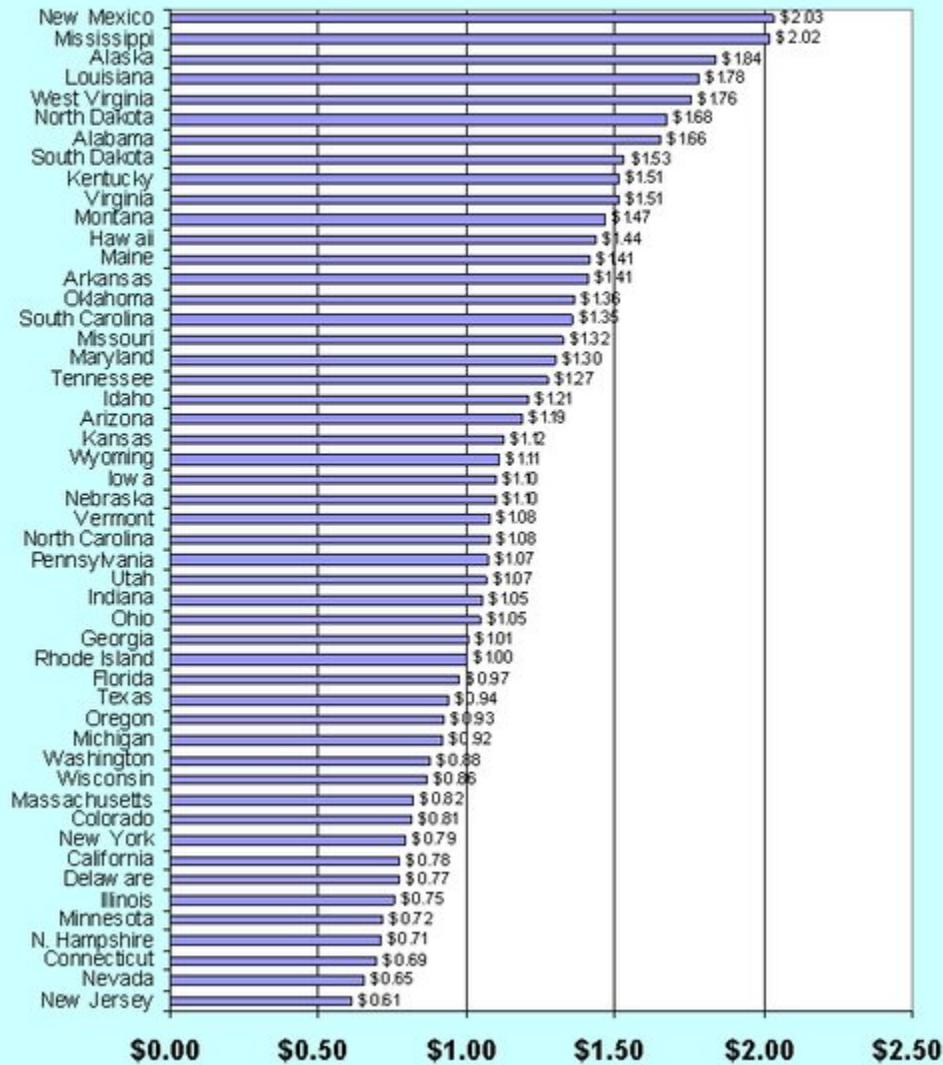
Sources: Census Bureau; Internal Revenue Service; *The Economist* estimates

\*Includes Washington, DC †US territory

# Limits to monetary union tools

- Limits to monetary union tools?
- Banking union
- Fiscal Union
  - Overview of European Fiscal Compact
  - Interaction of Monetary and Fiscal Unions

## Federal Spending in Each State Per Dollar of Federal Taxes FY 2005





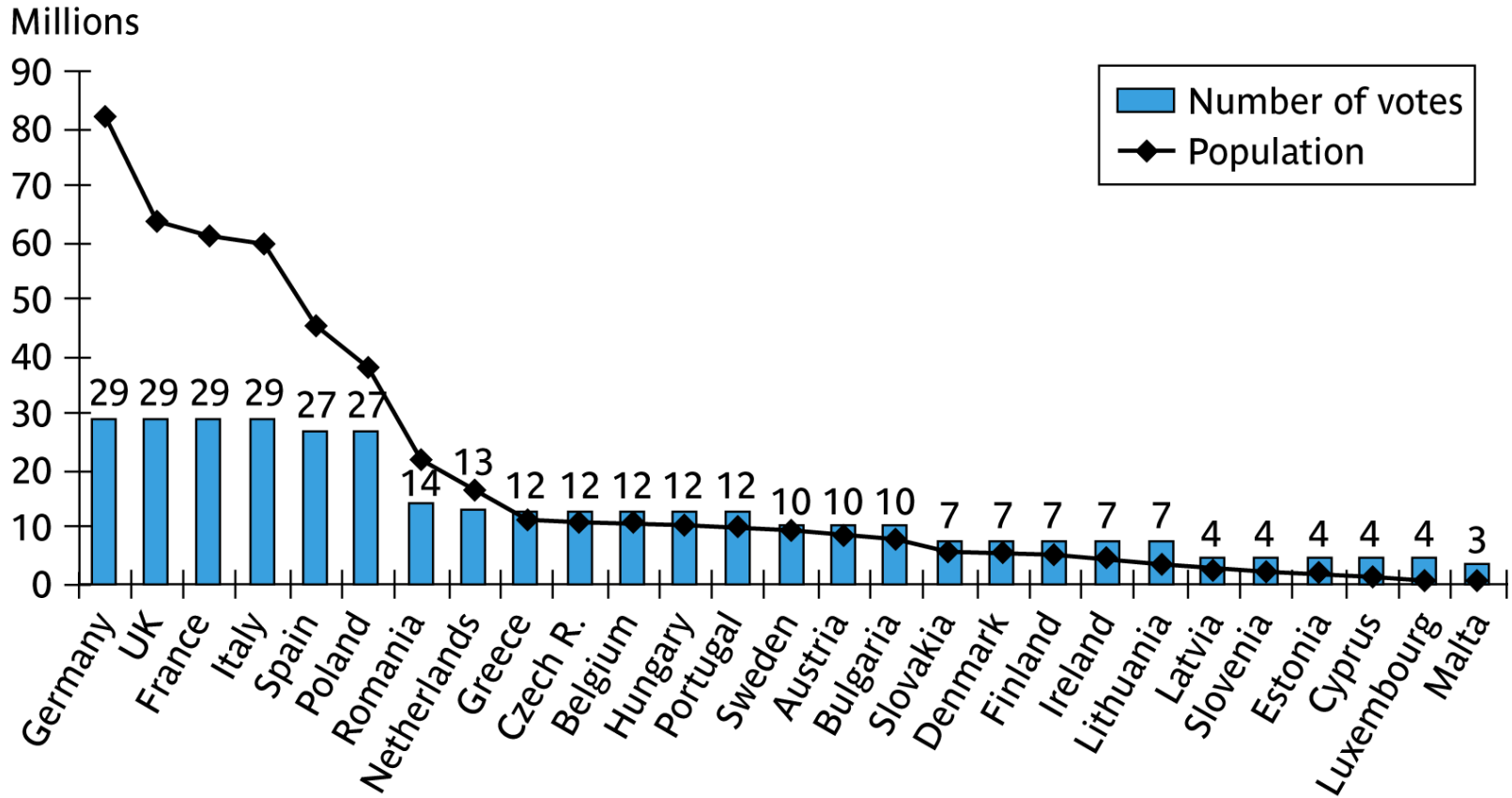
# Monetary Union with Fiscal Union

- Interactions between monetary policy and national fiscal policies.  
Union-wide fiscal policy eliminates potentially inefficiency of game between sovereign governments [Guiso, Herrera, Morelli (2012)]  
Inefficiency depends on cultural differences; can express via coefficient of public good; culture conformity constraint on policy.
- Design common institutions — *fiscal union* — to mitigate clash.
- Functioning institutions may feed back to taste change?
- Decentralized country, plus subsidiarity, convergence of national fiscal systems to fiscal union?

# Monetary Union with Fiscal Union

- National democratic accountability interacts with union-wide need *more than proportional* power to smaller states [Casella (1992)]
- Adjusted population weighting enshrined in voting procedures. *B&W Graph.*

# Economical view of decision-making



# Monetary Union with Fiscal Union

- National democratic accountability interacts with union-wide need more than proportional power to smaller states,  $\gamma > \sigma$ ?
- Adjusted population weighting enshrined in voting procedures. *B&W Graph.*  
But reasons to worry. E.g. changes in 2014: Lisbon Treaty. 2014. Or 2017, at Poland's insistence, at the wish of a single member reverting to old Nice rules. Lisbon Treaty more power to smallest states and Germany; Spain, Poland and middle-sized states biggest losers.
- *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union*, signed March 2, 2012 (all EZ, and all other EU, except UK, Czech Republic), took effect January 1, 2013.
- strengthens Stability and Growth Pact, rules for coordination and oversight over the national fiscal policies.

# Monetary Union with Fiscal Union

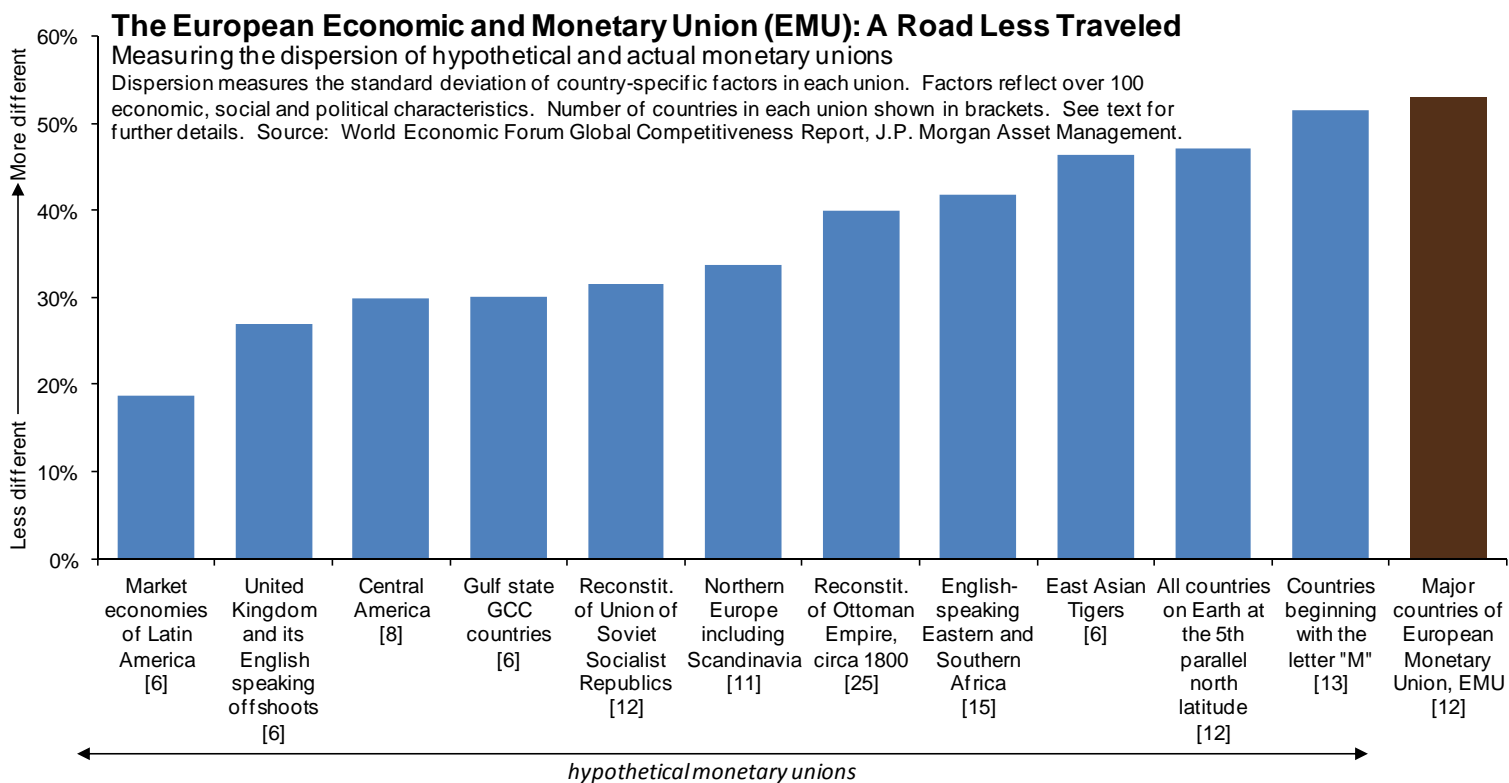
- *Balanced budget rule*: “annual structural deficit”  $\leq 0.5\%$  GDP (if debt as a share of GDP  $< 60\%$ , structural deficit at most  $1\%$ ).
- *Debt brake rule*, if debt  $> 60\%$  GDP, reduce at an average annual rate of at least one twentieth ( $5\%$ ) of the exceeded percentage points.
- *Automatic correction mechanism*: If not compliant with balanced budget, or debt brake rules, automatic correction mechanism triggered, to be defined individually by each state, comply with EU directive, institute National Fiscal Advisory Council. National monitoring of observance.
- Debt issuance coordination, “better coordination and planning.”
- Notify of policies for improving competitiveness, employment and financial stability.

# Lessons

- Dysfunctions: taste heterogeneity vs. economies of scale  
*Economies of scale* in provision of common public goods high  
Europeans very *heterogeneous* culturally, linguistically, and  
economically
- Have European publics come closer together, or further apart,  
during crisis?
- Political contagion?
- “Stark” heterogeneity? See JP Morgan *Graph*.

Topics: how lonely a road is Europe traveling; Graham-Dodd and Shiller US equity valuation measures; casual reading

**Europe and the road less traveled.** As we wait for the next round of fiscal transfers from North to South, European Central Bank rescue operations, IMF firewall expansions, foreign capital flight, deferral of tighter bank capital standards, elections, Bundesbank resignations, protests, rising unemployment and generally miserable economic data in the European Periphery, it's worth remembering something broader about what Europe is up to. There is no small amount of economic hubris associated with the European monetary project, and the chart below shows why. Multinational monetary unions are rare (*see Appendix*). Some regions debate adopting them, like the Persian Gulf, but decide not to, preferring to retain independent monetary policy. Europe went ahead anyway, despite large differences between member countries. Just how different? **Countries in the European Monetary Union are more different than just about any other monetary union you could imagine:**



What does this chart show?

- The best way I know of to compare countries is via the World Economic Forum Global Competitiveness Report. This compilation rates 142 countries on over 100 factors related to labor and goods market efficiency; government institutions (property rights, corruption); macroeconomic soundness (debt, deficits); health and education; business sophistication (local supplier quality/quantity); and capacity for innovation (quality of scientific research institutions, R&D spend, patent grants).
- Using this raw data, I imagined what other monetary unions might exist, and how different their constituents would be. The chart shows the country dispersion for hypothetical unions comprised of the UK and its English-speaking offshoots (US, Can, Australia, Ire, NZ); and of countries in Central America, Latin America, the Gulf, Northern Europe, Africa and Southeast Asia (*see Appendix for details*). **All of these hypothetical monetary unions have lower country dispersion measures than the European Monetary Union. And yet, these regions have resisted the temptation to form one.**
- I even reconstituted the old Soviet Union by combining the Russian Federation with 11 former republics, and the Ottoman Empire, by combining 25 countries which now inhabit its 18<sup>th</sup> century borders. I also added a random monetary union comprised of the 12 countries on Earth located at the latitude of the 5<sup>th</sup> parallel (north), and another union comprised of the 13 countries on Earth whose names start with the letter "M". Even these groupings exhibited less dispersion than the EMU.

And still, Europe soldiers on, even as the rest of the world avoids monetary union in circumstances more favorable to it. **What remains are political questions regarding how much inflation and fiscal transfer Germany can sustain; if a true fiscal union can be created, seen by some as indispensable to the Euro's future (see Bordo 2011); and how much austerity countries like Spain can take.** As this is a road less traveled, it's hard to know how it will turn out. It's a tough road, and the chart helps explain why. Europe's problem is not just one of public sector deficit spending differences, but also of deeper, more fundamental differences across its various private sector economies. Whether it's equities, credit or real estate, EMU valuations need to be considerably more attractive than US counterparts to justify investment given the challenges of the European project.

# Lessons

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*Economies of scale* in provision of common public goods high  
Europeans very *heterogeneous* culturally, linguistically, and  
economically
- Will European publics come closer together, or further apart,  
during crisis?
- Political contagion?
- “Stark” heterogeneity? See JP Morgan *Graph*.  
Size easier to account for, yet exaggerates heterogeneity.  
Large countries, not necessarily too heterogeneous. “Law of  
large numbers” re taste.



# Lessons for the EU: Hamilton (1755 – 1804) and Future EU Architecture

- Alexander Hamilton: US assume states debt (revolutionary period), understood US tax revenue, for US to borrow.
- US states spent on canals and roads, defaulted in mid-1800s. Long-run consequences (England still trying to collect from Mississippi).

# Lessons for the EU: Hamilton (1755 – 1804) and Future EU Architecture

- Alexander Hamilton: US assume states debt (revolutionary period), understood US tax revenue, for US to borrow.
- US states spent on canals and roads, defaulted in mid-1800s. Long-run consequences (England still trying to collect from Mississippi). See Graph. Wallis Table.
- US federated nation creation teaches us:
  - Need tax revenue to borrow. Eurobonds?
  - Federated states' default have long-lasting spillovers: spreads over Canadian provinces, 19th cent., but went back to markets.
- Has the crisis generated political solidarity and trust among EZ countries?
- What should we expect for Greece from ECB's policy QE initiative? Little unless Greece is more competitive.