



# Lessons for Europe from Fiscal Federalism in the United States

C. Randall Henning

American University and Peterson Institute

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# Outline

1. Value of Comparison
2. Balanced budget rules
3. Multiple layers of debt rules
4. State of New York and Constitution
5. Problem of dysfunctional subfederal units
  - a) Restoring the no-bailout clause ( or « making Maastricht work »)
  - b) Coupling debt and concurrent tax authority
  - c) Procedural debt rules and democracy

# Value of Comparison

- Caveat: Differences between the United States and euro area qualify the lessons that can be drawn
- Comparison is nonetheless hard to resist
- Not because the U.S. example is somehow more enlightened, but simply because:
  - It happened first
  - is a successful case of a continental monetary union, in which state debt accumulation has been limited
- A lens through which non-Europeans view the euro crisis; important for external communication
- A case that influences the metrics used by and perceptions of private actors in, for example, capital markets

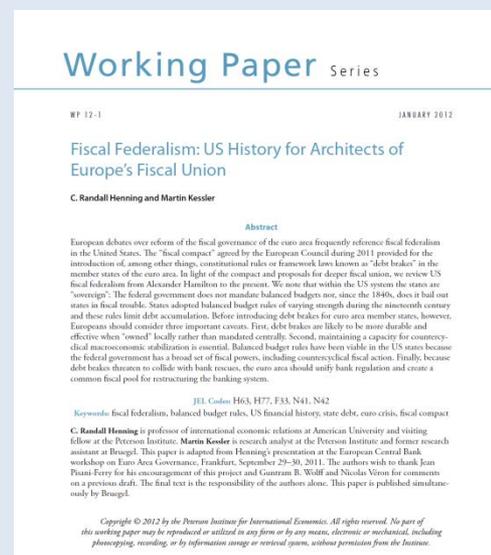
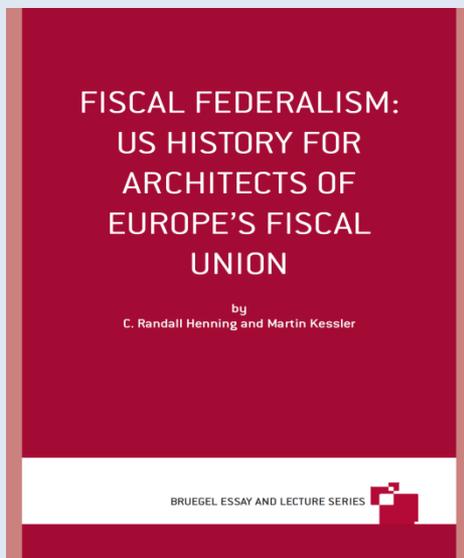
# Value of Comparison (cont.)

And history is a laboratory of ideas. To quote Barry Eichengreen (2011)

“The role of historical analogy in policy . . . is not to dictate action but to shape the consideration set – that is to say, to define the options.”

# Balanced-Budget Rules

- *Fiscal Federalism*, a Bruegel Essay with Martin Kessler, co-published by the Peterson Institute
- Inspired by the ECB workshop on euro area governance in September 2011



# Context and Debate

- A. The succession of fiscal rules based on the Maastricht treaty -- SGP I and II, six pack (and two pack) – culminating in the Treaty on Stability, Coordination and Governance (TSCG)
- B. The balanced-budget rules (BBRs) of the U.S. states were frequently invoked in advocating “debt brakes.”
- C. Although state debt has indeed been limited, the context of these rules was critical to their success and not fully acknowledged.

# Main Points

- BBRs apply mainly to current expenditure; debt issuance for public investment is permitted
- They operate in the context of a full federal system of fiscal powers, including countercyclical macroeconomic stabilization
- Banking Union: sovereigns and banks are de-linked
- Nationally unified capital market, « private insurance » against asymmetric shocks (de Grauwe)
- Without these, the BBRs of the states would not be viable

# Effectiveness

- Moreover, it is not clear how effective these rules are in restricting debt accumulation
- Consider the case of Illinois:

## **Illinois**

The Article VIII, Section 2 of the Constitution of Illinois reads:

- (a) The Governor shall prepare and submit to the General Assembly, at a time prescribed by law, a State budget for the ensuing fiscal year. The budget shall set forth the estimated balance of funds available for appropriation at the beginning of the fiscal year, the estimated receipts, and a plan for expenditures and obligations during the fiscal year of every department, authority, public corporation and quasi-public corporation of the State, every State college and university, and every other public agency created by the State, but not of units of local government or school districts. The budget shall also set forth the indebtedness and contingent liabilities of the State and such other information as may be required by law. Proposed expenditures shall not exceed funds estimated to be available for the fiscal year as shown in the budget.
- (b) The General Assembly by law shall make appropriations for all expenditures of public funds by the State. Appropriations for a fiscal year shall not exceed funds estimated by the General Assembly to be available during that year.

# But . . .

To quote Judy B. Topinka, the State Comptroller of Illinois,

The state budget “isn’t balanced, it’s never balanced. . . . There’s always ways to have things off budget – one of them is all these bills” before the legislature.

*Financial Times*, November 11, 2011

## So, BBRs do not prevent deficits...

<b>Budget shortfall</b>		2009	2010	2011	2012
California	in \$ Bn	37.1	45.5	17.9	23
	in % of General Fund	37%	53%	21%	27%
Illinois	in \$ Bn	4.3	14.3	13.5	5.3
	in % of General Fund	15%	44%	40%	16%
New Jersey	in \$ Bn	6.1	11	10.7	10.5
	in % of General Fund	19%	40%	38%	36%
Total all 50 States	in \$ Bn	109.9	190.8	130	102.9
	in % of General Fund	15%	29%	20%	16%

Source: Center for Budget Priorities

## Nonetheless, state debt is quite limited ...

	Debt	2009	2010
California	in \$ Bn	134.5	148.9
	in % of State GDP	7.3%	7.9%
Illinois	in \$ Bn	56.9	61.4
	in % of State GDP	9.0%	9.5%
New Jersey	in \$ Bn	56.9	60.9
	in % of State GDP	12.1%	12.7%
Total all 50 States	in \$ Bn	1,045	1,113
	in % of State GDP	7.5%	7.7%

Source: Bureau of Economic Analysis, computations of the authors

# III. Layers of Rules for States

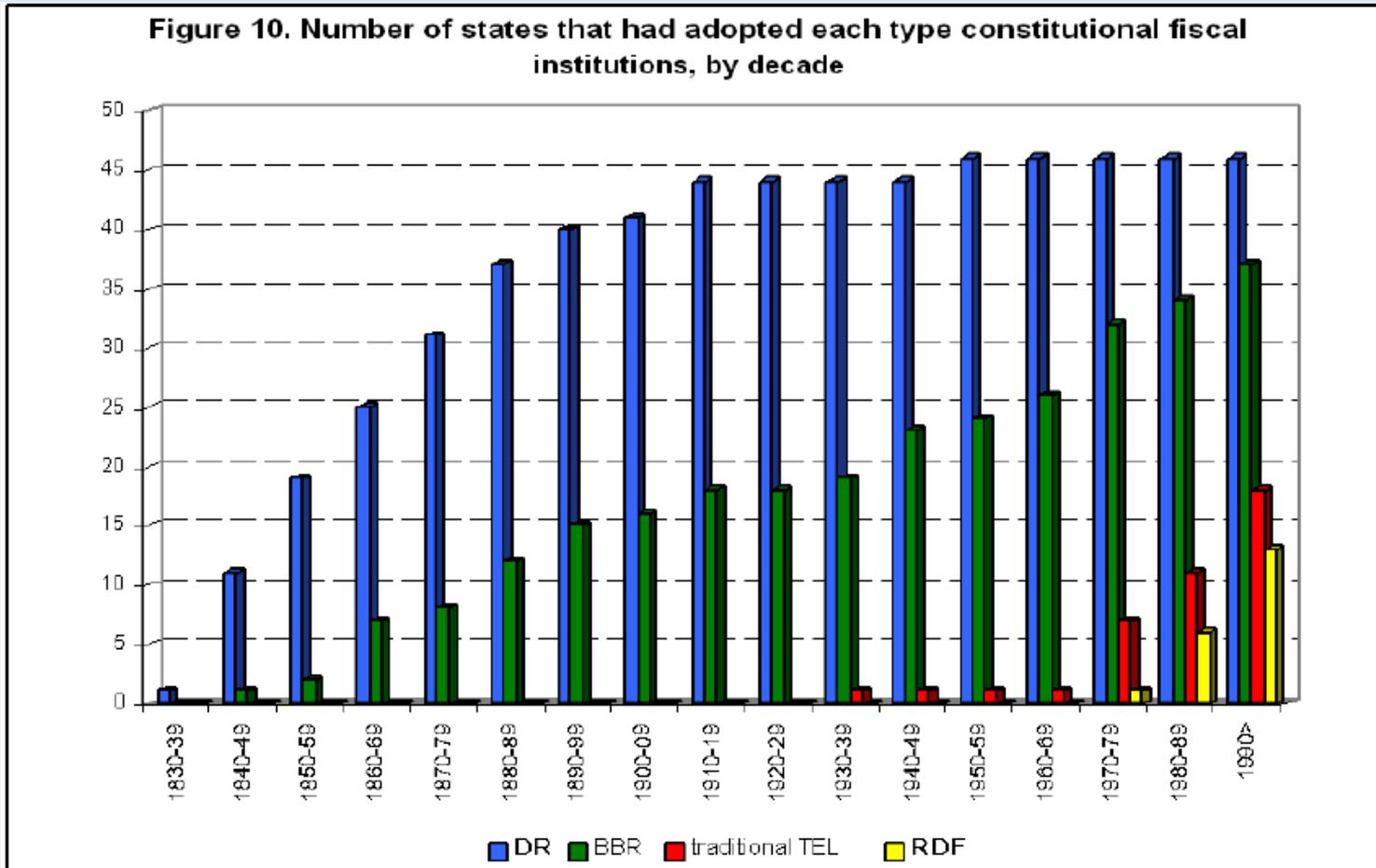
- BBRs coexist with other sets of rules for state finances
- After the 1840s, states adopted procedural rules to raise the political cost of debt issuance: bond issues for capital projects were subject to approval by the electorate.
- BBRs followed
- Pattern of fiscal shifting and response with a new set of rules.

# State Budget Rules: 4 Types

- “Debt restrictions” (DRs): laws allowing the issuance of new debt that is matched to specific expenditures, usually investment, subject to approval by a referendum or other procedures
  - *Goal: Good fiscal governance*
- “Balance Budget Rules” (BBRs): Requires revenue to balance expenditure
  - *Goal: Avoid deficits*
- “Tax and Expenditure Limits” (TELs): direct constitutional limitation on taxes and expenditures
  - *Goal: prevents growth of government*
- “Rainy Day Funds” (RDFs): requirements to save surpluses in good years that are then available to supplement tax revenue in lean years
  - *Goal: Smooth cycles and compensates shortfalls not planned in the budget*

(Rodriguez-Tejedo and Wallis 2012)

# Budget Rules



# Lessons from States' Rulemaking

- (1) Rules are not stable. They shift problems to other levels of government and other forms of finance. Which requires a new set of rules to fix, generating a succession of layered rules over time. Is Europe following a similar path?
- (2) Balanced budget rules are not the only, or perhaps even the most important, reason that the debt of the states has been contained. Though some studies show positive effects, the multiplicity of rules makes this difficult to sort out.
- (1) Raising the political cost of debt issuance by procedural rules could be more effective in limiting debt accumulation, and perhaps more democratically consistent.
- (2) The no bailout norm has been a critical context.

# Stark Contrast with the Euro Area

- BBRs have been propagated from the center, rather than adopted autonomously by states → domestic political “ownership”
- Community institutions play the leading role in enforcement of the rules, whereas the U.S. federal government has no such role
- Next-generation proposals call for tighter and more intrusive management of member policies
- EAMS have not been allowed to “fail”
- Banking union (federal backstop to financial crises) is moving forward, but slowly.

# New York and the Constitution

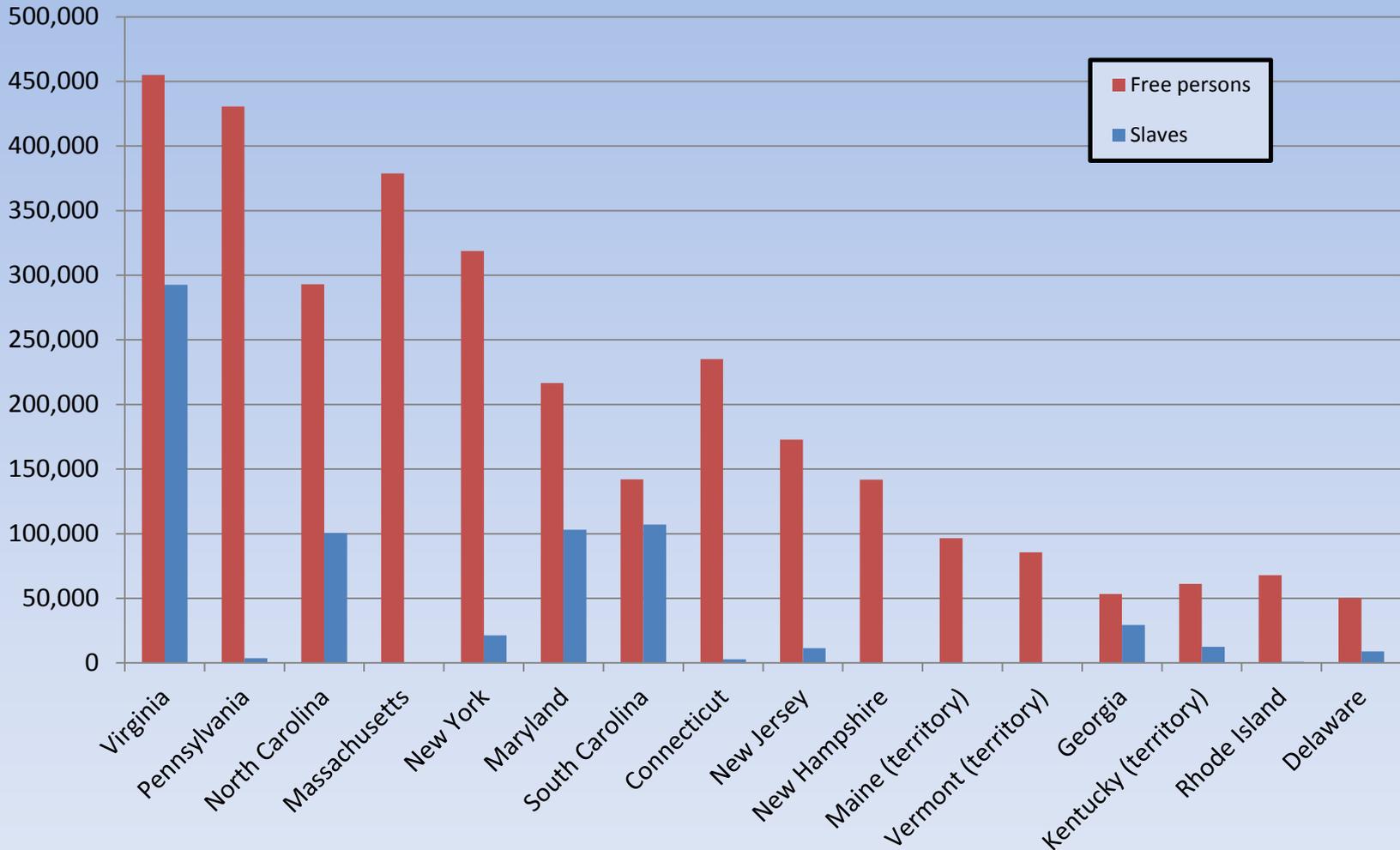
- New York State held a particularly important role in the transition from the Articles of Confederation to the new Constitution during the 1780s
- Roughly analogous to a large, creditor contemplating fiscal union in the euro area today

# New York: Central Puzzle

Why would the state, with one of the two largest ports in the country, surrender tariff revenue to the Congress?

The puzzle is highlighted by simple comparative data on the states . . .

# State Size by Population



Source: 1790 Census

# Four Largest Ports and Revenue

TABLE VI  
CUSTOMS RECEIPTS IN FOUR MAJOR PORTS

<i>State</i>	<i>1785–1788</i>	<i>1792–1795</i>
New York	\$ 603,000	\$ 4,653,000
Philadelphia	622,000	4,299,000
Baltimore	346,000	1,829,000
Charleston	404,000	1,064,000
Total	\$1,975,000	\$11,845,000

Source: Edling, Max M., and Mark D. Kaplanoff, "Alexander Hamilton's Fiscal Reform: Transforming the Structure of Taxation in the Early Republic." *The William and Mary Quarterly* 61 (2004), no. 4 : 713-744.

# Composition of State Revenue, 1785-87

TABLE I  
THE STRUCTURE OF GOVERNMENT REVENUE, 1785-1787

<i>Income</i>	<i>New York</i>	<i>Pennsylvania</i>	<i>Virginia</i>	<i>North Carolina</i>	<i>South Carolina</i>
Direct tax	\$83,000 (32%)	\$205,000 (42%)	\$828,000 (70%)	\$131,000 (77%)	\$324,000 (62%)
Customs	143,000 (55%)	162,000 (33%)	282,000 (24%)	30,000 (18%)	111,000 (21%)
Excises and fees	9,000 (4%)	80,000 (16%)	33,000 (3%)	10,000 (6%)	28,000 (5%)
Other	21,000 (8%)	47,000 (9%)	30,000 (3%)		56,000 (11%)
Total	\$257,000	\$494,000	\$1,173,000	\$171,000	\$519,000

Source: Edling and Kaplanoff 2004, p. 720.

# Under the Articles of Confederation

- New York, like the other states, did not pay its requisitions
- Vetoed the 5 percent federal tariff proposed by Congress in 1783
- Prompted the calling of the Philadelphia Convention in 1787

# Why did New York ratify?

1. To create a customs union and wield greater bargaining leverage with Great Britain
2. State citizens held federal government debt; not because New York anticipated federal assumption
3. The state had a vital interest in common defense, having been a battleground during the Revolutionary War

# Lessons from New York

1. Connection between debt and taxes intimate
2. Their federalization was simultaneous; would have been difficult to centralize these sequentially; incrementalism is risky
3. Capital markets focus on this connection now

# Dysfunctional States

- The approach of tighter rules and stronger enforcement implicitly assumes that state governments are rational
- Sometimes they are instead politically dysfunctional and thus fiscally irresponsible
- Grappling with them is one of the most vexing problems facing monetary and fiscal unions

# Trichet Proposal

- The former President of the ECB has advocated “federal governance by exception” (May 2012)
- In case of noncompliance with corrective actions decided by Commission and Council, the institutions, with European Parliament, should be able to impose them on a member (e.g. VAT)
- Enhancement of democratic credentials of the EU institutions to address the legitimacy problem
- An extension of principles already in place (members are subject to fines) rather than a wholly new intrusion on sovereignty

# Trichet Proposal (cont.)

- The proposal is another step along the logic of the current approach in European fiscal rules
- However, the U.S. experience provides NO encouragement for this approach
- Are there examples elsewhere? If so, not likely to apply in the European political context.

# “Get Back to Maastricht”

- Fiscal and banking union protects the union from blackmail by fiscally irresponsible states
- Paradoxically, perhaps, fiscal federalism enables the union to enforce the no bailout position
- If we restore the no bailout clause of MT, ESM would not be necessary (see also Wyplosz 2012)
- But it should not be eliminated before the other elements of the fiscal and banking union are in place; as a transitional measure it is essential

# Coupling Debt and Tax

- For countries that are too big to fail and too big to save, a third way is necessary. So, thinking “outside the box” . . .
- Consider matching assumption of national debt by the union to (selective) concurrent jurisdiction over the tax base
- Considerable legal hurdles, of course
- But has the advantage of being (a) a balanced exchange, (b) centralizes the means of payment simultaneously with the debt, (c) addresses political dysfunctionality and concerns of capital markets

# Procedural Debt Rules

- Constitutional procedures can raise the political cost of debt issuance, better aligning incentives
- Matching debt to investment and subjecting issuance to a referendum seems to work (Wallis and Weingast)
- In states much larger than many of the individual member states of the euro area; perhaps worth thinking about in Europe . . .

# Closing Observation

- Some dismiss the American example on the grounds that the United States formed a political union, so the rest was easy
- There are reasons for caution in applying the U.S. lessons to Europe, but this is not one of them
- Founding Fathers created the political union at the same time they created the fiscal union; in fact, the fiscal mess made centralization of the political union necessary
- They had a much harder job than European policymakers have today; we should have high expectations for European leaders as well