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Eurozone faces many of the same political and economic pressures young U.S. did

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MINNPOST

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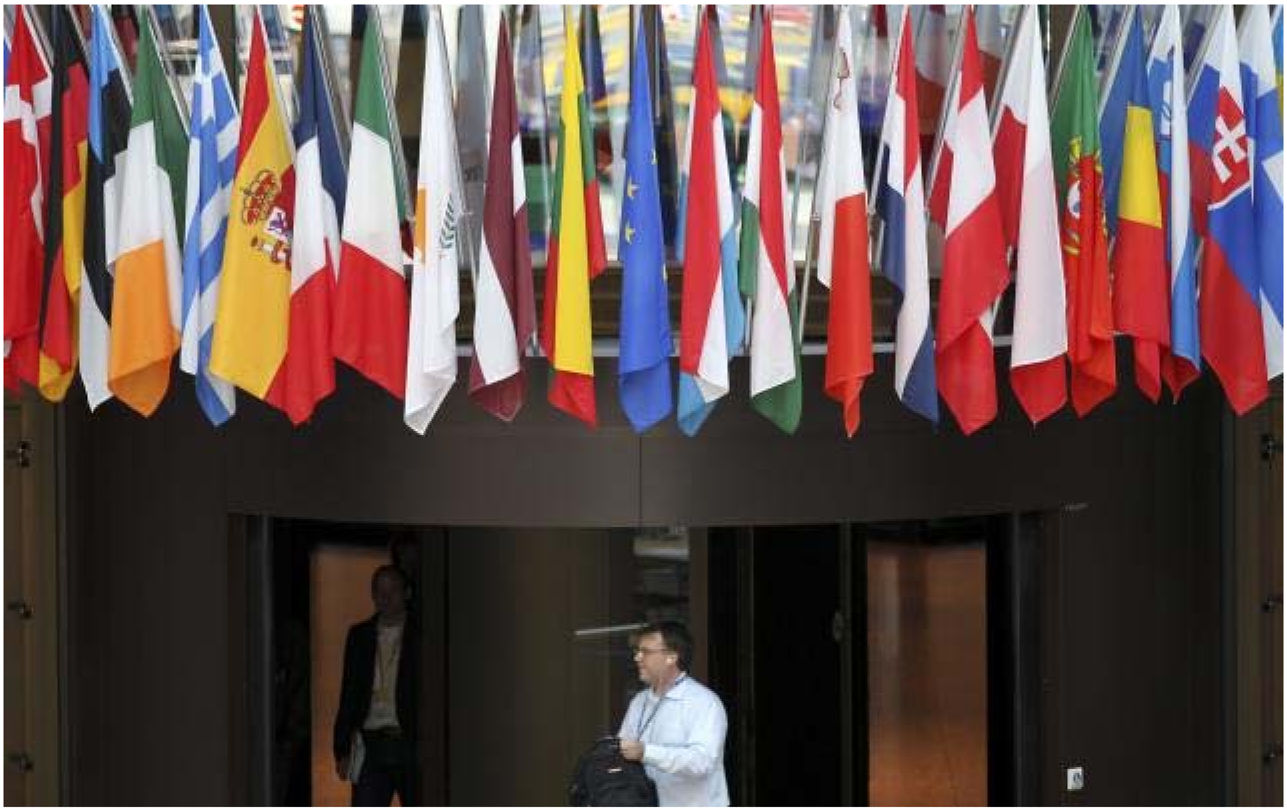
By Louis D. Johnston | 07/26/12



REUTERS/Francois Lenoir

As European leaders attempt to forge closer ties between the 27 EU member states, they might look to lessons learned by the United States during its first 100 years.

The euro crisis keeps rolling along with European Union government leaders meeting every few weeks to announce a new solution. It's now clear that there are only two possible endings to this drama.

One would be a partial or complete break-up of the Eurozone.

The other is for taxpayers in higher-income countries (Germany and the Netherlands) to bail out banks and governments in lower-income countries (e.g., Greece and Spain).

The American experience illustrates this dilemma and shows why the EU is hesitant to go down either of these paths but must ultimately choose one of them.

Before the Constitution

I teach American Economic History and always enjoy asking my students, "How did the United States government operate between 1776 and 1789?"

Many of them will cite the Constitution, forgetting that it wasn't in place until 1789. Others will say that each state operated independently and that there wasn't a United States until the Constitution was ratified.

The truth is more complicated. The 13 states operated under the Articles of Confederation from 1777 until 1789.

Under the Articles, the U.S. operated much the way the EU does today. Each state had an equal voice in the Continental Congress. There was a monetary union with a single currency, the continental. The national government could not, however, levy taxes; rather, the individual states voluntarily contributed to supporting the army, foreign service, etc.

As you can imagine, this didn't work very well.

The higher-income states (e.g., Massachusetts and Virginia) thought that other states were not paying their full shares during the Revolutionary War and thus withheld their payments in order to force others to pitch in. Much like the EU, the Continental Congress met to make deals about how much each state would pay and announce that everything was settled. Payments would then be delayed or not made at all, and the negotiations had to begin again.

The Constitution was designed, in part, to repair this problem. The federal government was given the power to collect taxes directly, rather than relying on the good graces of the states.

European officials in general — and German policymakers in particular — know this history, and they know how it turned out. Specifically, we have created a system where higher-income states consistently subsidize lower-income states both through bailouts and transfer payments.

The savings-and-loan bailout

From 1986 to 1995, more than 1,000 savings and loan institutions failed in the U.S. at a net cost to taxpayers of about $125 billion. See "The Cost of the Savings and Loan Crisis: Truth and Consequences" (PDF). According to Paul Krugman, Texas thrifts accounted for about 60 percent of these losses, or about $75 billion.

If the U.S. operated under the same rules as the EU, state government leaders would have met to decide how much taxpayers in Minnesota, Wisconsin and other states needed to contribute to bail out Texas banks. That isn't how it worked. Instead, Congress worked out a solution that involved a taxpayer-financed transfer from American citizens generally to savings-and-loan customers in Texas, Arizona and other Sun Belt states.

My guess is that Minnesotans then, much like Germans today, would have balked at this solution.

50 cents on the dollar

Transfers across states go on all the time. In particular, between 1990 and 2009, Minnesotans paid about $1 trillion in federal taxes and received about $500 billion in federal spending and transfer payments. By contrast, citizens in Mississippi and Alabama paid federal taxes of $500 billion and got $1 trillion of federal spending and transfers, about the opposite of Minnesota. (See the map and table here.)

In other words, Minnesota got about 50 cents on the dollar for its federal taxes while Alabama and Mississippi paid 50 cents for each dollar it received.

Just as with the savings-and-loan bailout, I doubt that Minnesotans would vote to send half of their federal tax dollars to Alabama and Mississippi, but this is exactly what the EU is asking Germans, Danes and other high-income citizens to do. It’s no wonder the Germans keep saying, “Nein.”

History matters

Why aren’t Minnesotans complaining about these transfers as loudly as the Germans?

History is probably the most important reason. It wasn’t easy to accept the movement from the Articles of Confederation to the Constitution. We often read about the Federalist Papers and how they were written in support of the Constitution, but we forget that there was also a strong anti-Federalist movement that argued against ratification. (When I hear the goals of the modern Tea Party, I often think they would have been on the anti-Federalist side.)

Even after the Constitution was ratified, the period between 1789 and 1865 witnessed political fights, sectional conflicts and ultimately a civil war over the relative powers of the states versus the federal government. The arguments about the proper balance between federal and state governments, especially in economic matters, have continued ever since — with much less bloodshed but just as much political bile.

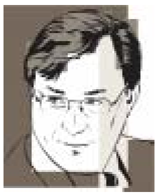
Today, Minnesotans and citizens of other higher-income states have grown up with the notion that we transfer resources across state borders. We may not like it when we hear about it, and wish that we paid less to — or received more from — the federal government, but I don’t see any movement to go back to a system that resembles the Articles of Confederation.

Europe is only 60 years into the process of integration. We’ve had more than 230 years to sort out our monetary and fiscal balances among the states and between the states and the federal government. It’s still a work in progress.

The Europeans now face must face these same questions in a matter of months and years instead of decades and centuries. No wonder they are having such a tough time.

(I thank Susan Riley for research assistance with this article.)

ABOUT THE AUTHOR:



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