Toward a European Fiscal Union, Part I

C. Randall Henning illuminates the lessons that Europe can learn from the United States in forming a unified fiscal and banking governance.

Steve Weisman: As Europe struggles to extricate itself from its financial, banking crisis and sovereign debt crisis, what lessons might the Europeans draw from, of all places, the United States? This is Steve Weisman at the Peterson Institute for International Economics with Randall Henning, senior fellow at the Institute who also teaches at American University, and who's been studying precisely this question. The Europeans say they want to move toward a more federal system. Randy, are there some things that the United States has gone through that are relevant here?

C. Randall Henning: Thank you, Steve. I am glad to be doing this with you. There is a lot of interest in Europe right now about the lessons that can be drawn from the US experience. The Europeans are beginning to look deeply into the US history. And a couple of things come out of this experience, going back to Alexander Hamilton and the formation of the republic, the transition from the Articles of Confederation to the Constitution, and how this evolves over the course of the nineteenth century and up to the present. There are a couple of lessons that I have drawn from this experience in my recent essay with Martin Kessler here at the Institute that we co-published with Bruegel. One lesson is the importance of having a central capacity for countercyclical fiscal policy at the federal level. One of the things that the Europeans point to in the US experience is the balanced budget amendments at the state level as being a critical part of the architecture. It's this balance budget amendment that they've sought to introduce into the European system in the form of the Fiscal Compact and the Stability Treaty.

Steve Weisman: But there is something missing from the European side that the US is able to do, no?

C. Randall Henning: Exactly. What the Europeans haven't done is create this central capacity for countercyclical fiscal policy at the level of the union. Introducing the balanced budget amendments without doing that is a recipe for trouble.

Steve Weisman: Just to avoid the daunting term "countercyclical fiscal policy," what you're talking about is spending or tax cuts in the face of a downturn that would boost the economy such as what the United States did with its stimulus package two years ago.

C. Randall Henning: Exactly right. The US has undergone a big countercyclical move over the course of the subprime crisis and recession that followed. Running a larger budget deficit during that recession and then during periods of boom and prosperity, the central government should run a smaller deficit, or ideally, even a surplus. That's what we mean by "countercyclical."

Steve Weisman: Even if Europe had a structure in which to do that, the politics might not favor it, just as people are turning against stimulus in the United States.

C. Randall Henning: The politics of this are always controversial. Part of the problem with operating a countercyclical policy is that oftentimes the decision to provide the stimulus isn't made until it's too late or sometimes it's made too early. These are issues that always come up. But in principle, Europe needs to have this capacity. It can't rely on doing this at the state level only and there are a couple of important reasons for this.

The Stability Pact as the Europeans are carrying this forward would envision leaving some room for maneuver at the level of the member states, but because there are linkages from one member state to another in terms of capital flows and trade flows, a stimulus in one country alone is going to leak abroad to the benefit of its neighbors, but be relatively ineffective within the country offering the stimulus. So, that's part of the rationale for doing it at the level of the euro area as a whole.

Steve Weisman: Randy, you mentioned there was a second element.

C. Randall Henning: Yes, there is a second element. What is critically important is that in the United States, the fiscal cost of bailing out the banks and rescuing the banking system has been borne by the federal government. If California, Florida, New York had been responsible for carrying the fiscal cost of bank restructuring, that would have completely blown the state budgets, right? Setting it up this way would have been completely inconsistent with a balanced budget amendment at the state level. This is not provided for within the European architecture right now and this underpins the importance of moving toward a banking union where the costs of restructuring, say, the Italian, the Spanish, the Portuguese, Irish banking systems, is collectivized or mutualized at the European level. If the Europeans don't do this, then the balanced budgets provisions within the fiscal pact and stability treaty won't be viable either.

Steve Weisman: I'm going to stop here and close off this segment of Peterson Perspectives Interviews and pick up in another segment where we'll discuss a little bit more specifically one case study: that of Spain. Thanks.

C. Randall Henning: You're welcome. Glad to do it.