The Washington Post

Tuesday, May 18, 2010

For a Solution to the Euro Crisis, Look to the States

By Martin Feldstein

The Greek budget crisis has made it clear that something must be done to limit fiscal deficits in eurozone countries. The attempt to do so with the group's Stability and Growth Pact has failed. Although the pact "requires" all eurozone countries to keep deficits below 3 percent of gross domestic product, not one of the 16 members is in compliance. The average deficit of the eurozone countries exceeds 7 percent of GDP. Something new is needed.

The structure of the Economic and Monetary Union (EMU) that created the euro actually encourages members to run large deficits. A country with its own currency would see that currency deteriorate and its interest rates rise if it sold large amounts of debt to global investors. But because EMU countries share a currency, there has been no market feedback to warn when a country's deficit is getting dangerously high. Since Greek bonds were regarded as a close substitute for the euro bonds of other countries, the interest rate on Greek debt did not rise as the country increased its borrowing -- until the market began to fear default.

There is now political consensus in Europe that new rules are needed to prevent large deficits, but there is no agreement on what should be done. The European Commission, the executive body of the European Union, proposed last week that the national budgets of each country be examined by the others before they are approved. While this control may appeal to those who want to strengthen centralized political power within the EMU, many members will reject it as excessive interference with national sovereignty.

It would clearly be anathema to the German government to have its spending and tax policies approved by France, let alone by Greece and Portugal. The problem for the EMU leadership is therefore to find a way to prevent excessive deficits while leaving member states free to shape their own spending and tax policies.

Here there may be something to learn from United States. Although the 50 states share a currency and each sets its own spending and tax policies, state deficits remain very low. Even California has a deficit of only about 1 percent of the state's GDP and total general obligation debt of less than 4 percent of state GDP. The basic reason for these small deficits is that each state's constitution prohibits borrowing for operating purposes. States can issue debt to finance infrastructure but not salaries, services, transfer payments or other operating expenses.

In some states, these self-imposed restrictions go back to the 19th century, a time when excessive borrowing led to state defaults. Those states wanted to assure potential lenders that such excess borrowing would not happen again. Over time, all states adopted such rules to help make the bonds they issued for capital expenditures attractive to investors. Although the states' balanced-budget rules differ in detail, with some using rainy-day funds to offset cyclical declines in revenue, they all succeed in preventing persistent operating deficits. If the EMU governments were to adopt similar constitutional rules, the interest rates on their bonds would fall.

Of course, important differences exist between EMU members and the U.S. states. Because Europe lacks a central fiscal authority, some provision must be made for temporary deficits when economic conditions warrant. European nations also have national security responsibilities that may require surges in defense spending. But if the budget rules are well articulated, the effectiveness of the fiscal discipline will remain.

Germany recently adopted such a constitutional amendment. Germany's central government must reduce its

deficit to 0.35 percent of GDP by 2016 unless a decline in GDP causes a larger deficit. The budget will be automatically reduced in the coming year whenever accumulated deficits exceed 1 percent, unless the GDP is declining. The subnational governments within Germany are required to achieve a balanced budget or surplus by 2020.

Other EMU nations could follow Germany's example, with modifications to reflect differences in political systems and in the relationship between the central government and subnational governments. EMU countries perceived to be in the greatest danger of default have the strongest incentive to adopt such policies because doing so would bring down their interest rates.

The European Central Bank could accelerate this process by restricting collateral to bonds issued by governments with satisfactory constitutional limits on their deficits. While a transition period would be needed, such a pronouncement would be a welcome reversal of the recent ECB policy of helping the commercial banks of France and Germany by accepting very low-quality sovereign bonds as collateral and by buying outright the bonds of Greece and Portugal.

The combination of national self-interest in achieving lower interest rates and an ECB rule on allowable collateral would create a powerful restriction on deficits. The resulting fiscal discipline would not require changes in the EMU treaty. It would also leave member governments free to determine the structure and levels of their taxes and spending, as long as their decisions did not violate their self-imposed constitutional limits.

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