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Comments by Johannes Fleck on:

Towards the Fiscalization of the European Union? Sovereign Debt Crisis and the Federal Power to Tax: Lessons from the Early United States in Forging a Genuine Fiscal Union (as of 19.11.2015)

by Tomasz P. Woźniakowski

The following four comments refer to economic aspects of the arguments brought forward in the paper. One of them was already mentioned by participants of the ADEMU working group meeting on January 14th during your presentation. I also have some remarks on specific statements which are not clear to me. Overall, my impressions is that the historical evidence, i.e. the perspectives of contemporary decision makers, makes a strong case but the quantitative evidence is so far not on the same level. Therefore, I recommend adding quantitative information regarding the economic factors considered and to provide some context to arguments related to them.

1) <u>Evidence on the debt burden</u>:
   a. An anomalous feature of the American war of independence is that the victorious party had to bear a burden large enough to threaten its economic stability. It might be interesting to investigate briefly in how many wars this was the case (I suspect very few).
   b. Why was it important to repay it? It is mentioned on page 10 (default not advisable because credit needed to develop country) but should be explained earlier.
   c. Who were the creditors? This could be mentioned in page 5 where a figure for total loans is given. Who gave them (and when) and how much was held by British interests, i.e. could have been defaulted on?
   d. How big was the debt burden? Economists like to express monetary values using tangible measures, e.g. relative to average yearly or monthly income, price of a certain amount of food supplies or value to build an average sized house. This expresses the "real" cost in terms of standard of living or consumption. I recommend to consider this because, so far, it is hard to understand how serious of a burden the war debt was – which is critical to the main argument of the paper.
   e. Servicing versus repaying the debt. This is an essential difference. I highly recommend to revisit the given numbers (for example on page 6), i.e. to make it clear whether two thirds of state revenues were needed for servicing or repaying.

2) <u>Evidence and details on the fiscal relationship between Congress and the states (pre Constitution)</u>:
   a. What is the meaning of the statement that Congress issued money (bills of credit) "on credit of states" (page 5, third paragraph)? Did states guarantee a certain value of the money issued by Congress? Note this would require to enforce fixed exchange rates to states curren-

cies, not just forcing citizens to accept continentals. Hence, Congress could have imposed the costs of the war debt on the states by printing money.

b. Page 5 second paragraph: What is the purpose of mentioning the high inflation rate in the context of the requisitions? Is this to make the point that the real value of requisitions was low or that by the time states actually paid, their value had eroded, i.e. states strategically lowered their contributions?
c. Who was the official debtor of the war debt? On page 6, the paper says: Congress had borrowed "on credit of the states". Does this mean that Congress was given permission by the states during the war to issue debt? If yes had it acted as the agent of the states or had they jointly assumed liability? If no, how was the debt distributed across states and had some paid back more than others?
d. Page 5, third paragraph: What is the meaning of rendering in this context? And what is the relationship of currency to the value of land (owned by whom)? Reducing a debt burden (at least partly) via inflation has been used frequently throughout history so it would be interesting to say more about why the states chose not to adopt the money issued by Congress as their own currencies.

3) <u>How the ratification of the Constitution affected tax powers and spending responsibilities</u>:

This is the essential element of the paper's argument. However, it leaves several relevant questions unaddressed and some pertinent statements might be regarded as incorrect by a meticulous economist. So far, the paper can be read to argue that by granting the federal government taxation power, the total tax burden within a state was reduced and the state governments could not apply indirect tax instruments. Both are incorrect.

A key insight of fiscal economics says that resources spent by any government (future, past and present) will eventually have to be provided for by private agents in some form, i.e. via fiscal taxation, inflation, or loss of savings (default). I recommend to guide the discussion of the taxation aspects according to this principle. Hence, in the context of this paper, the two main questions regarding taxation that need to be addressed to support the argument are:

a) How much taxes needed to be collected in total?
b) Who had to pay the taxes, i.e. citizens of what state and of what economic/social background?

So far, the difference between these two is blurry and, as a result, some statements seem partly incorrect. Some examples:

ad a)

- Page 9, first sentence of last paragraph: Why is the granting of tax power to the federal government a relief of the state tax burden? This is only true if tax burden means taxes collected by the state government, not taxes collected within a state. Thus, I recommend to carefully define the term state tax burden before using it.

- Page 10, first paragraph: The tax burden within a state, i.e. the tax burden per citizen, is not necessarily changed. And this is what should matter for tax rebellions, irrelevant of who collects taxes. If the argument is that citizens in any state were more willing to pay to the federal instead of the state governments, this needs to be explained in detail and evidence needs to be provided. In this case, the argument refers to the composition of the tax burden and not its size. (So far, the paper appears to attribute the cause of tax rebellions to the size of the tax burden, not its composition.)

ad b)

- Page 8, last sentence: The reasoning developed here makes it appear as if the socially explosive taxation was a necessary consequence of having state governments collect taxes. This is not correct. They could have implemented a progressive taxation system or levy taxes only on luxury goods, i.e. use indirect taxes, just as the federal government. The main question that needs to be answered in this context is why state governments did not (or could not) reduce the tax burden for poor citizens and shift it to wealthier citizens.

To support the paper's argument, I recommend conducting more carefully the exposition of these two main issues, both conceptually and empirically:

1) Conceptualize and compare the nationwide total tax revenue (federal plus state governments) versus the total tax revenue per state (state governments only) before and after the adoption of the Constitution. It should be made clear how the total amount of taxes raised and its composition were affected by the reform. Otherwise, the evidence in support of the paper's main argument remains opaque from a quantitative point of view.
   If it is indeed the case that each state paid less afterwards, there has to be a plausible explanation on the origin of this difference. Something to investigate in this context might be military spending: Moving the military authority and related expenses from the state to the federal level probably resulted in a smaller total defense budget.

2) Explain more carefully why the new fiscal arrangement allowed for more socially tolerable taxation in the states. In particular, why did the state governments not use indirect taxes, in particular those which had large ports, or progressive income taxation? In theory, this is not a tax instrument available only to the federal government. Most importantly, empirical evidence on the size of the total tax burden on average citizens before and after the reform needs to be presented. A term such as "tax heavily" (page 6) does not sufficiently characterize the extent to which the articles of the federation forced state governments to pursue societally unsustainable taxation policies.

4) <u>Comparing the US with EMU and lessons for EMU</u>
   a. Emphasize the constellation of factors simultaneously occurring in the US more clearly:
      i. Internal threat:

1. US: Elites in all states uniformly felt threatened by the social consequences of their tax policies required by the war debt. It was beneficial for them all to be able to call a centralized military to avoid having to force their immediate citizens to fight each other. (The Whiskey rebellion is a good illustration of this. Most of the federal army came from outside of Pennsylvania and the few in-state soldiers were from the Eastern part.)
2. EMU: Only in some countries do the social consequences of economic policies mandated by EMU institutions threaten the established order. Moreover, the extent seems to be much lower even in the affected states and not even extremely high youth unemployment triggers significant unrest. Instead, protests get channeled towards radical parties who are united in their stance towards less European integration.
   Importantly, the nature and scope of the economic threat is different: Germany is easily able to pay for Greek debt. Only in the case of a simultaneous and severe economic downturn of Italy and France would the degree of economic threat be comparable to the US case.

ii. External threat:

1. US: Only jointly, the US could stand up to another British intervention. At the same time, this situation meant that any state not agreeing to a joint solution would be left vulnerable. So some states were forced to agree even to a “bad deal”.
2. EMU: No perceptions of a serious external threat. Not even terror risk seems to be severe enough to agree on common, low-scale response (e.g. common secret service).

b. How heterogeneous were the US states at the time? This is important for any comparison and helps to understand what degree and dimension of heterogeneity the US had to overcome in the fiscalization process. Some interesting measures would be state debt (as far as I know some states had paid back in full while others where overburdened), economic structure (agricultural versus manufacturing), population, military (size, expenditures), revenues from different tax instruments (tariffs, direct taxes). Related to this last item is also the question if the coastal states really had to give up a large part of their revenues and apply fiscal taxes instead.
   If possible, it would be ideal to have a better understanding of how many imported goods were sold in non-coastal states to get an impression on how much of the imposts were implicitly paid by them. This is obviously highly relevant to the discussion on who were winners and losers from fiscalization.

c. US: Fiscal integration first; EMU: Monetary integration first. This key difference should at least be mentioned. Otherwise, it might be easy to refer to it when arguing that any comparison suffers from narrow limits. The sequence of integration steps might actually have fewer consequences than it appears to have on first thought. Maybe this topic warrants a paper of its own but I think it would be useful to check the literature and mention any pertinent findings to classify if this is a big or a small difference.

d. The proposals for new taxes in the EMU:
    i. Tariffs (as in US): There is a strong consensus among economists and policy makers that this is not a good tax instrument. The welfare effects from distorting specialization, division of labor and comparative advantages are considered to strongly outweigh any gains achievable through spending the tax revenues.
    ii. Tax firms which benefit most from EMU integration: It will be extremely difficult – if not impossible – to estimate this metric. Identifying respective corporations then becomes a political game and all states will shelter their national companies. This proposal will certainly provoke refusal by the overall majority of economists.
    iii. Avoid race to bottom and tax evasion: Yes and No. Yes, because states have incentives to lower taxes to attract companies. No, because a no tax equilibrium is not sustainable. (Consider the case of Ireland: Once assistance from other states was necessary, state government had to agree to higher taxes.)
    iv. Not all citizens can be in favor of a new tax. Taxes are always paid by someone so the question is the tax incidence, i.e. who has to bear it. For example, any tax on firms is borne by its shareholders, employees or customers (or all). Stopping firm tax evasion has the same effect.
    Moreover, all else equal, the total tax burden will fall (page 3, first paragraph) only if the federal government is more efficient in financing national policies, i.e. it achieves the same outcome with fewer expenditures. Again, in this context it is important to make a difference between moving the tax incidence (e.g. from poor to wealthy, from workers to capital holders etc.) to accommodate social objectives and the total amount of tax revenue that needs to be raised.

<u>Some specific comments</u>:

e. General point: What value of dollars is used in the paper? Current dollars or valued at a specific year?
f. Page 2, last sentence of first paragraph: What does "it" refer to? US or constitution?
g. Page 2, second half of fourth paragraph: What does "expand fiscally" mean? That EU cannot use fiscal policies to stimulate the economy or that the institutional setting does not allow it to expand its tax power (as in the case of the US)?
h. Page 3, second paragraph first half: Would be interesting to discuss how this problem was overcome in the US (imports partly paid for by non-coastal tax money) and contrast it with current EMU discussions (see also comment 4).
i. Page 4, last sentence of section 2: "Spending side is not part of the theoretical framework of the paper" - this contradicts those parts of the paper which argue that military spending was conducted by the federal government after the ratification of the Constitution. It also limits the comparison with the EMU where there is no consensus on what a hypothetical federal government could spend taxes on.

j. Page 5, third paragraph: “System was not working” This might be easier to understand if there is a reference to the discussion following in later parts of the paper.
k. Page 6: “A proposal from 1781 that had been rejected by Rhode Island was put on the table again in 1783 as a national tariff.” Isn’t this the same proposal as the one described on the last line of page 5. If yes, it might be better to use the definite article? Wasn’t it already proposed as a national tariff in 1781?